Consultation on Economic "Spillovers" in International Taxation

The IMF thanks all civil society organizations, NGOs, academia, think tanks, private sector, governments and individuals for providing written comments during this consultation process on Economic "Spillovers" in International Taxation. The on-line consultation process will run from February 14, 2014 to March 31, 2014. Please send your comments to IMFconsultation@imf.org.

Comments should be submitted no later than March 31, 2014.

Many thanks for inviting comments that might help the IMF and other governmental and non-governmental organizations address economic "spillovers" relevant to developments in international taxation.

I have a number of comments to make in a variety of areas relevant to the review being undertaken by the IMF, but am limiting my submission to particular concerns I have with steps being taken to deal with undeclared funds, and how these can negatively impact fragile economies. More importantly, I have, in what I have set out below, sought to summarize steps that could be taken by the international community to address the areas of concern that I have identified. I would be happy to elaborate on any of the ideas mentioned below should this be of interest.

I am a retired tax lawyer, now consulting with governments and others in relation to tax and wealth management issues, among others. A CV is attached. I have discussed some of the ideas contained herein with Christine Lagarde, informally, and also in a conference call with Jody Meyers and others of the IMF late in 2013.

We are especially, though not exclusively, interested in the outcomes for lower-income, developing countries in terms of tax revenues, underlying economic activities and international investment flows, and implications for countries' own tax systems.

My submission focuses on the outcome for lower-income, developing countries of global developments towards tax transparency.

There is rapid progress towards the adoption of global approaches to automatic information exchange, a dramatic difference from the methods of information exchange of the past, such as information exchange upon request. This progress is based on work of, among others, the U.S., the OECD and the EU.

The U.S. has made great progress in implementing its FATCA approach to tax compliance, and this has, in turn, made it easier for the OECD, with the support of the UK and others, to use FATCA as a basis for the development of a global standard for automatic information

exchange. The EU has been successful in moving forward with changes to be implemented to the EU Savings Directive, also an initiative that relates to automatic information exchange.

The ability of automatic information exchange to address the global issue of undeclared funds is substantial. An important, but sometimes overlooked, element of tax enforcement relates to the move to have anti-money laundering rules include tax crimes as predicate offences, something that has already been introduced in many countries, including the UK, Singapore and Hong Kong. Through changes to EU anti-money laundering rules and initiatives of the Financial Action Task Force, we are a short number of years away from comprehensive anti-money laundering rules in key financial centers that include tax offences as anti-money laundering offences.

Undeclared funds are a global problem, and measurement of the amounts involved is very difficult. The Tax Justice Network has reported the figures involved to be as high as over US$30 trillion. Oxfam has estimated that if taxes were properly paid by those earning the income involved, global poverty would be eliminated twice over.

Combining the impact of anti-money laundering rules that are effectively enforced (today, they are not) with bi-lateral and other automatic information exchange arrangements, undeclared money should be significantly reduced. A bank, for example, in a traditional bank secrecy country (of which there are many, such as the U.S., Switzerland, Singapore and others), will, where the anti-money laundering rules so provide, have to be comfortable that monies on deposit are tax declared in the home country, failing which anti-money laundering reports will need to be made. Connected to this will be automatic exchange of information agreements, whether or not part of comprehensive tax treaties, that require information to be automatically exchanged regarding the earnings of taxpayers connected to countries that have entered into automatic exchange agreements. Important to note is that anti-money laundering rules will apply even where there is no automatic exchange of information yet agreed with the relevant home country – but what happens in these cases is not yet clear.

Where countries have the economic and other power to be early on the list for automatic exchange of information, these countries will benefit their tax systems early on. This is already happening in relation to the U.S., with its rollout of FATCA, and will be the case for many European financial centers, and others, as part of OECD and EU initiatives.

Two realities, among many:

First, countries will only have capacity to negotiate and enter into a limited number of automatic information exchange agreements in the short and medium term, and the priority will clearly be to do so with countries, like the U.S. and certain Western European countries, that are pushing this on their agenda, and who have the negotiating power to force counterparts into such arrangements, such as where a comprehensive tax treaty can be threatened if automatic exchange is not agreed to.

