Christian Aid Submission

Response to the International Monetary Fund

Public Consultation on Economic Spillovers in International Taxation

March 2014

Christian Aid is a Christian organisation that insists the world can and must be swiftly changed to one where everyone can live a full life, free from poverty. We work globally in over 40 countries for profound change that eradicates the causes of poverty, striving to achieve equality, dignity and freedom for all, regardless of faith or nationality. We are part of a wider movement for social justice. We provide urgent, practical and effective assistance where need is great, tackling the effects of poverty as well as its root causes.

Christian Aid is pleased that the IMF is undertaking this consultation and is seeking to understand the potential and nature for spillovers in tax systems. The impact that one country's tax system can have on another's has been a key concern of Christian Aid's in our work on tax and development; for example the role that tax havens play in enabling resources to be shifted out of developing countries[1]. However the longer we have worked on this issue the more aware we have become of the potential for spillovers in other areas.

In recent years for example we have looked at the potential impact of UK decisions in reform of Controlled Foreign Company rules[2], the rubik agreement between the UK and Switzerland[3], and reform of the UK Disclosure of Tax Avoidance Schemes (DOTAS) system[4]. These examples help show the range of areas in which there is the potential for spillovers from domestic tax policy:

- Domestic tax policy changes leading to (inadvertent) changes in taxpayers behaviours in other countries (e.g. CFC reforms)
- Unilateral/bilateral tax policies by powerful economies affecting the policy space developing countries will be granted by other countries (e.g. UK-Swiss rubik deal)
- The potential for domestic reform to positively seek positive spillovers (e.g. calls for inclusion of tax avoidance schemes in developing countries in UK DOTAS regime)

Given this range, we encourage the IMF to seek a broad scope in this research, to seek to capture the whole range of potential for spillover impacts, and to look not just at the direct and quantifiable, but also to the more indirect and political spillovers which need to be highlighted to ensure that governments are aware of the potential impact of their actions when policy decisions are being made.

Policy coherence for development commitments made by many countries should have ensured that many governments were already seeking to address the spillover impacts of changes in tax policy on developing countries. This however is not the case, as we have seen by the response to, or rather ignoring of, the G20 to the recommendation of the IMF, OECD, World Bank and UN that such analysis be undertaken both as a baseline and when changes are being made to G20 country tax systems[5]. It is also notable that the UK government has rejected a requirement to conduct spillover analysis in response to the recommendations of the International Development Committee of the House of Commons[6]. It would be useful if the IMF were, as part of this

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[1] http://www.regjeringen.no/pages/2223780/pdfs/nou200920090019000en_pdfs.pdf - this report by Norway is probably the most comprehensive report on the impact of tax havens on development.
[2] The joint Action Aid and Christian Aid submission on this to the UK Government is attached as Annex A
[3] http://www.christianaid.org.uk/pressoffice/pressreleases/March-2012/use-budget-scrap-shoddy-swiss-tax-deal-christian-aid-urges-1903.aspx
[4] http://www.actionaid.org.uk/sites/default/files/doc_lib/dotas_submission_aa_ca_ogb_stcuk.pdf
[5] http://www.oecd.org/ctp/48993634.pdf pp 27-28
[6] http://www.publications.parliament.uk/pa/cm201213/cmselect/cmintdev/708/70804.htm - see response to recommendations 9 and 10

work, to be able to provide guidance to countries on approach(es) to undertaking spillover analyses to facilitate developed countries from undertaking such analysis.

Spillovers also exist at the international level. As the OECD and G20 countries are currently embarking on one of the biggest reforms of international tax rules for more than a generation with both the shift to Automatic Exchange of Information (AEOI) and the Base Erosion Profit Shifting (BEPS), it is vital that spillover analysis takes place. With the work on both AEOI and BEPS while the process is being led by the OECD/G20 it is clear from the discussion that these are considered projects with global impacts. Developing countries are likely to be both expected to comply with many of the new rules (if not immediately at least within the foreseeable future), and to be impacted by results of the new rules. Christian Aid, along with many others have highlighted the inequity in creating these new rules without the majority of countries who will be impacted by them having an equal role in the development of the rules[7]. To expect developing countries not only to be excluded from the decision making, but also for the OECD/G20 to not have a criteria to assess the impact of proposed reforms on developing countries is clearly unjust and risks creating new global rules that are only in the interest of a small number of countries.

