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CONSULTATION COMMENTS ON ECONOMIC SPILLOVERS IN INTERNATIONAL TAXATION

PWYP Norway on harmful effects of legal and illegal profit shifting

IMF has invited governments, civil society, academics and private sector stakeholders to comment on future analysis and research IMF may undertake on the subject of economic "spillovers" in international taxation. Economic "spillovers" in the meaning of the impact one country's choices in taxation may have on other countries, sometimes referred to as base erosion and profit shifting (BEPS)[1].

IMF has identified that there are broadly two sets of "spillover" issues that arise:

- The opportunities for *tax avoidance* (sometimes referred to as "base erosion and profit shifting") by multinational companies that are created by the interaction between national tax regimes and practices, and
- (illegal) *tax evasion* by high net wealth individuals using low-tax jurisdictions.

The current IMF work on which the consultation is being launched is said to relate to the first area.

Publish What You Pay Norway (PWYP Norway) are not able to see that such a distinction reflect our experience. There are numerous case situations in national court systems, findings in forensic accounting, findings in national tax authorities, findings in financial investigative authorities for investigation and prosecution, findings in journalistic work, findings in parliamentarian hearings, amongst others, that test

[1] *www.oecd.org/ctp/beps.htm*

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otherwise. The real life case experiences thus show that it is not only high net wealth individuals that are using low-tax jurisdictions through illegal tax evasion mechanisms.

Sadly, per today, it seems that the only instrument available for the government, on behalf of its citizens, and in the face of fragmented access to vital and necessary information, is to use the court systems to ask questions, for example on how costs have been calculated in order to try to establish a meaningful tax picture.

Court processes may drain national institutions for resources and may go on for decades. We have experiences from Norway indicating that it may take up to thirty years[2] in a court system, and the point being that still, after individuals have spent nearly a life time investigating and trying to establish the full puzzle picture, national authorities are left with questions unaddressed and most capital flows still unaccounted for.

Unfortunately, such concrete cases are not unique, but most often limited to countries that have the political and financial possibilities to try. Most countries would not stand a chance trying, and developing countries the least.

Hence, in order for the IMF to keep track of economic developments in countries and give guidance, such findings must be recognized and be an important focus that guide the IMFs further work.

On this basis, PWYP Norway would therefore recommend that the IMF should consider the following definition for future analysis of "spillover" issues that arise (and this way secure that the current IMF work can relate well to both areas):

- The opportunities for *tax avoidance* (sometimes referred to as "base erosion and profit shifting") by multinational companies that are created by the interaction between national tax regimes and practices, and
  (illegal) *tax evasion* by multinational companies through the use of combinations of tax mechanisms where the result would be illegal if done internally in one country or between two countries, but which is promoted as legal when low-tax jurisdictions are introduced as an additional country or in-between two or more countries with the sole purpose of saving tax at the expense of the country where an income originates (which could be referred to as "illegal base erosion and profit shifting"), to the detriment of other countries and investors.

PWYP Norway will for the following comments assume that both these situations are actually covered in what IMF has defined as *tax avoidance.*

PWYP Norway would recommend that the IMF recognize these worldwide cases and move towards the definition promoted by PWYP Norway. It is by now well established that there is also a massive *tax evasion* going on by multinational companies in addition to the *tax avoidance* identified in the definition by IMF. Even large audit firms have been time and again in court, and lost, with regards to helping multinational companies with tax evasion – and covering it up. The case of Arthur Andersen, once the most renowned audit firm in the world, helping Enron, at the time a large and much-admired multinational company, is just the tip of the iceberg. It is essentially impossible to use a

[2] *The Jahre case that took 30 years to resolve.*

definition that does not take into account also tax evasion (and downright criminal activity) done by multinational companies.

PWYP Norway is a national chapter in the worldwide network Publish What You Pay, which work for transparency and accountability in the extractive industries. While the Norwegian chapter is backed by 19 Norwegian civil society organizations, the full international network is backed by more than 800 organizations worldwide, most of them working in resource rich countries in the South.

In many countries in the world companies are not even required to publish what taxes they pay to governments in return for access to a country's finite natural resources. Although mechanisms now are in place in the USA and the EU, companies are still fighting such elementary transparency requirements, hindering investors, governments and citizens knowledge about what goes on in the company, what dividends are being paid and what comes into a country's treasury.

However, the situation in Norway is different. All companies in Norway have published what they pay in taxes for decades, and extractive companies have voluntarily published a form of extended country-by-country information since 2005. This demonstrates the significant contribution companies make to public finances both in our own country and where it operates around the world, but also that this information is not at all damaging to the companies. It is also an important contribution in fighting corruption and citizens can check that the government has control with its revenue streams. This builds trust both towards the company and the government (the opposite situation does not).

As a result of that we already know what comes into our treasure box in Norway. PWYP Norway have therefore prioritized knowledge production to identify where the leakages seem to take place and suggest concrete, targeted and practical mechanisms that can substantially reduce or hinder abuse. We have demonstrated, through a series of reports, how mechanisms in the North can be used to exploit countries in the South. Such mechanisms have now started to be more and more exposed also in countries in the North, which are not immune to this development.

PWYP Norway will in these comments discuss issues and promote solutions that we think ought to be integrated in IMF's analyses and also recommendations.

1. Background

In the words of a leader in The Economist March 15th-21st 2014:

- *"As in America at the turn of the 20th century, a new middle class is flexing its muscles, this time on a global scale. People want politicians who don't line their pockets, and tycoons who compete without favors. A revolution to save capitalism from the capitalists is under way".*
- *"*Rent-seeking *is what economists call a special type of money-making: the sort made possible by political connections. This can range from outright graft to a lack of competition, poor regulation, and the transfer of assets to firms at bargain prices."*
- *"In the emerging world, the past quarter-century has been great for rent-seekers"*

- *"Capitalism based on rent-seeking is not just unfair, but also bad for long-term growth."*

PWYP Norway can underscore the above summarization by The Economist, as the Publish What You Pay network was kick-started for this reason.

