



ICRICT

Independent Commission for the Reform
of International Corporate Taxation



**A ROADMAP TO IMPROVE RULES
FOR TAXING MULTINATIONALS**

**A FAIRER FUTURE
FOR GLOBAL TAXATION**



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 has been established by a broad coalition of civil society and labor organizations including Action Aid, Alliance Sud, Christian Aid, the Council of Global Unions, the Global Alliance for Tax Justice, Oxfam, Public Services International, Tax Justice Network and the World Council of Churches. ICRICT is supported by Friedrich-Ebert-Stiftung and by the Ford Foundation.

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INTRODUCTION

We came together as the Independent Commission for the Reform of International Corporate Taxation in March 2015 to consider ways to reorient the existing system of international taxation away from serving the wealthy few and to focus it instead on addressing the needs of the vast majority of the population, in particular those living in poverty, the vulnerable and the marginalized.

A dysfunctional international taxation system has allowed Multinational Enterprises (MNEs) to avoid bearing their fair share of taxation, with severe consequences in countries where essential public services and infrastructure spending are cut, and the tax burden is shifted onto ordinary citizens, usually in the form of regressive consumption taxes such as value-added taxes (VAT).

Our aim was to promote a wider and more inclusive discussion, which we believe is essential to ensure the creation of an international tax system that contributes to funding sustainable development.

The existing system of international taxation has been exploited by MNEs to shift large portions of their overall profits to low tax jurisdictions. This system has further exacerbated tax competition, by pressuring countries into lowering tax rates. While there have been multiple global agreements to avoid double taxation of MNEs' profits, the transfer price rules used by these agreements

have been unsuccessful in avoiding the erosion of the tax base and ensuring that profits are taxed where the substantive economic activities of the MNEs actually take place. These agreements have also failed to find a common ground to avoid a race to the bottom.

Having taken into account the views of MNEs and their stakeholders, we called for a wider and more inclusive discussion of measures to reform the rules governing taxation of global profits of these enterprises, in our initial Declaration (2015), in our evaluation of the OECD's Base Erosion and Profit Shifting ("BEPS") initiative (2015) and in our report on Four Ways to Tackle Tax Competition (2016). In this paper we take stock of the state of reform efforts and outline a path ahead.

In 2012, when the G20 called on the OECD to reform the international corporate tax system through the BEPS initiative, it asked for a thorough reexamination of rules on international corporate taxation with the twin goals of instilling greater transparency and

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ensuring that profits are taxed where economic activities occur, so enabling developing countries to enhance their revenue capacity, as mobilizing domestic resources is critical to financing their development. As a result of this initiative, the OECD has taken some steps in the right direction but much more needs to be done to address the core deficiencies of the existing system for taxing MNEs' corporate profits.

The template for country-by-country reporting is a major step forward. Country by country reporting can play an important role in ensuring that profits are declared and taxes are paid where each MNE has a real economic presence. By making the basic relevant information openly available, country-by-country reporting has the potential

of allowing governments and members of the public to identify misalignment of profits in relation to actual economic activity. For these reasons, we consider critical that the threshold for country-by-country reporting be lowered to apply to a large majority of MNEs and that these reports be made public. If properly implemented, the information would benefit not just tax administrators but also civil society and other stakeholders (e.g. shareholders, investors, regulators) in monitoring whether income and corporation tax are aligned with the location of economic activities. However, we regret that the arrangements for access to this information, especially by developing countries, are still inadequate. We are convinced that the most effective solution would be open publication of these reports.

Unfortunately, we are of the view that until now the OECD's proposals provide only a patch-up of existing failed approaches and have failed to address the more fundamental issue of profit shifting that was part of the mandate for reform. In particular, the revisions to transfer pricing rules continue to cling to the underlying fiction that a MNE consists of separate independent entities transacting with each other at arm's length. The transfer pricing rules attempt to construct prices for the transactions among entities that are part of MNEs as if they were independent, which is inconsistent with the economic reality of a modern-day MNE—a unified firm organized to reap the benefits of integration across jurisdictions. Large MNEs are oligopolies, and in practice there are no truly comparable independent local firms that can serve as benchmarks.

