ICRICT

Independent Commission for the Reform of International Corporate Taxation

INTERNATIONAL CORPORATE TAX REFORM:

Towards a fair and comprehensive solution

ABOUT ICRICT

The Independent Commission for the Reform of International Corporate Taxation aims to promote the international corporate tax reform debate through a wider and more inclusive discussion of international tax rules than is possible through any other existing forum; to consider reforms from a perspective of public interest rather than national advantage; and to seek fair, effective and sustainable tax solutions for development.

ICRICT was initiated and is supported by a coalition of the following civil society and labor organizations: Action Aid, Alliance-Sud, the Arab NGO Network for Development, the Center for Economic and Social Rights, Christian Aid, the Council for Global Unions, the Global Alliance for Tax Justice, Oxfam, Public Services International, Tax Justice Network, South Center, Canadians For Tax Fairness and the World Council of Churches. The creation and work of ICRICT is supported by Friedrich-Ebert-Stiftung, The Joffe Charitable Trust, The American Assembly, The Network for Social Change, Friends Provident and The Andrew Wainwright Reform Trust.

For more information, visit the ICRICT website at icrict.com.

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EXECUTIVE SUMMARY

• A comprehensive reform of the international corporate taxation system is now seven years in the making. The efforts to reform have continued, largely due to political and civil society pressures, and an acknowledgment that the outcomes so far have only patched up existing rules.

• A fair and comprehensive reform should result in an international tax system that is simpler, easier to administer, more efficient and more equitable. Any reform actions taken now should be the first step towards taxing multinational corporations (MNEs) as single and unified firms, using formulary apportionment based upon objective factors.

• Current OECD proposals move “beyond the arm’s length principle” and focus on the allocation of the global profits of MNEs, but they fall short of explicitly adopting a unitary enterprise principle advocated by ICRICT, many developing countries (led by the G24 of developing countries) and civil society. The acceptance that it is global profits of MNEs which should be apportioned shows real progress, together with the ambition to stem the race to the bottom in tax competition by providing a floor with a global minimum tax, which in our view should be 25%.

• However, real concerns remain as to the extent of the current reform process and whether it will be watered down by pressures from MNEs and some governments and political compromises. In particular, we are concerned about the proposal to separate “routine” and “residual” profits and make only the latter subject to formulary apportionment, as well as the proposal to rely only on sales for determining the distribution of taxable profits.

• Whilst the institutional framework has been made more inclusive, the credibility of OECD as the appropriate body to continue to lead this work remains in question. Despite the creation of the “Inclusive Framework”, much still needs to be done to ensure effective participation and representation of developing countries.

• We await with interest the outcome of the ongoing negotiations, but as a Commission we do not regard the likely outcome in 2020 as an end point, but rather as the first step towards creating a genuinely fair international tax architecture, which will require multilateral discussions extending well beyond current process and involving the United Nations system, because it is the only forum where all countries are represented.

1. THE PRESENT SITUATION

The negotiations to reform the international tax system have reached a crucial conjuncture. It is now agreed by the G20 that comprehensive reform is needed and with strong leadership it is now possible. The Programme of Work[1] published in May 2019 by the OECD Inclusive Framework on BEPS ("Inclusive Framework") outlined work to develop a consensus solution on the key elements of the system, such as new rules for the allocation of income of MNEs and a template for a global anti-base erosion tax. A consensus solution is expected to be agreed by the end of 2020.

2. THE POLITICS OF TAX REFORM

Addressing global challenges such as rising inequality, climate change and forced migration requires a community of well-funded States willing to collaborate effectively. There will be no sustainable solutions to these challenges without fairer global tax rules.

Corporate taxation is one of the most important tools in addressing inequality; and tax avoidance by multinationals further increases income inequality, as corporate equity mostly belongs directly or indirectly (e.g. through investment funds) to wealthy individuals who receive profit income through dividends and capital gains.

Since the beginning of the process, the international community has been promised comprehensive and effective solutions, but so far reform proposals have fallen short of expectations.

Whilst the recent shift in the OECD analysis of the associated issues is positive and there is strong support for real reform by a number of countries, concerns that this process is going to lead, once again, to watered-down solutions remain. There is broad evidence of the need for fundamental reform, but the political will to move forward is essential.

