GLOBAL FINANCIAL INTEGRITY

International Monetary Fund
Consultation on Economic 'Spillovers' in International Taxation

Global Financial Integrity Comments
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Our organization, Global Financial Integrity, studies illicit financial flows and capital flight from developing countries, which by our calculations drained $946.7 billion in 2011, and $5.9 trillion between 2002 and 2011, from these countries' economies.[1] The drivers of these flows are varied and complex, but one major component is the desire to avoid paying taxes. While the amount of capital flight we have found is almost unfathomable—many times the amount of official development assistance these countries receive from other nations—the official trade data that our research is based on does not even capture many abusive transfer pricing transactions or capital flight from developed countries, suggesting the cost of tax evasion to the global economy may be much higher.

While we believe every country has the right to design and implement its own tax system, one country's tax policies can create strong incentives that drive how multinational companies (MNCs) and other taxpayers allocate capital globally. In our increasingly globalized economy, these 'spillover' effects can have a substantial impact on the health and growth of individual economies, particularly developing and emerging economies. Recent studies have shown the extent to which multinational entities deprive developing countries of tax revenue[2] and the very real human cost of this deprivation.[3] For this reason, we firmly agree on the need for significant adjustment to aspects of the international tax system, and we believe the OECD's Base Erosion and Profit Shifting (BEPS) project is a very good start, addressing many of the most heavily abused loopholes and offering novel options for larger systemic changes.

Through our research and outreach on illicit financial flows, we have heard significant concern about and interest in these issues from policymakers, citizens, and the media in a broad range of countries outside the OECD and G20 membership, such as Croatia, Malaysia, Nigeria, the Philippines, Rwanda, Tunisia, Zambia, and many others. While the project was initiated under a mandate of the G20, we appreciate the project's recognition that BEPS is a problem affecting developing countries as well and the OECD's moves to include developing countries' perspectives in the project. The OECD's structure does not allow for developing countries to make ultimate decisions regarding these international policies, however, despite directly affecting those countries, so we appreciate the IMF's effort to study these potential effects.

The BEPS project has broken important ground in recognizing that international tax principles simply have not kept pace with globalization and the digitalization of the world economy. There is a vast array of potential

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[1] Dev Kar & Brian LeBlanc, Global Financial Integrity, *Illicit Financial Flows from Developing Countries 2002-2011* (Dec. 2013), http://iff.gfintegrity.org/iff2013/2013report.html. *See also* African Development Bank & Global Financial Integrity, *Illicit Financial Flows and the Problem of Net Resource Transfers from Africa: 1980-2009* (May 2013), http://africanetresources.gfintegrity.org/index.html.

[2] *See* ActionAid, *Sweet Nothings* (Feb. 2013), http://www.actionaid.org.uk/doc_lib/sweet_nothings.pdf ; ActionAid, *Calling Time* (Nov. 2010), http://www.actionaid.org.uk/doc_lib/calling_time_on_tax_avoidance.pdf.

[3] *See* ActionAid, *How Tax Havens Plunder the Poor* (May 2013), http://www.actionaidusa.org/sites/files/actionaid/how_tax_havens_plunder_the_poor.pdf; Christian Aid, *Who Pays the Price? Hunger: The Hidden Cost of Tax Injustice* (Mar. 2013), http://www.christianaid.org.uk/images/who-pays-the-price-hunger-the-hidden-cost-of-tax-injustice-may-2013.pdf.

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specific technical changes that could be made to update these principles, and the OECD's work in choosing among these is very important. However, we feel that progress on a single, significant theme—namely, transparency—underpins the entire project and will determine its success. The report initiating the BEPS project recognized the current lack of transparency in corporate accounts and tax information, finding current research inconclusive as a result of "shortcomings in the available data" and noting that "the available data may simply not be sufficient to indicate the level of BEPS that actually exists."[4] If the solutions embraced by the BEPS project do not include any remedy with respect to the lack of data that is available to analyze, there will be no concrete way to measure the success of any of the OECD's recommended measures.

As such, we recommend that the IMF study ways in which it can use existing data, or collect additional or different types of data, that will enable international institutions to determine if the changes made during the BEPS process are having the desired effect. We also address specific questions raised in the IMF's call for consultation below. Given GFI's focus as an organization, our comments and recommendations for further study are driven by the goal of greater transparency—in the information that taxpayers report to tax authorities, in the information shared between tax authorities, and in the information available for the public to use to hold their tax system and tax policies accountable.

1. How does the current network of bilateral 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 bilateral tax treaties important to the attraction of international capital, and if so why/how?