The OECD reform proposals, while helpful at the margins, do not help resolve the basic challenge of ensuring that MNEs pay taxes where they have real economic activities take place and create value. They still provide too much opportunity for profit shifting, especially through the exploitation of intangible assets (intellectual property, trademarks, etc.). This is an issue for both developing and advanced countries, but so far tax rules have prioritized the perspective

of advanced countries which are the homes of MNEs. This is a major reason why they have failed to ensure that profits are taxed where activities take place (at the “source”), in favour of where the companies that receive income are based (in the country of “residence”), which can easily be manipulated.

We therefore reiterate our call for a paradigm shift in formulating rules for taxing MNEs. If national taxing authorities and multilateral institutions truly wish to stop BEPS, they must abandon the fiction that a MNE is made of separate independent entities and can use transfer prices to determine profit allocation and instead move towards a unitary taxation approach. To contribute to such a change in practice, we have evaluated a range of proposals and ideas, which are outlined here. Our general conclusion is that global formulary apportionment, coupled with a minimum corporate tax rate, would be the most effective and fairest version of unitary taxation. Acknowledging the scale of the challenge in such a move, and to support the reorientation of the rules towards this goal, we also endorse some more immediate options for improvement, especially for developing countries.

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APPROACHES TO UNITARY TAXATION

True reform would begin with confronting the reality that modern-day MNEs are unified and highly integrated group of entities that are under single control and have a single set of owners. That means jettisoning separate-entity taxation of MNEs and the use of

transfer pricing rules to determine profit allocation in favour of taxing them as unitary firms. With the help of a range of specialists, at the Commission we have examined and evaluated three such approaches:

(a) worldwide residence-based taxation,



(b) destination-based cash-flow tax, and



(c) formulary apportionment.



While each has advantage and drawbacks, in our view the fairest and most effective approach would be unitary taxation with formulary apportionment.

A unitary approach should apportion the MNE's global income to the different jurisdictions based on objectively verifiable factors rather than resort to the fiction of arm's-length transactions or that one could possibly calculate what arm's-length prices might look like.

These factors, such as employment, sales, resources used, fixed assets, etc., should be

chosen to reflect the MNE's real economic activity in each jurisdiction. Just as important, these factors cannot be easily moved around the group to avoid taxation. Relocating employees to a low-tax jurisdiction involves much more than transferring intangible assets to a letterbox company in such a jurisdiction, and a firm has even less power over the location of its customers.

Furthermore, these objective factors reflect in different ways actual economic activity, while the separate entity principle and transfer pricing rules enable profit shifting to MNE's entities lacking economic activities.

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We are aware of the two major criticisms which are frequently made of formulary apportionment: first that states could not agree on a formula, and secondly that the enterprise could still play jurisdictions against one another, by focusing on the factors in the formula.

In the Commission's view, both these arguments overlook the point that, in choosing a suitable formula and the corporate tax rate, states would need to take into account interacting factors: not only the tax revenue it would produce, but also the effects on inward investment. This creates a basis for compromise and convergence between states.

Whilst the sales factor in the formula cannot be manipulated, apportioning profits according to other measures of economic activity, such as employees and assets, may affect inward investment. This may pressure countries to veer towards single factor (sales) formulary apportionment. However, sales based apportionment may limit the tax base of developing countries, where much income is generated by asset- and labor-intensive activities. A suitable formula will, therefore, need to reflect the different needs of, and be negotiated by, both advanced and developing countries.

Unitary taxation with formulary apportionment would establish a much clearer, more effective, and fairer method of allocating the tax base of MNEs. Whilst formulary apportionment will effectively eliminate profit shifting, countries will still be able to compete against each other by lowering the corporate tax rate to incentivise investment or

the relocation of activities – pressures which are, of course, also present in the current system. It is therefore important to avoid a position where a move to formulary apportionment further exacerbates the race to the bottom in corporate tax rates.