The issue at hand is this: the huge and short-term benefits to the few are essentially a theft from the many, both in this generation and in future generations. At best it can result in a long-term economic slowdown and more financial crises to come. At worst it may result in severely undermining the public sector even in previously stable countries by moving un-taxed revenues from countries over to low-tax (or no-tax) jurisdictions. This effectively creates a large number of free riders in the form of multinational companies who are seeking profits from resources and free markets, but are unwilling to pay their share. This is an unsustainable world that will lead to distress, conflict, nationalizations, war, and the loss of property, investments and life for businesses and citizens and forcing people to become refugee masses.

2. The issue

Of the rent-seeking methods mentioned by The Economist some are mainly used by the countries own politicians, like outright graft and the transfer of assets to firms at bargain prices which is normally done to internal companies that is connected to the establishment, and not to multi-national companies. This type of theft can only be dealt with by citizens demanding fair elections and the wider community communicating clearly how despicable it is to hold a whole country hostage for the only purpose of power and self-enrichment.

Multinational companies will mainly use varieties of arguments around lack of competition and poor regulation in order to legitimize their creation of legal and illegal base erosion and profit shifting. It is this last issue that IMF wants input on.

In the report "The Case for Windfall Taxes – a guide to optimal resource taxation"[3], PWYP Norway has summarized the issue as such with respect to the extractive industries, a sizeable portion of base erosion and profit shifting out of resource rich, but poor, countries and out of countries with markets where these products are being sold. The issue was summarized as follows:

> *"Due to lack of balanced government regulation,*
> *there exist today a situation where companies that use tax havens*
> *to reduce their tax burden through capital flight*
> *out of countries with resources or markets are*
> *effectively using monopolistic methods*
> *to create more wealth for themselves than their competitors.*
>
> *Through capital flight techniques, these companies*
> *are creating a situation where they can*

[3] A briefing of the report is attached to this letter for the benefit of the reader.

takeover or outcompete their competitors
due to that they have higher cash flows than these competitors.

This creates a form of competition
that undermines the entire funding of the public sector
to do its job of providing public goods,
effectively creating instability in capitalism
that puts investors and private citizens money and life at risk
through loss of profits, capital, wealth and security".

Is this an overstatement? On May 21st 2013 the European Commission President Jose-Manuel Barroso in a speech at the European Parliament on estimate of tax evasion in Europe said:

> *"The total loss of revenue due to illegal fraud and unacceptable evasion is estimated to be around one trillion euros [1000 billion Euros] a year. Let's put that into some perspective: one trillion euros is nearly double the 2012 combined annual budget deficit of all the Member States."*

This is the effect of illegal fraud and unacceptable tax evasion in EU alone, and other estimates for EU are higher. This is related to all industries, not only extractive industries, which have a lower share in base erosion and profit shifting in developed countries than in developing countries.

In the same report PWYP Norway identified that the discrepancy between taxes and expenditures in the world has been increasing at a galloping pace since the year 2000. This is a highly unsustainable und unstable situation, and has to be reined in by the international community, including through both the acknowledgement of such a situation by everybody and in the guidance from institutions like the IMF and the OECD. An informed position, concluding in a decision not to act on this situation would be to willingly let the world decline into a very fatal state of affairs.

Table 1: Growing wedge between taxes and expenditure:

Billions USD	1995	2000	2005	2010	2012
World GDP	29 991	32 745	46 539	65 141	79 138
Taxes	4 388	4 714	6 562	8 319	18 821
Expenditures	5 063	5 331	7 953	11 556	28 656
Undercoverage	- 675	- 617	-1391	-3237	-9835

Sources: 2012 The Heritage Foundation, all other years World Bank statistics.

What is significant to recognize is that it is not only resource rich, but poor, countries in the South that suffers, and the suffering is not even restricted to the countries in the North with large buying power which creates the markets for many of the multinational companies (the US, the EU, China, Japan). The investors themselves who have invested their funds in the multinational companies are suffering, as the cash in the multinational companies to a greater and greater extent is stashed away in and invested out from low-tax (or no-tax) jurisdictions. This fact creates the paradoxical situation that cash-rich companies need to lend money (!) in order to pay out dividends to their investors. This need for lending money to pay dividends puts a downward pressure on the maximum dividend a company will pay out to its investors. Investors are thus not receiving their

fully entitled economic effects from the companies they are invested in, and investors are thus not at full liberty to perform their role in having the capital markets (investors) decide which industries and which companies within each industry that they want to support at any given time. A market failure is thus created in the capital markets that are dangerous to the very fabric of society of today.

Today's international tax system is therefore in dire need of a major overhaul, and not only some minor tweaking to fix the smaller issues, leaving the big holes open. As so eloquently said in the consultation release: *"The current set of national laws and practices potentially affect macroeconomic outcomes in terms of tax revenues, the level and direction of investment flows, and incentives to adjust national systems in response to the decision of others."* PWYP Norway thus welcomes the opportunity to provide comments to the IMF on these issues.

3. Premises for the issue and the comments from PWYP Norway

The basic premise is that we need a sustainable world for unlimited generations.

In order for the world to be sustainable it needs the most efficient use of its resources, and in particular of its non-renewable and finite resources, which has a huge environmental cost to exploit. The economic system that many seems to think that provides the best model for efficient use of resources is equal competition; equal competition in accessing resources most efficiently and equal competition in transforming these resources into goods and services and distributing these goods and services to where they are needed (markets). Market failure is a concept within economic theory where the allocation of goods and services is not efficient. In other words, the social costs of producing the good or service (all of the opportunity costs of the input resources used in its creation) are not minimized, and this results in a waste of some resources. A sustainable world needs as little waste of resources as possible.

A sustainable world can be said to be dependent on three things: resources, markets and moderation. Without resources there will be no goods and services, without markets there will be no distribution and sales and thus no economic benefit but without moderation the worlds' resources are used too fast and create an unsustainable world.[4] A governments' main instrument to introduce moderation is to have higher value-added tax (VAT) on non-essential goods compared to essential goods like water and basic foods. We will in our consultation comments concentrate on resources and markets as these are the object of rent-seeking/economic spillovers/base erosion and profit shifting/capital flight.

