CENTRE FOR BUDGET AND GOVERNANCE ACCOUNT ABILITY
Interrogating Policies, Informing Debates

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Response from the Centre for Budget and Governance Accountability (CBGA) to the Consultation on an IMF 2019 Analysis of International Corporate Taxation

The Base Erosion and Profit Shifting (BEPS) international reform led by the G20 and the OECD clearly has made progress that would have been thought of as difficult just five years ago. That this pace of change has been possible is a strong indicator of the rise in public interest, and concern, in these matters and highlights the need to be even more ambitious.

While this reform has proposed some solutions for some of the most egregious tax avoidance mechanisms, it has failed to deal with the core mechanism of tax avoidance. The transfer pricing system and other tax avoidance mechanisms remain available to multinationals and are in fact incentivised and legitimised as a result of the BEPS process.

We believe that one of the biggest deficiencies of the BEPS process has been its inability to address the core problem of our global tax system[1]: the separate entity approach to taxation and transfer pricing. Nowhere is this more evident as in its inability to come to terms with the changes brought about by the digital economy, which is increasingly becoming the economy itself.

The reform of the international corporate tax system is at a critical juncture. The OECD has achieved what it could, within the constraints of its mandate, but has shied away from examination of the most fundamental problem. The OECD ongoing work on the digital economy exposes all the contradictions of transfer pricing to the extreme and demonstrates that it is no longer fit for purpose.

The international community is at a crossroads: continue to tinker at the edges with a broken system designed for the last century or look at solutions designed to fix the problems of this century and deliver a sustainable international tax architecture fit for purpose. The risk is that if we do not fix the current system then disenchantment with the global tax system will feed into the ever-growing distrust of global institutions and the rise of populist politics.

The current multinationals' tax avoidance structures are conceptually straight-forward: low profits are declared in high-tax jurisdictions, both in developed and developing countries, through the use of limited risk structures (e.g. limited risk distributors/manufacturers), excessive debt and deductions for intangibles, so that the balance of profits is attributed to intellectual property, funding and strategic functions/risks (e.g. global procurement, management, intellectual property related activities) in low tax jurisdictions. As IP and non-intensive labour functions can easily be relocated where it is most tax effective with the current system, multinationals can in practice decide how they distribute their profits across jurisdictions. A system that attributes the large share of its profits to the ownership of

[1] See the Kathmandu Declaration on Curbing Illicit Financial Flows: Restoring Justice for Human Rights

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intellectual property and the performance of certain functions/risks is also particularly detrimental to developing countries, which are not home to multinationals' headquarters and intellectual property.

The arm's length principle or the separate accounting principle to calculate transfer price is essentially flawed and we recommend moving away from this as a practice. **There is a need to discuss alternative measures like the formula apportionment method but these measures should not be decided upon without proper consultation with developing countries.**

Please refer to the report on A Fairer Future for Global Taxation for further reading.

A system of **multi-factor global formulary apportionment**, **together with a global effective minimum corporate tax rate**, is an alternative 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. A global effective minimum tax drastically reduces the financial incentives for multinationals to shift profits between jurisdictions and for countries to cut their tax rates.

The allocation of multinationals' profits between countries for taxation purposes is a fundamentally distributive task. Multinationals are unitary businesses making profits in a global marketplace, where profit can only be achieved through the integration of their activities across jurisdictions, and the value of the multinational as a whole is bigger than the sum of its individual parts.

A simple, formulaic approach would ensure that global profits and associated taxes could then be allocated according to objective factors such as the sales, employment, resources (and even digital users) used by the company in each country, rather than where they locate their different functions (procurement, marketing, funding, etc) and claim their Intellectual Property.

The use of the profit split method to allocate profits can be useful if the allocation factors used to split the profit are standardised and weighted consistently; else in our view it would create further opportunities for tax avoidance.

During the next phase of the BEPS process ("BEPS 2.0") we urge governments represented in the Inclusive Framework, the UN Tax Committee and all multilateral institutions, to move away from the current transfer pricing system and look for alternative solutions to discourage abusive transfer pricing practices. Furthermore, most developing countries do not have the policy space to shape international tax standards which affect them disproportionately. It is imperative that developing countries are heavily consulted with before the next phase of BEPS.

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We value the important role that the IMF can play in the step towards sustainable international tax architecture.

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