The bilateral tax treaty system has, in theory, many advantages—it provides certainty and efficiency for taxpayers and tax authorities, as well as facilitating cooperation between tax authorities. However, while tax treaties are important for preventing cases of double taxation, many tax treaties also enable corporate tax avoidance strategies of "double non-taxation," through jurisdictional arbitrage, or "treaty shopping." The effects of treaty shopping are acutely felt in low-income countries, many of which are subject to very one-sided tax treaties with developed nations, as the government of the Netherlands recently recognized.[5] We welcome the BEPS project's efforts to take corrective action on this front.[6]

Bilateral tax treaties have also provided the basic legal authorization for exchange of information between tax authorities, but this information has largely been available only upon request, rendering the system useful, at best, only for ongoing investigations and not uncovering broad-ranging tax evasion. Recently, however, the concept of automatic exchange of tax information has gained substantial political momentum. The G20 has recognized automatic exchange as the "new global standard" and the OECD has produced a 'Common Reporting Standard' for implementation on a bilateral or multilateral basis.[7] We encourage the IMF to closely study the potential effects of this standard not only on tax collection, but also on economic activity in general, as it becomes more difficult for taxpayers to obscure their affairs.

There has been considerable debate in the OECD and elsewhere on the usefulness to developing countries of automatic exchange of information, and indeed even whether automatic exchange should be extended to developing countries. Ensuring those countries can maintain confidentiality and effectively limit access to data

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[4] Organisation for Economic Co-operation and Development, *Addressing Base Erosion and Profit Shifting* (Feb. 2013), http://www.oecd.org/ctp/beps-reports.htm.

[5] *See* Government of the Netherlands, *Dutch Government to Tackle International Tax Avoidance* (Aug. 2013), http://www.government.nl/news/2013/08/30/dutch-government-to-tackle-international-tax-avoidance.html.

[6] *See* Organisation for Economic Co-operation and Development, *BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, Public Discussion Draft (Mar. 2014), http://www.oecd.org/ctp/treaties/treaty-abuse-discussion-draft-march-2014.pdf.

[7] *See* Organisation for Economic Co-operation and Development, *Standard for Automatic Exchange of Financial Account Information* (Feb. 2014), http://www.oecd.org/ctp/exchange-of-tax-information/Automatic-Exchange-Financial-Account-Information-Common-Reporting-Standard.pdf.

received appears to be a significant concern, although we have not seen any research regarding the data security standards that exist in developing countries with respect to financial account information. Also at issue is whether those countries are able to collect and generate the data necessary to reciprocate the data exchange, as the OECD standard would require as drafted. We encourage the IMF to study both of these questions, as well as whether developing countries should be offered tax information exchange under "first-instance asymmetry," that is, initial information exchange with the expectation that it would be reciprocated only by some later date.

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

Any effective U.S. tax reform package must begin with the premise of eliminating the principle of deferral. By allowing MNCs to avoid tax on foreign income until it is repatriated, deferral creates the largest and perhaps most devastating of the U.S. tax system's perverse incentives, leading MNCs to recharacterize income as foreign whenever possible and hold it offshore indefinitely (the so-called "lock out effect") in hopes that they may be able to repatriate it at a much lower tax rate later through recharacterization or a "tax holiday."

The same accounting gimmicks that are used to extract U.S. income and "invest" it overseas can be used to avoid taxes on income in other countries as well, and thus with deferral American MNCs are able to move capital around the world freely and completely untaxed. Adding to the list of perverse incentives, the income is typically booked in a tax haven and can be used as collateral for the companies to borrow against back in the U.S., or even borrow directly from their offshore subsidiary. Were the U.S. to end the principle of deferral and remove one large incentive for profit shifting, it would lead MNCs' tax reporting to better reflect economic reality, potentially benefiting not just the U.S., but all countries in which the MNC operates.[8]

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?

We have advocated for a long time that MNCs should disclose basic financial information on a country-by-country basis—at least their revenues, profits, taxes paid, and employment figures for each country in which they operate (whether via a branch or discrete subsidiary)—as part of their annual reports and tax returns, and this proposal has been adopted as part of the OECD's study of potential transfer pricing reforms.[9] This information would be extremely helpful to tax authorities by providing a simple method for judging how closely companies' tax reporting reflects economic reality and where a country's tax policies should be strengthened to limit arbitrage opportunities.

However, requiring MNCs to disclose this information publicly would have many additional benefits.[10] Academics could use the data to analyze global trends in capital allocation and study weaknesses in the global tax regime. Civil society organizations and journalists could highlight anomalies and raise questions about MNCs' operations in certain countries. Legislators would benefit immeasurably from having citizens identifying problems in their tax code and crafting innovative solutions. Finally, publication of the information greatly

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[8] *See also* Citizens for Tax Justice, *Congress Should End "Deferral" Rather than Adopt a "Territorial" Tax System* (Mar. 2011), http://www.ctj.org/pdf/internationalcorptax2011.pdf.