Resources are either renewable or non-renewable natural resources, people or capital to help transform natural resources into goods, distribute goods and market goods and services to a market. Transformation of natural resources needs people, distribution of

[4] *The report from the UN climate panel, «Climate Change 2014: Impacts, Adaptation and Vulnerability», tells us that the world will be faced with enormous challenges with respect to warming of the planet, access to food and water, draught and refugee streams. National states and the world community will have to mobilize all their economic resources, including using VAT to introduce moderation on the use of the Earth's resources, to meet this future scenario.*

goods needs people and markets are people. The more people - the larger the market. Capital markets are dependent on people with money that they save or invest.

Tax revenues are needed to provide people or companies with public goods. A public good is a commodity or service that is provided without profit to all members of a society, including companies, usually by a government and sometimes by an organization. A person or a company can utilize a public good without the utilization affecting negatively other uses of the same public good except for possible timing effects.

Public goods are needed where there are people.

Tax revenues are therefore needed where there are people.

Tax revenues can only be levied on a person or a company that have positive revenues. Positive revenues go beyond minimum living costs for persons or the cost of doing business for companies.

The principle is therefore that
- countries which have resources that are desired in markets,
- countries that have people to transform resources to goods or
- countries that have markets where goods and services can be sold

are essentially the only places which can create positive revenues for people or companies (value creation). These countries should be allowed to collect tax revenues without unequal competition.

The logical conclusion is that taxation should happen in the country with value creation in order to fund the creation of public goods to the people in the same country without any efficiency losses to low- (or no-) tax jurisdictions. This will promote the most efficient use of resources and markets, and minimize the efficiency losses to for example low- (or no-) tax jurisdictions where there are minimal public goods needing funding.[5]

This has the consequence that ideas are worth nothing without resources and/or markets, and the concept of royalties and fees across border without them being based on value creation is generally not valid.

Typically the low- (or no-) tax is only for non-residents, an obvious sign that the regulation creates unequal competition. If such regulation creates unequal competition in the jurisdiction in question, if allowed for residents, then that regulation is also unequal competition outside of the jurisdiction in question.

As a general rule, a country should perhaps only need to respect rules in other countries that are equally applied to both residents and non-residents.

Unfortunately, this would still not be enough, though, as some of the low- (or no-) tax jurisdictions are effectively so small that they need next to nothing to sustain them. Hence, the above principle would thus effectively only take care of some of the larger states who functions like low-(or no-) tax jurisdictions for multinational companies. The

[5] *Low- (or no-) tax jurisdictions have for the most part very few people that needs public goods (examples are the English Channel islands, Caribbean Islands, Mauritius etc), or their public goods are fully financed internally in the country (examples are Switzerland, the Netherlands etc).*

next chapter will therefore address some of the major classes of (legal or illegal) base erosion and profit shifting.

4. The problems and the solutions

The problems and the solutions are so interlinked and intertwined that it is almost not possible to discuss the one without the other. We have therefore chosen to comment problems and solutions together. It is said in the consultation request that *"the IMF project is intended as far as possible the consequences of the existing ... international regime"* and that IMF is mainly *"interested in the outcomes for lower-income, developing countries in terms of tax revenues, underlying economic activities and international investment flows, and implications for countries' own tax systems"*. PWYP Norway will comment based on this approach.

A. Ways of handling royalties and other fees

In chapter 3 above we established that it is the ability to extract a resource, to transform it into goods, to distribute those goods and to provide goods and services to a market *in the most efficient way* that creates sustainable value. The fact that somebody has a trademark, a business concept or other intangible assets where they do not have access to resources or markets does not in itself generate value and does not in itself demand returns. Only when a trademark, a business concept of other intangible assets is *applied* in a country with resources or people (transformation of natural resources or markets) can value creation happen.

The Starbucks example:
Starbucks is a company amongst many other multinational companies that have entered the media picture due to its practice of reducing taxes through amongst other the use of low- (or no-) tax jurisdictions and royalties for the brand name and the business concept. As any other owner that sets up business in another country, the owner will get his/her return when after-tax dividends are paid. By allowing royalties to be deducted before tax a market failure is introduced, whereby a multinational company has the ability of combining the payment of royalties (or other deductible fees) with low- (or no) tax jurisdictions. The resulting lowered tax can be used to reduce prices and the competition is not equal anymore.

Based on the Starbucks example there can at least be three ways of dealing with royalties and other fees that create unequal competition:

- Royalties and fees can be disallowed for tax purposes (can be done unilaterally)
- Withholding taxes can be applied to royalties and fees (can be done unilaterally)
- Replace royalties and fees with the underlying cost, allowing for a proportionate deduction in many countries of the overhead cost associated with the concentration effect of multinational companies.

Disallowing royalties and fees are in essence not a sound concept, as there are some real costs behind these (which is why they have been allowed to enter tax calculations as deductions in the first place). The problem is that the royalties and fees may be extremely disproportionate relative to the real costs behind.

Replacing royalties and fees with a proportionate share of underlying (overhead) cost may solve the problem, but this is often a black box for the countries and tax administrations involved and thus not necessarily an ideal instrument for countries with weak tax administrations.

Applying withholding taxes on royalties and fees is however a concept that needs further investigation as this (1) places the taxation where the value is created (in the country which generates the positive revenue) and (2) can be introduced unilaterally by a country if done correctly.

We will thus investigate the use and calibration of withholding taxes in the next subchapter. This is because the application and level of withholding taxes on royalties and fees cannot be seen unrelated to the withholding taxes applied on dividends.

B. Bi-lateral tax treaties and the issue of withholding taxes

One outcome of bi-lateral agreements is the level of withholding taxes issued on dividends, relative to the level of withholding taxes issued on other inter-company monetary flows. Most countries have few withholding taxes on other inter-company flows than dividends and interests, and between most countries the rates have been negotiated down. This creates many different problems, not the least that it is more attractive for multinational companies to use other types of flows than dividends to get money out of a country when there is withholding tax on dividends but no withholding taxes on other types of monetary flows. The problem with this is that while dividends are after-tax cash flow, all other inter-company monetary cash flows are pre-tax and thus collectively part of capital flight (un-taxed flows) from these countries. Indiscriminate withholding tax on dividends is thus part of the problem and needs to be solved if leakage of pre-tax flows is going to be reduced significantly.