We therefore urge the IMF to highlight the need for spillover analyses to be undertaken and included as a key criterion in the assessment process of the current international reviews of tax rules. We would also highlight that spillovers should not just be seen, and analysed, in terms of revenues, but should also consider issues such as policy space, the progressivity and gender bias of the tax systems, impact on investment, growth, stability etc.

We have attempted to give answers and/or thoughts on the eight areas specifically identified by the consultation call below. However as should hopefully be clear we do not necessarily feel that the parameters of the questions reflect the limits of where work and analysis of spillovers should be set. There is clearly a need, as identified in the report to the G20[8], for both baseline and forward looking spillover analysis, there is also a need to consider both technical and political spillovers.

We are happy to provide further detail on any of the points raised in this submission, please contact Joseph Stead, Senior Economic Justice Adviser, jstead@christian-aid.org

Responses to specific questions in consultation:

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?*

   Recent reports by NGOs have highlighted the potential cost of double tax treaties to developing countries[9], there are clearly several ways in which treaties can have impact on developing countries.

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[7] See https://www.christianaid.org.uk/Images/No-more-shifty-business-response-to-OECD_tcm15-68250.pdf and http://www.christianaid.org.uk/images/policy-brief-g20-fixing-the-cracks-in-tax.pdf

[8] http://www.oecd.org/ctp/48993634.pdf

[9] See http://www.eurodad.org/files/pdf/524d3b7c8e8ed.pdf on Latin America, http://somo.nl/publications-en/Publication_3958 on the Netherlands tax treaties impact in developing countries, and http://www.swissinfo.ch/eng/business/Swiss_double_tax_treaties_a_one-sided_affair.html?cid=37852214 on Switzerland's approach to DTAs, as well as the questions raised in

At the most direct level there are concerns that developing countries are being forced to significantly reduce their withholding taxes in return for tax treaties. While there are a variety of reasons for both signing DTAs and the specific terms that are established within them, there appears to be little direct research on the policy processes adopted by developing countries with regard to DTAs. This might be an area for the IMF to provide useful additional research, and to help provide tools and support for developing countries to analyse the potential utility of DTAs.

Both treaty shopping and the lowering/abolition of withholding taxes as well as costing revenues directly, may also be denying developing countries the ability to use withholding taxes as a simple and effective means by which to impose taxes. While many developing countries have limited capacity to enforce complex transfer pricing rules and regulations withholding taxes are a potentially effective alternative, but the scope to utilise them is being progressively reduced.

There does not appear to be clear evidence either way on the benefit of DTAs for attracting investment[10]. This may well be because of the variability both of motivations for signing DTAs; fear of driving away FDI to competing jurisdictions, seeing DTAs as a desirable norm etc., as well as the actual content of the DTAs, some of which may be beneficial, whereas others appear to be damaging. Assistance to help assess the costs and benefits of DTAs, and in negotiating DTAs may be useful. Greater understanding of the costs and benefits of DTAs to developing countries could also help to provide for guidelines for developed countries to follow in negotiating with developing countries to prevent developed countries abusing their stronger political and economic power[11] and to provide assistance to developing countries in asserting their needs in negotiations.

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?*

This is an area where more research is needed. There are various ways in which asymmetric tax treatment of debt and equity has an impact on tax bases. The most obvious is the use of thin capitalisation. While many countries have introduced rules to prevent the use of thin capitalisation to avoid substantial amounts of tax, this is less the case in developing countries, where even where laws exist they are not always followed; it appears that some companies are seeking to play to the limits of the capacity of the authorities, rather than the limits of the law.

While the logic of treating debt and equity differently for tax has some logic, this is brought into question when the debt is entirely, or mostly, the MNEs own money

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https://www.actionaid.org.uk/sites/default/files/doc_lib/calling_time_on_tax_avoidance.pdf and http://www.actionaid.org/publications/sweet-nothings about use of tax treaties in company structures to minimise tax.

[10] See for example http://www2.warwick.ac.uk/fac/soc/economics/news_events/conferences/peuk12/paul_l__baker_dtts_on_fdi_23_may_2012.pdf - which argues that DTAs have no impact on FDI, and http://personal.lse.ac.uk/barthel/docs/dtt_fdi.pdf which claims that they do.