Global reforms require effective collaboration among all States beyond immediate national self-interest. Unfortunately, individual governments' negotiating positions sometimes look primarily to the likely tax revenue impact of the new proposals and the protection of their own multinationals or preferential tax regimes.

We believe that addressing the complex global challenges that the world is confronted with today require visionary decisions that put national self-interest aside, and prioritise collective efforts to stop the race to the bottom in tax competition. Governments should move towards a sustainable international tax system that will benefit both developing and advanced economies in the long run.

3. THE ICRICT PERSPECTIVE

Multinationals operate through centrally managed business models, whereby their high global profit margins are due in a significant part to the integration of their activities across jurisdictions.

Most of the world trade takes place within multinational groups and it is therefore impossible to establish meaningful and unambiguous arm's length prices to value transactions among firms that are part of a multinational group. Such fictional prices are at the core of the current transfer pricing system, and as we note, will continue under some of the main proposals

[1]https://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.htm

currently being considered. In practice, the current international tax system gives MNEs too much discretion to allocate profits to low tax jurisdictions and thus minimise their tax payments – opportunities that are not available to domestic firms, particularly SMEs, which thus pay higher effective corporate tax rates in their home jurisdiction.

As a Commission, since 2015, we have called for a new approach that would "reject the artifice that a corporation's subsidiaries and branches are separate entities entitled to separate treatment under tax law, and instead recognize that multinational corporations act as single firms conducting business activities across international borders," leading to the proposal for "a system of taxing multinational corporations as single and unified firms, using formulary apportionment based upon objective factors, such as sales and employment".

Different allocation formulae (i.e., choice of factors and weighting) could be developed for broad sectors of the economy (e.g., manufacturing, services, extractive industries) to recognise the principle that different supply and demand factors interact in creating MNEs' global profits (e.g. sales, employees, capital, natural resources) but distinctions and carve-outs should be kept to a minimum to reduce complexities and opportunities for tax avoidance.

We have also proposed measures to curb tax competition[2] and the race to the bottom in corporate taxation, in particular "agreeing on a minimum corporate tax rate".

We are convinced that a system of multi-factor formulary apportionment, together with a global minimum corporate tax rate would be the best way forward. Recognising the need for transitional measures, any current reform should lead in this direction.

We have furthermore underlined the inadequate accountability and lack of legitimacy of the current institutional framework, calling for discussions over creating the appropriate framework for international taxation to be brought under the aegis of the United Nations.

4. OUR VIEWS ON DESIRABLE OUTCOMES

We welcome the acceptance by the Inclusive Framework of the principle that MNEs are global unitary businesses, and that the allocation of profits should begin from the MNEs' global consolidated accounts, hence adopting a unitary approach. We also welcome the move towards formulaic approaches to allocate MNEs' profits between countries and the introduction of a global minimum tax to stop profit shifting to MNEs' subsidiaries subject to low or no taxation.

However, the outcome of the negotiations should be judged on whether it moves away from the current obsolete and dysfunctional system towards a system that is:

- **Simpler:** revisions to the system should simplify it so as to drastically limit tax avoidance opportunities and ensure that tax authorities can protect the tax base from artificial profit shifting;

- **Easier to administer:** revisions should reduce compliance costs for multinationals and audit costs for tax authorities and provide multinationals with tax certainty;

- **More efficient:** revisions should reduce distortions on where economic activities take place and where these activities are said to have taken place.

[2] https://www.icrict.com/icrict-documentsfour-ways-to-tackle

• **More equitable:** the allocation of multinationals' profits between jurisdictions for taxation purposes is a fundamentally distributive task; revisions to the rules will result in redistribution of taxing rights, and this should take into account the impact on both developed and developing countries, their relative contribution to the global economy and their fiscal needs.

Solutions must be comprehensive and not be limited to the digital economy, since all firms (multinational and national) increasingly use digital technologies as an integral part of their business practices.