Multinational companies need one road that they can use to take money back to the home country, and that should be based on after-tax funds, i.e. through dividends.

Withholding taxes must thus be organized such that it is *more* attractive, not *less* attractive, to dividend money than to use other monetary flows, and this can only be the case if the withholding tax is less than other withholding taxes or, preferably, zero.

When there is withholding tax on dividends, multinational companies have incentives to minimize their original investment and use the revenue cash flow from the initial investment to investment more. If new investments are allowed to be deducted against previous investments' revenues (no ring fence), then new investments will delay tax payments to the country in question for years. Withholding tax on dividends is thus also a mechanism that *reduces* the flow of investment funds into the country by the individual company.

Most countries have organized their tax systems in such a way that the tax level of the other tax mechanisms are tailored at giving the level of government revenue that the authorities have targeted to fund the public sector and the level of services intended. Putting a tax on after-tax cash flows are thus an unnecessary mechanism, that in most

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cases have opposite effects than intended, which in most countries is to have the companies reuse their cash flows for further investments, which in most cases only delay tax payments.

While it is desirable to put the withholding tax as low as possible, or preferably at zero, the opposite is the case for other inter-company cost cash flows which is not based on reimbursement of identifiable cost items (interest payments higher than interest payments to external financiers, internal insurances over and above what is normal business practice, royalties, management fees, technical service fees etc). Even small percentages of pre-tax cash flows to such items will have a significant effect on the after-tax profits and the ability to pay taxes in the country in question.

Withholding tax on these elements, especially if withholding tax on dividends is put to zero, will make it attractive for multinational companies to use dividends as their preferred method to get after-tax cash flows out of a country in return for their investments. If there is no withholding tax on these elements, there will still be incentives to maximize these elements as these elements are then taken out of the country pre-tax, while dividends are always after-tax.

What is the correct level of withholding tax on these pre-tax inter-company cash flows? There is no set answer as tax levels differ in the countries in question. As a general rule the withholding tax should be built up using the following logic (%-ages to be determined by the individual country) in order to ensure that after-tax based dividends are always a preferred method of repatriation of funds compared to pre-tax inter-company cash flows:

50% of the corporate tax rate in the country[6]
+ 50% of the difference between the corporate tax rate in the country and the corporate tax rate in the receiving country (if lower)[7]
+ The level of withholding tax a country has on dividends[8]

Examples:

If a country's corporate tax level is 30%, and the receiving country's corporate tax is 10% (low-tax jurisdiction) and there is a 5% withholding tax on dividends, then the withholding tax on pre-tax inter-company cash flows would be:

30% * 50% + (30%-10%) * 50% + 5% = 15% + 10% + 5% = 30%

With the same example, but the receiving country's corporate tax rate is 0% (no-tax jurisdiction), but the country in question has designed its withholding tax rate to be 0%, then the withholding tax on pre-tax inter-company cash flows would be:

30% * 50% + (30%-0%) * 50% + 0% = 15% + 15% + 0% = 30%

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[6] *Corporate tax rates are converging towards 30% or lower. 50% of the corporate tax rate would thus mean that a withholding tax on pre-tax cash flows would thus be max 15%, which is the normal non-negotiated withholding tax rate in many countries.*

[7] *Towards countries with normal corporate tax levels, this element would result in zero or close to zero additional withholding tax. Towards countries with low- (or no-) tax, this element would increase the withholding tax significantly. This would eliminate the difference between countries, and would make it irrelevant whether an investment is done from the home country or through a tax haven.*

[8] *In order to keep the difference between withholding tax on dividends and other withholding taxes constant. This element should preferably be 0 as withholding taxes on dividends ought to be zero.*

If the receiving country on the other hand has the same tax rate as the country in question (normal tax jurisdiction) and the withholding tax on dividends is set to zero, then the withholding tax on pre-tax inter-company cash flows would be cut in half relative to a no-tax jurisdiction, allowing the receiving country half of the taxation rights:

30% * 50% + (30%-30%) * 50% + 0% = 15% + 0% + 0% = 15%.

There would thus be a clear difference whether the receiving country was a low-tax (or no-tax) jurisdiction or a "normal" tax jurisdiction with approximately the same tax level as the country in question. One thus avoids the downward spiral of negative tax competition, a key issue in todays' world. Each country is thus allowed to uphold the tax level needed to produce public goods for the people and the companies present in the country with minimum influence from other countries. The remaining competition of different corporate tax rates between countries with larger populations must be regarded as healthy in order to have a downward pressure on countries not to put their corporate tax rates too high.

If desirable, the maximum rate that could be used through this methodology was the country's own corporate tax rate. It would be no benefit for the multinational company to invest in the country through a low-(or no-) tax jurisdiction. Thus the multinational company would have savings or gain otherwise by

(1) avoid having intermediate companies in low-(no-) tax jurisdictions and
(2) avoiding to accumulate cash in low-(or no-) tax jurisdictions and have to lend money in order to pay dividends to its investors
(3) avoiding negative competition from companies that have larger cash flows through establishing themselves in low- (or no-) tax jurisdictions.

With this way of building up the withholding taxes on pre-tax inter-company cost cash flows(and setting withholding tax on dividends to zero), then a country would have an almost automatic protection against capital flight and multinational companies which uses low-(or no-) tax jurisdictions.

The good thing about this thinking is that it can actually be enacted unilaterally in a country, but the best thing is if this becomes the preferred method to ensure that after-tax dividends are the preferred method of repatriation of funds by multinational companies, and that IMF has this as a method they can promote towards the individual countries to reduce capital flight on the cost side of companies.

C. Dealing with derivatives and capital gains

It is very unlikely that a country will ever be able to protect itself against base erosion (legal or illegal) and profit shifting unless they are able to tackle the profit shifting capabilities of derivatives and capital gains. Neither derivative abuse nor capital gains issues are dealt with using the mechanism of differentiated withholding taxes as described in 4B above.