To forestall this competition and the resultant distortionary effects, global formulary apportionment should be accompanied by an

agreed minimum rate for taxing all apportioned profits. At the Commission we believe that such a system of multi-factor global formulary apportionment, together with a minimum corporate tax rate, offers the best method of ensuring that source countries where the activities generating MNE's profits take place receive their fair share of tax revenues from these profits.

OTHER APPROACHES

As already indicated, the Commission evaluated two other approaches which also entail unitary taxation: residence-based worldwide taxation (RBWT); and a destination-based cash flow tax (DBCFT). However, we concluded that they are both inadequate.

Under RBWT, the home country of a MNE would tax the enterprise's global profits, but with full credit for foreign income taxes paid. Thus, instead of apportioning the MNE's profits to different jurisdictions, RBWT allocates the rights to tax those profits among the jurisdictions. It gives the initial right to tax to the source jurisdiction, retaining ultimate taxing rights (net of credits due for foreign taxed paid) for the country of residence of the

MNE's parent company. This has the advantage of removing the temptation for source countries to offer tax incentives to attract investment, since the profits would anyway be taxed in the parent's jurisdiction. However, RBWT is unlikely to be of benefit to developing countries, where fewer MNEs parent companies are resident.

Furthermore, RBWT's critical tax consequences would depend on identifying the residence jurisdiction. Regrettably, however, no matter how the jurisdiction of residence is defined, that definition would remain subject to manipulation. Focusing on the place of incorporation would be futile, as corporate charters are easily relocated. Some have

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suggested looking through to ultimate owners, by defining residence on the basis of the majority of shareholders. This would require reliable and regularly updated share registers. Even this may not help much, as financial derivatives would allow individuals to renounce nominal ownership while continuing to receive the economic benefits. This would make it easy for MNEs to relocate their home jurisdiction (or “invert”) to one which offers a low tax rate.

In our view, the manipulability of the definition of the residence jurisdiction, which is central to an RBWT regime, is a fatal flaw when it comes to taxing MNEs. But residence should continue to be the linchpin of a system for taxing individuals. And for that purpose, the Commission encourages reinforcing the definition of residency and adopting other measures to deter opportunistically timed moves to tax haven jurisdictions, and the abuse of corporate vehicles by individuals. One model is the US

“exit tax,” which is imposed on individuals renouncing their residency and which values their worldwide asset holdings at current market prices.

A DBCFT would tax the MNE’s global profits in the country where sales to the MNE’s ultimate customers take place, after allowing immediate expensing of all cash outlays, including capital investments and labor costs. It would be economically equivalent to a subtraction-method value added tax with deduction of payroll expenses. Proposals for such an approach were put forward in the US in 2016, and extensively debated in the first part of 2017, but have now been rejected, due to a number of drawbacks.

First, it would raise difficult practical questions of taxing a MNE with little or no physical presence in the jurisdiction, so effective collection would need cooperation between states. Furthermore, disallowing deduction of foreign production costs (the border adjustment) would likely be treated



as protectionism under the rules of the World Trade Organization, leading to trade wars.

Finally, developing countries with small consumer markets, especially those relying on exports of mineral resources, would raise little revenue through DBCFT as exports would not be taxable and profits will only be taxed in the

country where sales to the exporting MNE's ultimate customers take place.

We believe that these unattractive consequences also disqualify the DBCFT as a feasible alternative to global formulary apportionment with a minimum tax rate.

STEPS ALONG THE ROAD

While a system of formulary apportionment is the long-term aim, we are convinced that additional measures can be adopted in the short term leading in this direction. Such reforms can move the current system away from the dysfunctional independent entity principle and use of transfer pricing rules, and realign the rules to treating MNEs according to the economic reality that they operate as unitary enterprises.