We acknowledge that a number of developed countries are also calling for "tax certainty" (i.e. mandatory arbitration or other dispute resolution mechanism) to be a condition for a redistribution of taxing rights towards developing countries. We believe that developing countries should not accept stricter and asymmetric dispute resolution mechanisms as a condition for consensus to be found. The real need is for rules which are fairer, clearer and easier to administer, to reduce the scope for conflict, and for efficient and fair systems of dispute resolution which are in accordance with twenty-first century principles of justice. Deficiencies in prevailing systems of arbitration have been widely discussed, and the creation of a global system for the resolution of tax disputes should be the subject of a separate set of discussions.

5. OUR ANALYSIS OF THE CURRENT PROPOSALS

Negotiations are ongoing within the Inclusive Framework to develop new rules for the allocation of income of MNEs and a template for a global anti-base erosion tax.

In our view, the outcome of this negotiation should result in a new set of rules that is applicable to most if not all MNEs, so any revenue threshold applied for firms to be covered by the new rules should be set at a relatively low level.

A new approach to allocate the income of MNEs is being proposed, which would keep the existing transfer pricing in place to determine locally-generated profits (so called "routine profits") taxable locally, and then allocate a fraction of the remaining global profits of the MNE (so called "residual profits") through a formula.

We reject the approach of separating "residual" from "routine" profits on three grounds:

1) It is not possible to distinguish conceptually between residual or routine profits of a MNE, as profits are essentially the result of the global activities of the firm. In empirical terms, it also difficult to differentiate them in a meaningful way, as is evidenced by the radically different definitions proposed by the OECD and the IMF.

2) In a well-designed corporate tax system the cost of capital is fully costed (with often more than economically justifiable deductions for depreciation and interest), so that only excess "pure" profits (i.e., economic rents) are taxed and thus that there is no disincentive to enterprise investment and sustainable growth.

3) Existing transfer pricing rules are not fit to determine "routine profits", as demonstrated by the large number of associated tax disputes.

Under the new approach under consideration by the OECD, part of the identified "residual" profit will be reallocated in proportion to where the MNE has final sales. Choosing to allocate taxing rights by reference to sales alone would create winners and losers both between developed and developing countries, and disadvantage countries with relatively small domestic markets, or those with substantial exports, particularly of natural resources and tourism. As rich countries consume more, allocation of profits by sales only is likely to result in an unequitable distribution between countries, in favour of developed countries.

We support the **much simpler** allocation of MNE income that would take place under the proposal which was put forward by the Intergovernmental Group of Twenty-Four (G24) of developing countries for fractional apportionment, as this would allocate all profits through the use of a **balanced** formula (including employment in particular, as well as the use of natural resources), which would reflect value generating economic activities along the supply chain of MNEs.

We also support the current proposal for a global anti-base erosion tax. In our view, an effective global minimum tax should:

1) Be set at an agreed minimum rate of 25%. We are concerned by the possibility of a much lower minimum effective corporate tax rate becoming the international benchmark which would effectively incentivise a "race to the minimum". Developing countries, which rely relatively more on corporate tax income as a source of government revenues, would be the main losers from such a trend, as would SMEs in developed countries, which will still pay the full rate. The 25% figures is determined by the current corporate average tax rate in G7 countries[3]**.**

2) Be applied on a country by country basis and allowing for blending[4] of the tax paid at the jurisdictional level only (allowing countries to offer incentives for economic development in special zones or regions, provided the MNE's effective tax rate in the country overall exceeds the minimum), without allowing for global blending (which would allow MNEs to offset high tax in some countries by shifting some income to low-tax jurisdictions).

3) Not include carve-outs for incentive regimes (e.g. Patent Box regimes), as it is recognised by the OECD Inclusive Framework that carve-outs "would undermine the policy intent and effectiveness of the proposal".

6. GOVERNANCE

The OECD has expressed its commitment to a responsible, effective, and inclusive multilateralism[5]. This commitment should be understood in the context of States' obligation to contribute towards creating an international environment that enables the fulfilment of human rights.

The 2015 Addis Ababa Action Agenda[6] emphasized the importance of international tax cooperation which should "be universal in approach and scope and should fully take into account the different needs and capacities of all countries".