C1. Derivatives

Derivatives is a class of financial instruments that can be used for beneficial purposes (like hedging) but that can also be used for massive profit shifting across borders. In real life situations shifting of up to 20% of a company's *gross profit* across national borders have been seen without the country in question having neither the regulation nor the competence to avoid this profit shifting.

The problem with derivatives is that while the use of derivatives for hedging purposes will have a zero to slightly positive profit expectation, the use of derivatives for profit shifting has the ability to amass losses in a country while at the same time having a back-to-back agreement in another country that return the same profits as the original agreement in the country in question returns losses. This is impossible to discover for the tax administration in the country, as they are not party to the back-to-back agreement and never sees whether the losses accumulated in the country from derivative contracts (and similar contracts with some of the same characteristics as derivative contracts) are negated for the multinational company through gains in other countries.

The problem is compounded by that new derivatives are created all the time, and it is impossible to design regulation against each derivative. If one would stop leakage as a result of the use of derivatives, then one would have to find a universal method to avoid the negative effects of derivatives while not destroying the positive sides of derivatives. Luckily there exists such a method.

PWYP Norway has through the report "Protection against derivative abuse"[9] documented how derivatives can be used for massive profit shifting, with real life examples of how this is actually done. The report goes through the various forms of derivatives, including their legitimate use. Most importantly however, it gives examples of how these instruments have been and can be abused in order to transfer funds across borders with the intention to avoid taxation on parts of the revenues (in this context from extraction activities, but it is just as valid for other activities by multinational companies not part of the extractive industries). The report outlines two general methods how derivative abuse can be avoided. Of these two, the recommended method is the separation method, as it fits best with how most countries tax and legal system is organized and has general applications also for use of derivatives outside of extractive industries (the other method is more tailored towards extractive industries).

The separation method consists of separating out gains and losses from derivative transactions and handling them in a separate tax base. Since the monetary expectation from the legitimate use of derivatives (like hedging) is zero or slightly positive over time, the having gains and losses from derivatives in a separate tax base does not harm the legitimate use of these instruments. Any derivative losses can be offset against future derivative gains in the same tax base, and derivative gains will be taxed at the normal tax rate if companies are not allowed to defer these gains for some time to use towards future derivative losses. As the monetary expectation is zero or slightly positive, then the country in question do not expect to have much revenues from the use

[9] A briefing of the report is attached to this letter for the benefit of the reader.

of derivatives from legitimate uses such like hedging, and can allow deferral of gains for some time for use against possible future derivative losses.

However, the massive benefit of having derivative gains and losses in a separate tax base comes from the inability of multinational companies to use derivatives and similar type of transaction pricing to create contracts that have a more than proportional (more than 50%) probability of creating losses in the country while at the same time having opposite derivative contracts that creates gains in other tax jurisdictions, normally low- (or no-) tax jurisdictions. Separating derivative gains and losses into a separate tax base, separated from the company's other activities, thus have the built-in ability to protect legitimate use of these instruments while at the same time automatically severing off the ability to abuse a country's tax system by amassing derivative losses in a country. Since the losses are in a separate tax base, the company will never have use of these losses unless they actually expect gains in the future, which the company does not unless it use derivatives for hedging purposes, i.e. legitimate use.

The report "Protection against derivative abuse" describes this in more detail. The good think again about this thinking is that it can actually be enacted unilaterally in a country, but the best thing is if this becomes the preferred method to ensure that derivatives cannot be abused by incomplete legislation and lacking competence in the tax authorities, and that IMF has this as a method they can promote towards the individual countries to reduce capital flight from derivatives while still protecting the legitimate use of derivatives.

C2. Capital gains

Capital gains is another area where most countries tax regulation are lagging compared to the ability of multinational companies to organize their activities and ownership in such a way that they can be almost guaranteed that a capital gain can either be tax free or the taxes can be lagged or shifted in such a way (using amongst other derivatives) that the tax consequences are neutral for the company. How to shift capital gains through derivatives is also described in the report "Protection against derivative abuse".

Most multinational companies form their investment decisions in two stages:

- The investment decision itself, with everything invested in the country in question. This decision has to be positive in order for the company to invest in the country.
- The financing decision, which investigates whether ownership in other countries can increase the gains for the company at the cost of lowering the taxes to the country in question. This decision almost always introduces low- (or no-) tax jurisdictions and is the chief reason why the use of low- (or no-) tax jurisdictions is so abundant among multinational companies.

However, since a company will never invest in a country unless the investments decision itself is positive (the investment makes business sense), then the financing decision is in 98% of cases only "icing on the cake" for the multinational company. The damaging thing about the financing decision, though, is that this is where a multinational company starts to get competitive advantages compared to national companies. This competitive edge is not because the multinational company has better concepts, lower costs or is

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more efficient than the national company. No, this competitive edge is *only* based on the financing decision.

Organizing withholding taxes the way described in 4B above will take care of royalties and other type of inter-company cost cash flows, but it will not take care of possible base erosion and profit shifting as a result of defects in the capital gains taxation. It is thus necessary to have specific rules with respect to capital gains.

The best rules one can have are one or more of the following:
- Capital assets needs to be owned within country
- If capital assets are allowed to be owned outside of the country, then the rent can be separated and withholding taxes applied to the interest element:
    - Capital element based on normal economic life
    - A capital element based on less than normal economic life (shortening) which is taxed with withholding tax because it is the country in question which is financing the shortening of the payback period. This can be joined with the interest element below for all practical purposes.
    - An interest element equal to the difference between rent paid and the capital elements (see above) which is taxed with withholding tax because it is the country in question which is effectively losing the capital
- Capital assets are allowed to be owned outside of the country and a capital depreciation is allowed under the same rules as if the asset was owned in the country. Any differences between the depreciation over its economic life and the payment cross border is taxed with withholding taxes.

To demand that capital assets are owned within a country is very normal when it comes to fixed assets. However, it is also possible to demand this for movable assets if the asset is going to be used for a continued purpose for several years (for example for using an FPSO to produce an oil & gas field or a vehicle park for mining a resource deposit). The key thing is that the asset is not used interchangeably for producing other companies' natural resources and goods. A capital gain would thus be taxable (or not taxable) within the country in question according to the country's own tax regulation when and if the circumstances so dictated.