The EU draft legislation on the common consolidated corporate tax base (CCCTB) is at present the best move in the right direction. It would provide multi-factor formulary apportionment of the combined income of a commonly controlled group, although only within the EU. ICRICT therefore strongly supports this initiative. However, we believe the EU should adopt an approach that prevents the shifting of profits outside the EU.

The Commission also supports approaches for allocating income to a MNE's operating subsidiaries without the need for a search for so-called comparable transactions used to test

the arm's length nature of transactions between MNE's affiliates.

One approach that rejects the pursuit of mythical "arms-length comparables" is the profit-split method, which the OECD has accepted since 1995. This method apportions the combined profits of relevant related affiliates of the MNE, based on "allocation keys" which reflect each entity's contribution to the generation of profit, albeit at a transaction-level rather than at an entity-level. Work is still continuing on this method as part of the BEPS project, and we recommend that it should be systematized and extended.

Another alternative has been proposed, described as the shared net margin method. This would simply ascribe to a MNE's local affiliate a net profit rate set as an appropriate fraction of the global net profit rate of the corporate group as a whole. The method assumes, quite reasonably, that a MNE is unlikely to try to understate its global profitability in its consolidated accounts, as that would put it at a disadvantage in the capital markets. The benchmark fraction of the

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group’s net profitability percentage which the local affiliate would be required to earn would be set to ensure meaningful, although still relatively modest, tax revenue for the source jurisdiction. Since the profit rate would be applied to earnings before interest, the tax base would not be eroded by means of intragroup loans.

Brazil currently applies a variant of this method, specifying different sets of rules for local affiliates to determine the maximum amounts of deductible expenses and the minimum amounts of taxable income, based on fixed gross margins according to the types of businesses or transaction. These rules minimize the need for subjective judgment and discretion, so they have proved easy to administer, and have resulted in a limited number of conflicts and court cases between MNEs and the Brazilian tax authority.

These are essentially methods for apportioning profits, opting for the simplicity of a fixed margin over the malleability of arm’s-length transfer pricing. They would provide a more effective approach especially for developing countries, where it would be a waste of scarce resources to try to develop the skills needed to apply other methods.

The Commission also proposes unilateral adoption of formulary apportionment as a backstop



to arm’s-length transfer pricing results. In the absence of global coordination and agreement, an individual country or region could consider implementing formulary

apportionment as part of a domestic alternative minimum tax regime. In such a regime, formulary apportionment would determine the income base for computing an alternative minimum corporation tax.

The country could define the local corporation tax base by applying a multi-factor formula to a MNE's global income, and compute the minimum tax payable on that apportioned income, for example at 80 percent of the regular corporation tax rate. The minimum tax would be payable if it exceeds the jurisdiction's regular corporation tax payable computed on the MNE's local income as determined under conventional arm's-length transfer pricing methods.

Such an alternative minimum tax regime could be enacted as domestic legislation without the need to repudiate existing multilateral agreements and commitments to the arm's-length principle, including the OECD transfer pricing guidelines. This would extend the concept of "safe harbors"

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accepted by the OECD, which are simplification measures that relieve eligible taxpayers from certain obligations otherwise imposed by general transfer pricing rules. It would be similar in effect to other unilateral anti-abuse measures, including the United Kingdom's diverted profits tax, that already serve as an adjunct to arm's-length transfer pricing.

We believe that unilaterally adopted, either as an anti-abuse rule or a safe harbor, profit apportionment methods can play an important role in ensuring that tax is paid where real economic activities take place.



INSTITUTIONAL FRAMEWORK

Since its establishment, at the Commission we have highlighted the urgent need to reorganize the institutional architecture for international taxation in the light of economic globalization. We believe that all countries should have a voice in reforming the international corporate tax system. The OECD should not be the only body where these discussions should take place. Not all countries have a seat at the table in the G20/OECD BEPS process. Moreover, the discussions in BEPS public consultation meetings have been dominated by multinational corporations, who consistently outnumber civil society, academic, labor, and country representatives combined, and are often doubly represented by their tax advisers and special industry groups in addition to corporate executives.