[11] See also the recommendations in http://www.concorddanmark.dk/pdf/concord/Concord%20Denmark%20report_%20What%20%20the%20EU%20should%20do%20to%20make%20taxes%20work%20for%20the%20poor.pdf which argues for the EU to adopt a 'tax treaties for development' policy.

obtained from the finance function of an MNE, rather than external debt raised on the open market. There are therefore questions on if there should be different rules regarding loans than those obtained from the parent companies own resources, and loans that are obtained from the open market.

Whilst perhaps going beyond the remit of the question posed, there could also usefully be research done on how risk assessment feeds into issues such as debt financing, and subsequent tax implications. From discussions with MNEs and tax professionals it is clear that the assessment of the risk of a given venture affects the debt to equity ratio; for example where there is deemed to be a significant political risk in a country it is more likely to be financed by debt than equity (to reduce the exposure of assets to an unstable political environment), and further the price of servicing that debt is likely to be higher. All of which is likely to lead to a reduction of profits declared in country, and hence a reduction in tax due.

A key question in this scenario is therefore how reliable the risk assessment is, should developing countries be perceived to be riskier investments than they are in reality, then both the level and cost of debt is likely to be higher and taxes paid lower[12].

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?*

   Christian Aid has not, thus far, done quantitative research in this area.

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

   Christian Aid has not done significant research into this area, but agrees that it is an issue that would benefit from further research.

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?*

   There is a broader question on whether the arm's length principle (ALP) is the best approach for determining the distribution of profits across multinational enterprises. Many of the transactions of MNEs do not have comparable unrelated transactions, and so seeking to apply an arm's length price is increasingly an exercise in fiction. As Christian Aid, and others, have argued, a more fundamental review is needed to determine the best approach towards taxing MNEs to provide a system that adequately allows all countries to tax the economic activity that is taking place, and value created, within their jurisdiction[13].

   The challenges facing developing countries seeking to tax the activity and value genuinely created within their borders, in a process that is administratively feasible for their level of capacity are clear, and there are potentially a variety of solutions. Chapter 10 of the UN practical guide to transfer pricing illustrates how the larger emerging economies have

[12] http://www.pwc.com/us/en/risk-compliance/assets/PwC_PoliticalRisk_052006.pdf this report for example suggests that on the political risk side there is substantial improvement can be made on how risk is assessed.
[13] See reference 7

sought to introduce their own approach to transfer pricing, that while still fitting within the current framework of transfer pricing, also enables the ALP approach to function more appropriately to their context. These approaches vary, for example though recognising the value created in location saving[14], or using fixed margins to adapt to the lack of comparables and reduce complexity in administration[15]. What is unclear is how free smaller developing countries are to pursue such policies themselves; there is considerable resistance to some of the methods adopted by emerging economies to transfer pricing, resistance that smaller economies are unlikely to be able to resist.

There are other potential options[16] that could be considered, generally focussed on being able to match the capacity of developing country revenue authorities. What needs to be kept in mind as such options are considered and researched is the costs that may be attached to improving administrability. It should not be that developing countries have to bear all the costs through reduced revenues due (even if payments may increase due to ease of use), companies are also likely to gain through reduced administration costs. It is also likely that if improved administrability leads to conflict with developed country tax regimes developing countries will be placed under pressure to bear the cost of writing off any double taxation rather than developed countries, most likely under the justification that a different approach is a 'deviation' from the ALP. It shouldn't be the case that developing countries have to forfeit revenue as the price to have a system that works for them, and so alongside a need to have a process to give developing countries policy space to implement tax policies that suit their context there needs to be a matching process to enable potential conflicts between such policies and developed countries to be resolved in a manner that respects commitments on policy coherence for development.

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?*

Christian Aid, along with many other NGOs, believes that there needs to be further research done into the potential costs and benefits of formulary apportionment and/or unitary taxation, especially on the potential impact on developing countries. As globalisation has increased, and MNEs have increased both the integration of their production, and their share of global trade and production, both the logic and practicability of the ALP is diminishing. It is increasingly impossible to suggest that an ALP can be (easily) established, as too many transactions do not take place between unrelated parties, the effort then required to create an ALP not only distorts logic, but also requires a substantial effort both to create by the company, and also to assess by tax authorities. The development of the ALP both as contained within the OECD guidelines, and as practiced by some of the larger emerging economies clearly shows that the ALP has been evolving to try to contain some of these issues. This difficulty clearly forces the question on if the ALP has reached its limits.