Second, many financial centers are adopting strategies designed to "go slow" in the sense of allowing loopholes in anti-money laundering rules (this through the requirement of "double criminality", among others, which means that if something would not be a tax offence in both countries involved, no reporting arises) and through a selective approach to entering into

bilateral exchange of information agreements. Broadly, the financial services industry and financial centers are focusing on the U.S. and Western Europe as the first countries in respect of which tax evasion is being targeted…low on the priority scale are countries most in need of tax revenues, those that are developing and which may have other problems with their tax systems. These countries that are most in need will be the least likely to gain in the short or medium term.

While for the moment, anti-money laundering rules are generally not being overly enforced when it comes to taxpayers from many developing countries, as such rules do become better known and focused on, the risks to wealth owners from fragile countries will increase. The reality is that not all countries are actually ready for the full tax transparency that the world is working towards. What happens where a taxpayer is a resident of a developing country the tax system of which does not respect privacy, meaning that information the tax authorities have is improperly made available to journalists and others, perhaps including kidnappers interested in knowing who has what? What if there is corruption in the tax system, and tax proceeds are, in part, diverted improperly? What if information on an individual's assets and income lead to a corrupt approach to a bribe to avoid a full tax audit? And what of countries that use tax information to attack the political enemies of the state?

Taxpayers connected to countries whose tax systems are not ready for full transparency will be forced into finding ways to avoid new reporting and compliance systems, in part relying on the insufficiency of the home country tax system to fairly tax income. In some cases, taxpayers will be encouraged to abandon their residence to avoid being taxpayers, something that contributes little to the local economy. In other cases, untaxed assets might well be converted into investments that do not attract the tax compliance that passive investment portfolios with banks now attract. Again, not something that encourages investment into the home country which needs it most. It is the entrepreneurs who can hugely benefit a home economy with their knowledge and experience of the country that are encouraged to invest abroad and find ways to distance themselves economically and otherwise from the place they know best. Meeting the tax laws of many developing countries is simply not an option given the practicalities of how the tax system operates.

An approach that could address the needs of both the home country and the individual taxpayer would involve having a suitable non-governmental organization, perhaps Transparency International, evaluate the tax systems of countries, measuring levels of corruption, misuse of taxpayer information and other characteristics relevant to the determination of the countries that are ready for full tax transparency.

Where countries are not ready for full transparency, financial centers could agree to ensuring tax compliance by identifying the relevant owners of assets and income, and agreeing to withhold tax on initial capital and annual income, say at a figure of 10%. The proceeds of the withholding tax would be maintained in a fund that would be made available to the home country involved under certain conditions. Because the taxpayer would be considered tax compliant in the financial center involved, no anti-money laundering or other reports would need to be filed.

On agreeing to accept the funds held for it as settlement of tax due in relation to assets subject to withholding, the withheld amounts would be paid over to the home country. It would also be possible to have withheld amount be the subject of disbursement with international oversight, something that may be particularly appropriate for countries where tax revenues are improperly applied. In some cases, the tax withholdings might have a role in repayments of outstanding international loans or otherwise. Clearly, the IMF can have a leading role here.

The objective of the withholding arrangements implemented would be to be temporary – at such time as the country involved adapts its laws and practices such as to be considered ready for full tax transparency, automatic exchange of information would be implemented, making the withholding approach unnecessary.

Short term – immediate revenues that can be applied as they need to be given the circumstances of the country involved. Medium and long term – an influence on what the country needs to do to establish an effective and fair tax system that can operate in the interests of the country and its taxpayers.

1. How does the current network of bi-lateral double taxation treaties, and the spillovers that can arise from treaty shopping, affect low income countries? What changes in the design of treaties could be beneficial for those countries? Is the existence of bi-lateral tax treaties important to the attraction of international capital, and if so why/how?

In the context of this proposal, bi-lateral treaties are accepted as being of great value to countries, and are noted as an important negotiating tool in encouraging the adoption of automatic exchange of information. Developing, low-income countries do not have the negotiation position of developed countries vis-à-vis financial centers and will not be early on the list of countries with which automatic exchange of information will be negotiated.

Negotiations relating to access of withholding taxes can lead to comprehensive tax treaties that include important clarity on the taxation of inbound investment, encouraging investment into the low-income country involved.