The second method is splitting a rental into a capital element based on normal economic life and an interest element and charge withholding taxes on the interest element, possibly only on the interest element that is higher than the interest the company pays to external financiers. This method is essentially easily combined with application of the withholding tax method described under 4B above.

The third method is the same as the second, with the main difference being that it is the tax depreciation period in the country in question that is used rather than a capital element based on normal economic life. This method creates more arbitrary results and is not very robust seen from a global point of view.

Only the first method creates capital gains inside the country. For the other two methods it is the use of withholding taxes on the interest element that makes up for that there is no need for capital gains taxation. For capital gains it is also necessary for countries to decide on the following with respect to taxation or not:
- treatment of sales of shares in the company owning the assets instead of sale of the

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assets themselves

- does the sale of shares in the company within the country have to be approved before the transaction is carried out?
- does the sale of shares in the company within the country create a capital gain to be taxed?
- do the change of ownership further up in the chain of ownership create the same obligation to pay capital gains tax as the sale of shares in the company within the country?

These are questions that a country needs to answer, and which IMF needs to find a common understanding on, in order for capital gains taxation not to inadequate. The same thinking as with the revenues lies behind the question: whether it is the assets that are sold or the shares in the company that are sold, the value of the sale is based on the value of the underlying asset.

The thinking with respect to capital gains on sale of assets can in essence be split in two and utilizing the principle of symmetrical treatment of capital gain and future deductions:

- if a sale of assets results in a taxable gain, then the country in question gets earlier taxation. This earlier taxation needs to result in the buyer being able to depreciate the purchase price of the asset.
- if the sale of assets does not result in a taxable gain, then the country in question will wait with the taxation until the future revenues and the buyer continues to depreciate the sellers tax base.

It is obvious that for most developing countries in need of funding of public goods early and with potentially weak tax administrations, will find taxation of capital gains desirable. The benefit of this is that the value is set between independent parties, and the taxation thus becomes more fair (not influenced by the government). The issue is that the country may create larger fluctuations in taxation from year to year, and the countries thus needs to have some mechanism to smooth the use of funds across several years or being used for particular projects.

Taxing capital gains is preferred when combined with the possibility for tax base erosion and profit shifting by the new owner (the buyer). The risk is that it is the buyer with the greatest ability and willingness to shift profit out of the country that is also able to put up the largest purchase price. In a competitive market sales of assets may thus in fact promote the companies willing to go the furthest with respect to base erosion and profit shifting. Taxing capital gains from sale of assets are thus a method that can level the playing field between companies.

The thinking with respect to capital gains on sale of *shares* in a company that owns assets in a country needs to take into account the same thinking. Sale of shares vs sale of the assets is often just a matter of convenience. It is easier to continue the activities undisturbed within the company rather than moving them to a new company. The problem stays though that there is a risk that it is the buyer with the greatest ability and willingness to shift profit out of the country that is also able to put up the largest purchase price for the shares. This goes in the direction of also taxing capital gains from the sale of shares, and rather allowing the company to increase its future deductions within the company (symmetry). This can be done by increasing the value of the assets in the company *and* the value of the paid in equity. The benefit for the country is immediate taxation based on an independent valuation of the activities between third parties. The benefit for the company is that it is allowed deductions from the purchase price to be included against future revenues (which the capital gain is calculated based on in the first place). The fact that a company gets future deductions for the purchase price will also allow for higher capital gains and thus higher taxation to the country

in question. Country risk will however work in the opposite direction, and the capital gains taxation will thus be done on a truly third party valuation.

D. Solving the principal-agent problem through extended country-by-country reporting

One issue that is high on the agenda is the inability

- for investors to follow their money and be better able to prioritize which companies to invest their money in because lack of insight
- for regulators to create the appropriate regulation for multinational companies and national companies alike
- for civil society to ensure that companies are playing by the same rules.

These issues can be summarized as the principal-agent problem with the investor, the regulator and the broader society (represented by civil society) being the principal and the (multinational) company being the agent. The principal–agent problem occurs when the company (the "agent") is able to make decisions that impact another entity (the "principal"). The dilemma exists because sometimes the agent is motivated to act in his (the company's) own interest rather than those of the principal (the investor/the regulator/the society). The investor thus risk receiving less dividends than anticipated, the country (the regulator) risk receiving less taxes than anticipated and the society at large risk receiving less public goods than anticipated. The reason is that funds are not taxed and the after-tax profits dividended to shareholders, but rather funds are channeled into low- (or no-) tax jurisdictions and reinvested out of there, and multinational companies have to lend money as discussed before in order to pay dividends to their investors. This puts a downward pressure on dividends, and investors are not allowed to perform their role in the capital markets which is to themselves decide in which companies to invest in, to stay invested in and to divest from.

PWYP Norway have built upon the country-by-country reporting of taxes introduced in the US and EU and partly extended country-by-country reporting done by extractive companies like Statoil (Norway) and some mining companies to propose an extended country-by-country reporting which has been almost fully enacted in Norway, and which we believe will also enter the country-by-country reporting in the US, EU and other countries once regulators see the ability of the extended country-by-country reporting to solve a lot of the principal-agent problem.

The essential problem is that investors, regulators and civil society lack basic and vital insight into multinational companies. The effect of this lack of insight is the principal-agent problems seen in the world today, where a majority of the trade in the world is effectively going on inside the multinational companies. This creates a variety of tangled problems such as the base erosion and profit shifting identified in this consultation, but also statistical problems, problems of competition not being level between national companies and multinational companies and even among multinational companies.

The country-by-country reporting is a large step forward with respect to getting insight into tax payments by country, although quite an elementary step as it is irrational for a country to give away access to its non-renewable and finite resources without knowing what it gets in return in taxes to the country's treasure box. However, such a standard does not put the tax payments into the correct context, i.e. it is not possible to have a view on the taxes relative to the resources put in (employees, investments and operating cost), the results coming out

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(production and revenues) and the profits generated (revenues less cost). This can only be done by disclosing the tax payments together with key financial statement numbers and numbers for the resources involved (for extraction companies) and the people involved. This is called extended country-by-country reporting, and this has been introduced in Norway as a follow-up on the introduction of country-by-country reporting in EU and US.