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[14] See China and India chapters in https://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf
[15] See Brazil chapter in https://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf
[16] See for example from Michael Durst
http://www.taxjustice.net/cms/upload/pdf/Durst_2010_developing_countries.pdf,
http://www.un.org/esa/ffd/tax/2013EGM_EIT/Panel2Durst.pdf,
http://www.amiando.com/eventResources/H/V/CYE7Hakmw8ufWq/Michael_Durst_.pdf

The integrated production systems of many MNEs makes a unitary approach, seeking to treat MNEs as the integrated units that they are is a logical response to these challenges, and arguably more logical than trying to treat integrated entities as unrelated.

It is therefore disappointing that the OECD/G20 BEPS process has decided not to include investigation of such alternatives to the ALP as part of the BEPS process, and we encourage the IMF to undertake further research into this area.

The results of an alternative approach for developing countries (and other parties) is likely to depend to a large part upon the process by which such changes are implemented. There are concerns that a shift to new approaches without either meaningful participation by, or assessment of impact on, developing countries are unlikely to substantially benefit developing countries, and we reiterate the need for their, and an impact assessment, inclusion in the process for reforming international taxation.

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

That such situations are able to arise clearly demonstrates a problem in the current international tax architecture, the response to which would appear to need to take place at various levels.

- A better, and shared, understanding needs to be developed on where value is created. There are clearly challenges to some claims for significant value (and hence profits) to be created as a result of limited economic activity. The development of the digital economy is clearly part of this problem and solutions need to be found on how to tax what can be viewed as 'digital rents', as well as agreed approaches on where value is actually created in a hyper connected world..
- Tools to enable the effective identification of profit shifting – for example country by country reporting.
- The rules to enable countries negatively affected to challenge such situations, this needs to take two forms:
    - Rules, such as a reform to the ALP/introduction of alternative approaches (e.g. unitary taxation) to reduce the ability for profit shifting
    - Rules to enable jurisdictions to challenge another jurisdiction where policies have been deliberately adopted to encourage profit shifting, rather than genuine economic activity.

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'?*

There may, arguably, be a place for certain form of tax incentives – it may for example be one of the few tools that developing countries can use to help attract certain activities (e.g. R&D) that would otherwise go to countries with significantly better infrastructure (both physical and human). Whether this should rightly be called tax competition is debatable, as arguably the point in this scenario is that the two economies are not ordinarily in direct competition with each other.

Furthermore the actual scope for such approaches to be used are likely to be limited as the areas where developing countries might want to use tax competition (e.g. R&D)

developed countries are also engaged in tax competition with each other leaving little room for developing countries to be able to use .

What we have instead is tax competition being used as an easier alternative to hard public policy (really improving education, infrastructure etc) and as a shorthand for 'attractiveness' e.g. with the World Bank Doing Business Indicators. Many companies claim that tax is not the primary factor in location decisions, with factors such as infrastructure, educated workforce etc being deemed much more important. Given this, tax competition that reduces a government's ability to provide (either directly or indirectly) those more important factors is almost certain to be harmful at least in the long run. Developing countries, starting from a much lower infrastructure and capital base are obviously at a much greater risk than developed countries in this respect.

Forms of tax competition that may be harmful may include:

- Creation of tax free special enterprise zones – while these may have the potential to attract new industry to countries there are numerous potential risks too:
    - Companies shifting from outside the special enterprise zone to within it, therefore diverting rather than creating activity
    - Companies that are attracted to special enterprise zones do not integrate into the wider economy, and shift at the end of any incentive period – there is therefore a pressure to either extend tax incentives permanently, or to lose business.
- Competition to provide the 'best' double tax treaties. Here there can be competition from both sides negotiating, leading to especially aggressive competition. Developing countries may be seeking to out compete their neighbours, while developed countries are often seeking to ensure that they conclude a treaty that makes investing through them more attractive than investing via a developed country rival.
- Downward pressure on headline rates (e.g. corporation tax), leading to either reduced revenues, more regressive tax system structure, or both.
- Increased use of tax incentives to attract foreign investment which become both a race to the bottom, and permanent rather than temporary incentives.

These are only a couple of examples, there are many more and they may vary from country to country. There appears to be a growing appreciation of the dangers of tax competition for developing countries, but thus far appears to be lacking are proposals on how to avoid the prisoners dilemma of tax competition. We encourage the IMF in addition to analysing the problem to also seek to identify solutions.