2. How (if at all) does the asymmetric tax treatment of debt and equity contribute to any unintended reduction in the tax bases of individual countries, and of the world's overall taxable profit? What solutions would you prefer, if you see this as a problem?

The proposal described here focuses on the more fundamental issue of increasing tax revenues through proper enforcement of the tax system and the identification of untaxed assets and income. There needs to be encouragement for taxpayers to become compliant, adding to tax revenues and the tax base, but also opening the door to re-investment into the home country. Taxpayers owing undeclared assets are, at present, tempted to invest outside the home country.

The proposal is also designed to accelerate the development of proper tax systems that are the basis for countries to be able to generate the tax revenues they should generate. The reality for many fragile, developing countries, is that they have relatively high "headline" tax rates, but

very low levels of actual tax collections from wealth owners, particularly those able to make use of offshore financial centers.

3. Have you observed any shifts in capital or investment flows as a consequence of recent shifts in large capital exporting economies toward territorial taxation and away from worldwide taxation?

There is much to say on this topic. Given how easy it is to move assets and people around, a greater focus on territorial taxation can simplify tax systems and make it easier to ensure that developing countries earn their fair share of taxes. Adoption of territorial approaches to taxation, however, are not a prerequisite to the proposal working to generate short term tax revenues for countries that need these revenues most.

4. Would an end to deferral of taxation under worldwide taxation regimes (such as that in the US) be beneficial for some countries?

For developing countries whose tax systems are "not ready" for full information exchange, the reality is that if deferral of taxation is eliminated, taxpayers will seek other means of avoiding home country reporting. Where a tax system is corrupt, or where there are dangers in information coming to the home country because of political or other considerations, tinkering with the home country tax system will not produce the tax revenues that are expected. An interim, confidential and simple withholding system can be a compromise that results in immediate tax revenues and which encourages the "clean up" of tax systems that need to be put in order to work effectively.

5. Do you have suggestions regarding amendments or the introduction of possible special regimes under the arm's length pricing method that would be of benefit for developing countries, in terms of revenue outcomes and/or administrability?

This is not directly relevant to the proposal, but as developing countries are encouraged to adapt their tax systems, a shift to a greater focus on territorial income formulations can be beneficial. Transfer pricing rules are important in any mechanism that allocates income and key is to make sure that the current ease with which these rules can be applied to shift income to low tax countries is addressed.

6. Do you have views on the potential outcomes of an adoption of formulary apportionment and/or unitary taxation -- of some degree (including, for example, some form of 'residual profit split') -- for developing countries? Other countries? International business? If you support such a system, what allocation factors would you suggest?

Again, not directly relevant to the proposal for a simple withholding system, but formulary apportionment and other approaches need to be considered in the development of effective tax systems in an increasingly smaller world.

7. How should the international tax architecture treat jurisdictions where significant corporate profits are booked, but which have relatively little substantive economic activity?

Under the proposal, the short term withholding regime would not focus on economic activity but will simply make sure that there is a level of tax revenue generated on assets held in offshore centers.

8. In your view, does the existence of tax competition -- whether directly, through the setting of tax rates, or indirectly, through the shifting of tax bases -- serve a useful purpose? Can one identify particular forms of tax competition that are 'harmful'?

Like all competition, tax competition is healthy and necessary to ensure that countries are imposing tax fairly and efficiently. Relevant to the proposal is to recognize that wealth owners faced with a corrupt or otherwise defective home country tax system will be encouraged to relocate, taking advantage of the tax savings and privacy protection afforded by this. For example, a wealth owner who has international business activities, and who is based in a country that is unstable and developing may fear having the local authorities be aware of global wealth. With growing transparency, and anti-money laundering rules that include tax as a predicate offence, a wealth owner may be forced to relocate to avoid putting their family at risk by complying with home country disclosure requirements. Relocation may be to a country that "competes" with its tax system – for example, the UK does not generally tax the foreign earnings of those who are "resident" in the UK, but not "domiciled" in the UK. Similar benefits can be achieved by relocating to a number of other places, including Hong Kong and Singapore, given their territorial tax systems. This competition is healthy as it encourages home countries to review their tax systems and to ensure that they are fair…but this process can be a long one, particularly in the case of fragile, developing economies – and hence the attraction of an interim withholding based taxation regime.