PWYP Norway has produced extensive documentation on the extended country-by-country reporting and a briefing on the latest report "An extended country-by-country reporting standard" is attached. The full report can be downloaded from www.pwyp.no.

The extended country-by-country reporting standard will ensure a more equal playing field for companies as all companies have to report in notes to the financial statements, country-by-country (no exceptions), the following 8 key financial numbers for extractive industry companies:

1. Investments
2. Production
3. Sales revenue
4. Costs (purchase of goods and services, employee cost, other operational expenditures and net finance cost – together or split up)
5. Number of employees
6. Payable tax debt 1.1.
7. Payable tax in the profit & loss statement
8. Payable tax debt 31.12.

Numbers 1-5 gives the context for taxes paid:
Investments gives the context for production, production gives the context for sales revenue and sales revenue less costs give the context for taxes paid, or more graphically represented:

Investments --> Production --> Sales revenue --> Sales revenue less Cost --> Net profit --> Taxes paid

Numbers 6-8 gives the taxes paid themselves:[10]

Taxes paid consist of:
Payable tax debt 1.1. + Payable tax in the P&L statement – Payable tax debt 31.12.

The reason why the extractive industry is so important is because these are by far the most significant industries with respect to tax base erosion and profit shifting out of developing countries in the South, and is therefore directly relevant for IMF's evaluation.

In order to counter principal-agent problems in today's world related to multinational companies and issues related to base erosion and profit shifting out of developing countries, it is highly beneficial that IMF supports and promotes extended country-by-country reporting as suggested by PWYP Norway. This will be a natural progression from country-by-country

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[10] *These lines give the taxes that are reported on the tax lines of a company, which is by far the majority of taxes. In addition there is a minor group of taxes that are accounted for as a cost and reported in the financial statements as a cost item. This group of taxes will have to be added in order to get to the full taxes paid, but the important thing in the financial statement reporting is to be able to connect the extended country-by-country reporting with key financial statement numbers. This is in order to avoid the need for costly auditing of the numbers. When connected to an already audited financial statement, the credibility of the numbers is unchallenged.*

reporting, and will put taxes paid into their natural context. Country-by-country reporting itself will give important information on taxes, but will not in itself help on the principal-agent problem. Only when taxes paid are put in their natural context, key financial statement numbers, and this context is reported country-by-country together with the taxes will country-by-country reporting help on the issue of principal-agent problem.

5. The specific questions formed by IMF

IMF has formed 8 questions that it desires answered during the consultation process. Here we will combine the problems and suggested solutions in order to see whether the questions are answered. The problems & solutions discussion under chapter 4 above must be seen as a comprehensive package designed to take care of the vast majority of issues with respect to base erosion and profit shifting by multinational companies. Extended country-by-country reporting is vital to address the principal-agent problem, but in itself it cannot solve profit shifting issues, hence the need for taking into account some of the other solutions as well in addition to the extended country-by-country reporting.

Question 1a: *How does the current network of bi-lateral double taxation treaties, and the spillovers that can arise from treaty shopping, affect low income countries*?

In PWYP Norway's opinion low income countries can be from significantly affected to critically affected by economic spillovers. The severity of the issue for a particular country is highly dependent on the country's dependency on (1) extractive industry companies in particular and (2) multinational companies in general.

Question 1b: *What changes in the design of treaties could be beneficial for those countries?*

We have discussed above that it is highly desirable that every country moves in a direction of not accepting

- Other countries tax regulation that is not applied equally to residents and non-residents
- Royalties and fees at face value, and rather introduce unilaterally a system of withholding taxes whereby after-tax dividends have no withholding tax while other non-transactional inter-company cash flows have withholding taxes built up using the suggested structure in order to promote the shortest ownership structure between the ultimate mother company and a subsidiary in a country. This will be to the benefit of the country, the company, the investors and the society at large.

The right of taxation in bi-lateral agreements should therefore be directed towards the countries that have the value creation, whether that is resource extraction, resource transformation and distribution or sale in markets.

Question 1c: *Is the existence of bi-lateral tax treaties important to the attraction of international capital, and if so why/how?*

The bi-lateral tax treaties are currently important for attracting international capital due to the effect they have on avoiding double taxation. However, the side effects of the bi-lateral tax treaties are such that it is desirable with a substantial redesign with respect to taxation rights, especially for the benefit of developing countries with value creation. Combined with a good system of withholding taxes, one can improve significantly on the system.

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Question 2a: *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?*

Debt usually results in interest deductions, and the interest element can vary vastly depending on type of financing. Equity results in after-tax dividends and hence no deductions for tax purposes.

Regular long-term debt issued directly between an ultimate mother company and a subsidiary using the same terms have next to no unintended consequences. However, it is obvious to see that multinational companies have everything to benefit from arranging their debt and debt-like instruments in such a way that the deductions are going much higher than regular long-term debt with same terms as the company's external debt. Such instruments include transfer pricing issues with respect to differences in the interest rates all the way to rentals that is based on shortening the calculated life of the asset and mark-to-market bindings that create enormous opportunities for profit shifting. If an asset is repaid during half its real economic lifetime with no opportunity to capture capital gains taxes at a potential point of sale, and this asset on top of this is linked to a fluctuating market rate, then it is obvious that the economic benefit easily will transfer to another country, most of the time a low- (or no-) tax jurisdiction.

Question 2b: *What solutions would you prefer, if you see this as a problem?*

The solutions are covered in chapter 4 above. The preferred solution is taxation where the value creation occurs, and ensuring taxation using a good setup of withholding taxes correctly designed and enforced.

Question 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?*

Yes, but the solutions outlined in chapter 4 above would level the playing field significantly, ensuring that there is equal competition whichever country an investment comes from.

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

With the solutions outlined in chapter 4 above, there would be less problems with any countries deferring taxation. As it is now, deferral does create problems with respect to dividending back funds to the home country as long as there is no tax credits from the country in question to prevent double taxation under worldwide taxation.