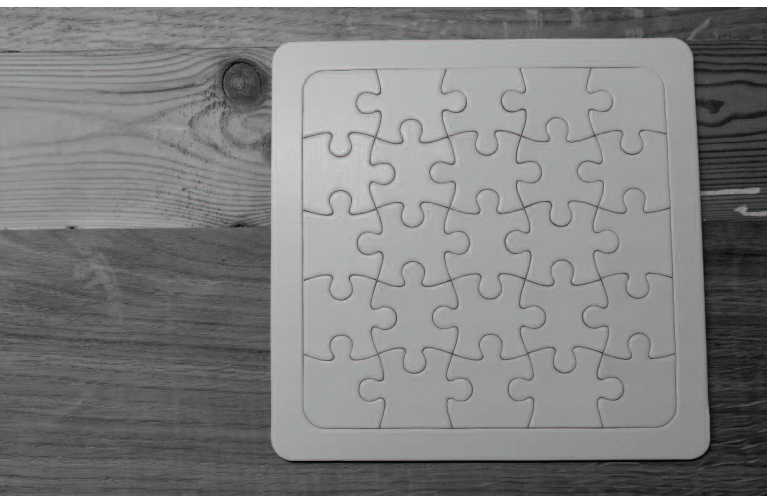
Hence, tax rules have prioritized the perspective of MNEs, and of advanced countries which are the homes of MNEs. This is a major reason why they have failed to ensure that profits are taxed at source, where activities take place, in favour of residence,

which can easily be manipulated. Only after widespread public pressure for reform did the OECD launch the BEPS project. It has sought legitimacy by obtaining support and participation from the G20 countries. And only after the main outputs were released, participation has now been offered to all states through the Inclusive Framework on BEPS and some cooperation with other relevant organizations, including the UN Committee, has now been established through the Platform for Collaboration on Tax.

This structure is disjointed and dysfunctional. It clearly falls far short of a truly global tax body, for which repeated calls have been made. Only the UN's universal membership and open and democratic structure can give full voice to the tax policymakers and the entire civil society from all countries. We therefore renew our call for international taxation to be brought under the aegis of the UN, which alone can provide the legitimacy for rules to coordinate such a central element in the sovereignty of all states.

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CONCLUSION



In directing the OECD to come up with an action plan against BEPS, the G20 leaders were responding to the groundswell of public sentiment in their countries against MNEs' dodging their fair share of taxes by attributing profits artificially to subsidiaries in tax haven jurisdictions. The outputs of the BEPS project so far have not really addressed the more fundamental issues of profit shifting that were part of its mandate.

As members of this Commission, with backgrounds in government, academia, and civil society from across the globe, we seek to be receptive to the voices of all MNE

stakeholders, including those who had prompted the BEPS project but ironically seemed shut out from it. Having heard from a wide cross-section of stakeholders and having analyzed the evidence, we renew our call to move away from arm's-length principle and towards a unitary approach to taxing MNEs. The fairest and most effective version of unitary taxation is multi-factor global formulary apportionment with a minimum corporate tax rate. We urge global leaders to adopt a roadmap towards this goal, including more short-term measures which would be more effective, easier to administer, and provide greater certainty, than the current defective methods.

The current system is feeding the historical levels of inequality, impeding the fulfillment of human rights, tearing away at the global social fabric and endangering future economic growth prospects. We are convinced that without a real global tax reform, the delivery of promises made in the 2030 Agenda for Sustainable Development will be severely compromised. The world's leaders now need to decide whether or not they signed up to those promises in good faith.

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ICRICT COMMISSIONERS



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Mr. José Antonio Ocampo (Chairperson) is Colombian and former United Nations Under-Secretary General and former Minister of Finance of Colombia. He is currently a Professor at Columbia University.



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