Annex A

Action Aid- Christian Aid Joint submission

Response to the consultation on Controlled Foreign Companies reform

September 2011

1. Introduction

1.1 Action Aid was founded as a British charity in 1972. ActionAid is an international NGO working in 45 countries worldwide, and our positions and recommendations reflect the experiences of our staff and partners in Africa, Asia, the Americas and Europe. Action Aid's vision is a world without poverty and injustice in which every person enjoys the right to a life with dignity. We work with poor and excluded people to eradicate poverty and injustice. In 2003 Action Aid became ActionAid International and moved its global headquarters from the UK to South Africa. ActionAid's rights based approach, which looks at the systemic causes of poverty, forms the foundation for its work on development. Action Aid continues to play a leading role in the debate in the UK and globally around tax justice, aid effectiveness and accountability for developing countries.

1.2 Christian Aid is a Christian organisation that insists the world can and must be swiftly changed to one where everyone can live a full life, free from poverty. We work globally in over 40 countries for profound change that eradicates the causes of poverty, striving to achieve equality, dignity and freedom for all, regardless of faith or nationality. We are part of a wider movement for social justice. We provide urgent, practical and effective assistance where need is great, tackling the effects of poverty as well as its root causes.

1.3 We welcome the opportunity to provide written evidence to Her Majesty's Treasury (HMT) consultation on proposed reforms on Controlled Foreign Companies (CFC). We are happy to provide further written and/ or oral evidence on any of the subjects covered in this submission via Jonathan Tench, Action Aid's Government Relations Adviser on Jonathan.Tench@actionaid.org or 07779 739402 and Sol Oyuela, Christian Aid's Senior UK Political Adviser on soyuela@christian-aid.org or 020 7523 2109

1.4 We have structured our response in 4 sections: summary of our key messages; background to our position; general comments on the proposed reforms; and specific comments on the proposed reforms.

2. Summary of key messages

2.1 We are concerned about the impact on developing countries of changes to the CFC regime proposed in the consultation document, as part of the government's broader corporate tax roadmap. The proposed relaxations, in particular the finance company exemption, are likely to eliminate the regime's deterrent effect on the shifting of profits from developing countries to low-tax jurisdictions by UK-domiciled multinational companies (MNCs). The risk is that this measure significantly affects developing country tax revenues, and thereby seriously undermines the 'value for money' that UK taxpayers obtain for their contribution to aid. Policy coherence for development requires a reassessment of these proposals.

2.2 The Government is committed to supporting domestic resource mobilisation in developing countries, including through more effective taxation of MNCs. To ensure

coherence between this policy and the CFC reforms, the government should assist developing countries to mitigate any impacts of the proposed reforms by:

a. Assessing the likely impact of the reforms on developing countries, namely the potential resulting change in MNCs' behaviour, and the characteristics of developing countries economic and political system (for example investment patterns, tax legislation, enforcement capacity) that would be likely to increase exposure to this impact.

b. Increasing the amount of development assistance devoted to revenue authority capacity building in these areas, and making it available to those developing countries' that have been identified as being at higher risk of being impacted by such reforms.

c. Championing international cooperation in areas that support developing countries' efforts to protect their revenue bases, including country-by-country financial reporting and multilateral instruments to exchange tax information.

d. Considering the spontaneous exchange with developing countries of any information on high-risk transactions obtained through companies' applications for exemptions.

2.3 With regards to the specifics of the proposals, we encourage the government to:

a. Reconsider the suggested full finance exemption in the light of its potential impact on developing countries.

b. Set establishment and local management criteria for certain exemptions that will help protect developing countries from transactions that are not based on economic substance.

c. Consider the precedent set by the low profits exemption in terms of materiality tests: a company may have a presence in a developing country that is not material to the company, but is of significance to the tax base of the country

3. Background to our position

3.1 Private sector-driven economic activity that is pro-poor, equitable and low carbon is one of the bedrocks of development. Taxation is essential to ensuring that the development benefits of that activity are fully realised through the provision of the public services needed to alleviate poverty; an adequately resourced state is also an essential enabling factor for economic growth.

3.2 UK-owned companies are major investors in developing countries, making pre-tax profits estimated to be in the region of £75 billion per year[17]. The tax revenues on these companies' earnings in developing countries, raised through a combination of corporate income tax and withholding tax on cross-border transactions, make a significant contribution to funding for poverty alleviation in those countries. In Ghana, for example, one pound in seven of tax revenue comes from corporate taxation, mostly from large taxpayers including subsidiaries of UK multinationals (Ghana Revenue Authority).