[3]https://ec.europa.eu/taxation_customs/sites/taxation/files/communication_taxation_digital_single_market_en.pdf p6 and https://ecipe.org/wp-content/uploads/2019/02/Corporate-Tax-Out-of-Control.pdf p32
[4]Blending refers to the ability of taxpayers to mix high-tax and low-tax income to arrive at a blended rate of tax on income that is above the minimum rate.
[5]http://www.oecd.org/france/achieving-responsible-effective-and-inclusive-multilateralism-paris-september-2018.htm and http://www.oecd.org/tax/beps/flyer-inclusive-framework-on-beps.pdf
[6]https://www.un.org/esa/ffd/wp-content/uploads/2015/08/AAAA_Outcome.pdf

The context for the continuing work in the BEPS project has expanded through the creation of the Inclusive Framework. This now has 134 members, a majority from developing countries. Formally, all members of the Inclusive Framework participate on an equal footing. In practice, this is far from true. Firstly, the Inclusive Framework is serviced by the OECD secretariat, recruited only from OECD countries. Secondly, effective participation requires considerable resources, creating a great imbalance between members. The pace of the negotiations and the pressure to reach a deal within a short timeframe further exacerbate this imbalance. Finally, there is an inevitable disparity in the bargaining power of countries, based on their economic and political weight.

Developing countries must be equal participants in the development of the rules of international taxation and not mere participants in processes where their views are sought merely for the appearance of broad consultation. This can only truly be possible in a space which allows equal and effective participation for all countries, including the poorest.

Discussions towards creating a global tax body within the United Nations (UN) should continue, as international norm setting is only legitimate in a democratic multilateral space, and only the UN can provide this. But for the moment, Inclusive Framework members should take the claim of fair representation and hold the OECD to account for it.

An outcome that does not have broad and deep buy-in by all segments of the global community, including developing countries and labour, will result in an illegitimate outcome that will not resolve the ongoing injustices of the global corporate tax system and will lead to further pressure for unilateral solutions and ultimately the undermining of the OECD's legitimacy in its claims to be the leading body setting norms for international taxation.

CONCLUSIONS

Resistance to a move towards unitary taxation of the global profits of multinational enterprises is starting to wane. However, the fast pace of the reform process and the pressure to reach a consensus means that the risk of unsatisfactory solutions is high, whilst issues of governance and full representation remain unanswered.

Whether what is ultimately agreed by the G20 is a success or not will depend on whether the reform meets the key tests laid out in this paper, and results in a new international tax system that is **simpler, easier to administer, more efficient and more equitable**.

We await with interest the outcome of these negotiations. However, as a Commission we do not regard the likely outcome in 2020 as an end point, but rather as the first step towards creating a genuinely fair international fiscal architecture which will require multilateral discussions extending well beyond the current process and involving the United Nations system.

ICRICT COMMISSIONERS

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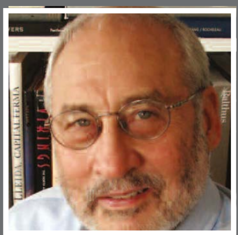

Mr. Joseph Stiglitz, is University Professor at Columbia University. In 2001, he was awarded the Nobel Memorial Prize in Economics.

Kim S. Jacinto Henares, is an International Consultant, served as the Commissioner of the Philippines Bureau of Internal Revenue and represented her country on the OECD Global Forum on Transparency and Exchange of Information and OECD Global Forum on Base Erosion and Profit Shifting.

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Ricardo Martner, is now an independent economist, after serving in the United Nations for more than 30 years. As Chief of the Fiscal Affairs Unit of ECLAC, he was in charge of the discussion of the Addis Ababa Action Agenda in Latin American and Caribbean Countries.

Wayne Swan, served as the Treasurer of Australia (2007-2013) including three years as Deputy Prime Minister.

Ms. Eva Joly, former Member of the European Parliament (2009-2019) where she served as Vice-Chair of the Special Committee on Tax rulings.

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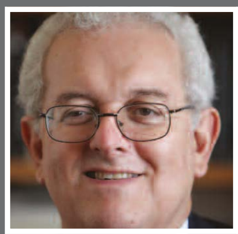

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