To completely solve the issue of deferral one would have to allow in the home countries the same type of deductions as in the subsidiary country (in addition to the solutions outlined in chapter 4 above). This would end any deferrals and align the cash flow and taxation in both subsidiary country and home country.

Question 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?*

For transactions:

> The arm's length principle is too easy to abuse with respect to comparable transactions. Mark-to-market principles (comparing a price to a market price) in essence create the ability to find any desired CUP's (Comparable Uncontrolled Price). The principle of amongst other mark-to-market means that all transactions internal in multinational companies are in essence compared to the marginal transaction in the market. This has a colossal effect on increasing the cost base in cross border transaction, and hence increases the deductions (the cost) in subsidiaries in developing countries in the South.
>
> It would be better to rather allow the transaction with its original cost base (the cost with which the item entered the multinational group), no additional profits allowed on the individual transaction. Any profits should be done using fees or allocation of overhead with the application of the right combination of withholding taxes as defined in chapter 4 above. This would make all transactions that ended up for deductions in a company in a developing country be treated as if they bought it directly from an external party (the intention of the arm's length principle), and to the extent that there are internally generated goods and services, those are either fully documented transactions with a profit equal to the average profit margin of the multinational company (fair distribution of the value creation and the taxation rights).

For non-transactions (all forms of royalties, interest, insurance, fees, overhead allocations etc where there is a general cost base that may or may not be unrelated to the charge):

> Yes, the solutions outlined in chapter 4 above is the preferred system by which avoiding profit shifting from royalties and fees that are not grounded in a proper cost base.
>
> An alternative, but less attractive so, is to have all overhead cost in multinational companies prorated to the various subsidiaries. However, this method creates administration problems and accountability issues.

Question 6a: *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?*

It is our view that formulary apportionment and/or unitary taxation could be potentially very damaging for developing countries, as low- (or no-) tax jurisdiction could be included to a significant degree if these apportionment/unitary taxation schemes are not very carefully designed. Most such schemes are open to significant influencing by the individual company especially apportionment of profits based on investments if multinational companies can include investments done out of low- (or no-) tax jurisdictions. PWYP Norway would rather go in the direction suggested in chapter 4 above with taxation where the value is created and using a simple system withholding taxes together with specific solutions for derivatives and capital gains and the introduction of an extended country-by-country reporting.

There could be other countries that could benefit from such arrangements, but this could only be answered based upon firm suggestions for such arrangements.

International business would likely benefit from formulary apportionment and/or unitary taxation, depending again upon the design of such arrangements. It is impossible to analyze this without firm suggestions. It is critical to avoid apportionment of profits based on investments as mentioned above as this continues the negative tax competition.

Question 6b: *If you support such a system, what allocation factors would you suggest?*

Based on the difficulty of implementing a system that is fair for developing countries, PWYP Norway can generally not support a formulary apportionment system and/or a unitary taxation system before concrete suggestions for such a system is put on the table for analysis. It is much more difficult to analyze the outcomes of such a system than the solutions promoted by PWYP Norway in chapter 4 above.

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

These jurisdictions should essentially not be allowed to influence other countries taxation rights anymore.

PWYP Norway is of the opinion that taxation should happen where the value is created, as outlined in chapter 4 above. If the solutions suggested in chapter 4 are carried out, and almost all can be done unilaterally by individual countries, then low- (or no-) tax jurisdictions are of little or no consequence anymore.

A country that wants to protect itself against the negative effects of low- (or no-) tax jurisdictions can thus focus on ensuring that they carry out the suggestions in 4B and 4C above unilaterally in their own country, and that the country supports the extended country-by-country suggestion in 4D being enacted worldwide.

Question 8a: *In your view, does the existence of tax competition – whether directly, through the setting of tax rates, or indirectly, through the shifting of taxes bases – serve a useful purpose?*

Tax competition, in the sense that a country in itself are allowed to set the tax level within the country which both national and multinational companies will have to adhere to, is beneficial. This is also possible, as discussed on page 11 above, if a good system of withholding taxes is implemented in countries.

Countries should essentially be solely responsible for setting the tax terms that they desire with respect to the utilization of resources inside the country, activities with respect to transforming resources into goods inside the country, distributing of these goods to markets inside the country or between countries, and selling of goods and services in markets inside the country.

The reason for this is that "not all countries are created equal". The need for public goods in the different countries differs vastly and promoting a tax system around the world that in essence forces everyone into the same box, like apportionment or unitary taxation, is a violation of the sovereign rights of individual countries. It can also lead to massive loss of tax revenue to the extent for example apportionment of profits based on investments is carried out, as many multinational companies have massive investments out of low- (or no-) tax jurisdictions.

And it is not needed. As long as countries are able to introduce unilaterally the solutions outlined in chapter 4B and 4C above, a country will be pretty well protected against harmful

tax competition.

Question 8b: *Can one identify particular forms of tax competition that are "harmful"?*

Harmful tax competition is when (1) a country introduces different tax regulation for residents and non-residents, thus allowing profit shifting from countries with higher taxation to countries with lower taxation and (2) the tax base in a country is eroded and profit is shifted to other tax jurisdictions through the sheer interaction of tax regulation in different countries through mechanisms that have unintended consequences and which would never have been allowed by the country in question had the legislation behind been suggested enacted within the one country

It is therefore self-evident that the solutions in chapter 4B and 4C and supporting the extended country-by-country reporting suggested in chapter 4D is desirable to countries that want to eliminate the consequences of other countries tax regulation on their own taxation of the value creation in the country. 4B and 4C will work directly within the country, while extended country-by-country reporting is addressing the more fundamental principal-agent problem which is currently an issue with multinational companies.

PWYP Norway sees that IMF intend to review all comments and post a summary of those received. PWYP Norway kindly request that the IMF either make public all comments received, or that a link is provided to the full PWYP Norway consultation comments at www.pwyp.no and similar links to other consultation comments if IMF chooses to provide a summary.

Yours sincerely,
On behalf of Publish What You Pay Norway,

Mona Thowsen,
Secretary General