[9] *See* Heather A. Lowe, Global Financial Integrity & Nicole Tichon, FACT Coalition (Feb. 2014), http://www.oecd.org/ctp/transfer-pricing/volume2.pdf, at 132–38, *commenting on* Organisation for Economic Co-operation and Development, *Discussion Draft on Transfer Pricing Documents and CbC Reporting* (Jan. 2014), http://www.oecd.org/ctp/transfer-pricing/discussion-draft-transfer-pricing-documentation.pdf.

[10] *See* Eurodad, *Exposing the Lost Billions: How Financial Transparency by Multinationals on a Country by Country Basis Can Aid Development* (Nov. 2011), http://eurodad.org/uploadedfiles/whats_new/reports/cbc%20report.pdf; Task Force on Financial Integrity and Economic Development, *Country-by-Country Reporting: Holding Multinational Corporations to Account Wherever They Are* (June 2009), http://www.financialtaskforce.org/wp-content/uploads/2009/06/Final_CbyC_Report_Published.pdf.

reduces the transaction costs of information-sharing, as MNCs would no longer need to send the information to every tax authority with jurisdiction over them.

There is growing political momentum behind proposals for country-by-country reporting. Norway and France have already adopted versions of comprehensive country-by-country reporting, and the United States and the European Union have adopted country-by-country reporting of payments to governments for oil, gas, and mining companies (the U.S. law is Section 1504 of the Dodd-Frank Act; the EU rules extend to timber companies and the EU has also adopted similar reporting requirements for financial institutions). Extending such provisions to all MNCs would be relatively painless, as the companies already compile such information for accounting and tax purposes. We encourage the IMF to study not only the specific effects on tax and transfer pricing administration of country-by-country reporting, but also the much broader and positive effects that public country-by-country reporting could have.

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

The use of tax haven subsidiaries by large MNCs is not only endemic but routine,[11] and has led to the creation of some rather ridiculous statistics, such as U.S. MNCs reporting aggregate profits of their Bermuda subsidiaries equivalent to over 1000% of Bermuda's GDP in 2008.[12] Such ridiculous results are perhaps the clearest indication of the perverse incentives created by international tax systems and the so-called "lock-out effect" of the deferral principle leads to these profits remaining unproductively in tax haven accounts. Bermudan subsidiaries are often used specifically to collect royalties on intellectual property developed and used exclusively overseas, but there are many different methods for using subsidiaries in Bermuda and other tax havens to subvert international tax principles.

While specific profit-shifting strategies can be limited through technical changes, a more general approach to profit-shifting is to broadly adopt and apply a version of the economic substance doctrine, disregarding transactions or structures without a substantive business purpose other than minimizing a company's tax burden. A major goal of the BEPS project should be to develop or improve methods of assessing tax based on corporate operations and structures without regard to tax haven subsidiaries or tax-motivated transactions, and we encourage the IMF to investigate how this principle could be applied in developing countries.

Another facet of this issue that has been very poorly studied is the effects of acting as a tax haven on a country's real economy. Small countries often assume that establishing advantageous tax structures and a vibrant financial services industry will generate local economic growth and job creation, but in reality tax-avoiding money is often transferred to unproductive accounts and used for overseas investments, and high-level financial jobs are often taken by expatriates. This leads to perhaps the greatest paradox of tax havens—in many, despite nominally high GDP, large portions of the population live in poverty. We encourage the IMF to study these effects and the potential microeconomic effects on these countries were the international tax system to considerably limit their utility as tax havens.

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?

The notion of "tax competition" is largely a product of the characterization and perception among many in the business community that taxes are merely "a cost of doing business," and that business should be directed to locations where this cost is minimized. However, we are reminded of the old adage "you get what you pay for."

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[11] *See* U.S. Public Interest Research Group, *Offshore Shell Games* (Aug. 2013), http://www.uspirg.org/sites/pirg/files/reports/Offshore_Shell_Games_USPIRG.pdf.

[12] Mark P. Keightley, Congressional Research Service, *An Analysis of Where American Companies Report Profits: Indications of Profit Shifting* 8 (Jan. 2013), http://www.fas.org/sgp/crs/misc/R42927.pdf.

Corporate executives generally understand that if you hire unskilled labor or do not invest in employee training, or purchase sub-standard materials, the corporation and its product will suffer as a result. The same holds true with respect to taxes—you do get what you pay for. A nonnegotiable premise for any productive discussion on ending BEPS should be that, as the learned American Supreme Court Justice Oliver Wendell Holmes Jr. said, taxes are "the price we pay for a civilized society," to which corporations have an obligation to contribute.

Sincerely,

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