3.3 Developed countries, on average, raise 35% of GDP in tax, yet many developing countries don't reach even 15% (Source: OECD Factbook 2010; ActionAid, 'Accounting for Poverty', 2009). If low-income countries are eventually to reduce their dependence on aid as a part of their public revenues, this needs to change.

3.4 The UK government has been at the forefront of efforts to increase domestic resource mobilisation, through the provision of bilateral funds and technical assistance to countries such as Rwanda, where revenue generation increased fourfold over a ten year period. DFID funding for research through the International Tax and Development Centre (ITDC), in which ActionAid and Christian Aid are partners, will ensure that DFID continues to lead on this agenda.

3.5 One aspect of the ITDC's research agenda is to study the mechanisms through which multinational companies can be taxed more effectively in developing countries, including by clamping down on international tax avoidance. Politicians and revenue officials from developing countries have spoken repeatedly about the detrimental impact on their public finances of aggressive tax avoidance by multinational companies (see, for example, http://www.businessday.co.za/articles/Content.aspx?id=141902).

3.6 In a globalised world, tax policy does not exist in a vacuum; decisions in one jurisdiction affect economic activity in another. We are therefore concerned about the impact changes in UK tax policy may have on aggressive tax avoidance developing countries. It is for this reason we submit the following comments on the proposed changes to the Controlled Foreign Companies regime.

4. General comments on the proposed reforms

4.1 Question 2A asks '*Do the proposals overall strike the right balance to deliver a more competitive corporate tax system while providing adequate protection of the UK tax*

[17] See ActionAid's submission to the consultation on interim reforms, which contains the working for this figure.

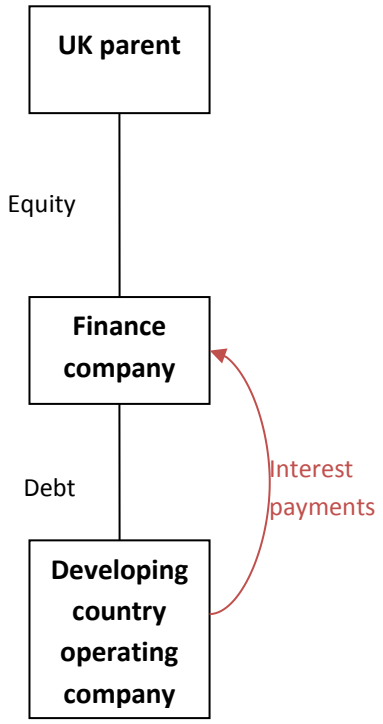
base?' While we understand that balancing these two imperatives is the main focus of the government's approach, this should not be to the complete exclusion of other factors influenced by the UK approach to tax.

4.2 Government ministers have spoken frequently of their desire to get maximum value for money from the UK aid budget. We wholeheartedly applaud the government's decision to ringfence the budget. However, it is important that government policy in other areas supports, and does not undermine, this decision. This is a matter of value for money for British taxpayers as well as of policy coherence.

4.3 The UK has supported commitments to policy coherence for development (PCD), including with regard to international taxation. For example, the 17 November 2009 EU Council conclusions on Policy Coherence for Development emphasise *"Improving transparency and countering illicit cross-border flows and tax evasion recognising that these have a severe impact on domestic resource mobilisation in developing countries."* Policy coherence means that where a policy shift is likely to have an impact on a developing country all efforts should be made to make sure that this impact is positive. The proposed CFC reforms are a PCD issue, because there is a potential impact on developing countries in the area of domestic resource mobilisation, to which the UK has committed as part of its International development agenda.

4.4 The consultation document states that an aim of the CFC reform is to encourage more businesses to be headquartered in the UK (H.7 (Economic Impact) page 93 of consultation document). There is an implicit obligation in seeking this aim to ensure a global environment where all countries in which UK-based MNCs operate, and particularly the developing countries in which they are major foreign investors, are able effectively to enforce their tax laws. As well as creating a system that is fair to businesses, we also need to create a system that is fair to the authorities of all the countries in which UK based companies operate, to give them the chance to benefit from the presence of MNCs, as the UK benefits from the presence of the headquarters

4.5 In light of the point made above, and within the parameters set by the consultation document, **our main concern is that the finance company exemption may increase the incentive for UK-domiciled MNCs to use finance companies based in low-tax jurisdictions to thinly capitalise subsidiaries based in developing countries (as illustrated in the diagram below). While it may not be the primary purpose of the CFC regime to protect developing countries from such activities, it is likely that they have had such an effect, and that the proposed reforms will end it.**



4.6 ActionAid suggested in a previous submission that reforms to the CFC regime could result in a substantial loss for developing countries, and proposed that the government conduct an impact assessment. To date, we understand that there has been no such impact assessment by the government, and instead the response has been to stress the tax capacity building work undertaken by HMRC and DFID in developing countries (http://www.publications.parliament.uk/pa/cm/cmtoday/cmstand/output/pbc175/pb110607a-03.htm)

4.7 We submit that a coherent approach to the CFC policy reforms requires:

a. **Assessing** the likely impact of the reforms on developing countries, by which we mean the potential change in MNCs' behaviour that may result, and the characteristics of developing countries (for example investment patterns, tax legislation, enforcement capacity) that would be likely to increase exposure to this impact;
b. **Increasing** the amount of development assistance devoted to revenue authority capacity building in these areas, and making it available to developing countries with characteristics that indicate they may be at higher risk;
c. **Championing** international cooperation in areas that support developing countries' efforts to protect their revenue bases. Developing countries' tax administrations require not only improved capacity, but also increased access to tax information. This cannot be gained through capacity building alone, it also requires developed countries to agree to, and implement changes in their approach to transparency. There are many potential areas of benefit in this regard, of which two that are likely to make a significant difference are:

i. **Support for greater corporate transparency,** in particular country-by-country reporting by multinational companies of a range of financial data, including payments to governments, production/sales volumes, profits and employees; and for all countries in which they operate, to enable revenue authorities to identify where profits may have been shifted offshore.
ii. **Support for multilateral information exchange initiatives.** This should include technical support for countries to implement regional agreements. In addition, all G20 members should sign and implement the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, put pressure on tax havens to sign and implement, and provide assistance to developing countries that wish to sign and implement this convention.

d. **Exchanging information** on high-risk transactions. As the regime is finalised, especially in intellectual property and finance company requirements, thought should be given to the information requested by the UK for verifying exemptions, bearing in mind that this information will be available for developing countries through information exchange, and could be exchanged spontaneously by the UK. One possible avenue would be to require a greater level of disclosure where the CFC was operating in a territory that does not have appropriate exchange of information obligations with the UK, compliant with the OECD standards, and with any developing countries the CFC trades with. This builds on the principle established in the French amendments to their CFC rules in 2010.

5. Specific comments to the proposed reforms

5.1 **Question 6D** (Full financial exemption): We are concerned at the proposals to allow a full financial exemption. As this would be available to companies with little or no economic substance in the UK, it would apply to companies whose operations are primarily overseas, including in developing countries. The proposed rate of 5.75% is already attractive and it is unclear why it is thought necessary to give even more incentive for the use of low-tax finance vehicles by offering a full exemption. It would also appear to be an incentive for shifting business and capital offshore. This would appear to be uncompetitive for those companies that have more activity in the UK as it provides greater benefits for those with less UK activity.

5. 2 **Establishment and local management conditions:** A number of the exemptions for CFCs have conditions based on establishment and local management criteria (e.g. Territorial Business Exemption and General Purpose Exemption). These conditions could help to prevent companies from using questionable transfer pricing transactions to shift profits offshore from developing countries, where legislative and administrative capacity may not be strong enough to prevent them. We therefore urge the government to consider these conditions from the policy coherence perspective, and set them in such

a manner as to ensure that exempt CFCs have local establishment and substance consistent with their role, and are actually managed in their territory of residence.

5.3 **Low profits exemption**: We are concerned by the precedent set by proposals to have an exemption based on a proportion of company size. A subsidiary, which is a small part of an MNC, may still be a significant part of a developing country's economy and so should not be exempted from scrutiny. We are concerned about any regulations in the developed world that potentially reduce supervision of MNCs operations in developing world on the grounds of significance to the MNC rather than the developing country, and so are concerned that, while this particular proposal includes an upper ceiling to ensure that only companies that are small in absolute terms are affected, it could set a worrying precedent in other arenas.

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