Base erosion and profit shifting

In the aftermath of the biggest financial crisis of our lifetime, fiscal consolidation has become an inescapable reality as many governments seek to rebuild solid foundations for growth, Masatsugu Asakawa writes

In the aftermath of the biggest financial crisis of our lifetime, fiscal consolidation has become an inescapable reality while the necessity for growth has recently been more and more emphasised. From this perspective the promotion of private sector growth is fundamental to make economic recovery and deficit reduction compatible. One of the keys to this is the creation of a competitive tax environment for business.

At the same time, governments must ensure that business bears its fair share of the tax burden. There is an increasing perception, particularly at the political level, that countries lose substantial tax revenue because of aggressive schemes aimed at eroding the taxable base or at shifting profits to locations where they are subject to a more favourable tax treatment. G20 Leaders convened in Mexico on 18-19 June 2012 explicitly referred to the need to prevent base erosion and profit shifting.

As shown recently by some striking examples, MNE's effective tax rates (the average rate at which an MNE is taxed on its pre-tax profits) can be much lower than the statutory rates of the countries in which they operate. There are a number of technical, non-disputable reasons for this and the bold signs of the gap between effective tax rates and statutory rates should not be taken as the ultimate truth. However, this gap has clearly broadened and this is largely due to aggressive positions taken by some MNEs.

Many of these strategies can be entirely legal. In some cases they may be responses to the lack of effective countermeasures in the tax system. In other cases, they may be based on provisions wilfully put in place by governments. Nevertheless, the results of these strategies put a spotlight on the tax system and require reflection by policy makers and other stakeholders. At stake is the ongoing credibility of the domestic and international tax systems that are key foundations for long-term growth and for reducing inequalities.

For years the OECD has promoted a policy of improved international tax cooperation between governments, to avoid double taxation of cross-border profits, ensure a fair allocation of taxing rights, prevent the introduction of harmful tax practices, and counter tax evasion and avoidance.

Corporate tax policy, and in particular its international side, may need a new look.

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Most tax rules are still grounded in an economic environment characterised by fixed assets, plant and machinery and a lower degree of economic integration across borders, rather than today's environment where much of the profit lies in risk taking and intangibles. Some rules and their underlying policies were built on the assumption that one country would cede taxation as the other would then be able to exercise it. With movements to global supply chains, and aggressive corporate tax structures, that assumption may often not be accurate and profits may often end up in a third, low or no tax, country.

International tax policies must therefore be adjusted to the current business environment, in a way that ensures a level playing field and a fair allocation of taxing rights among both developed and developing countries. With these premises in mind, the stage is set for meaningful improvements of the concrete tools the OECD already has to address base erosion and profit shifting, eg. in the area of tax policy analyses, tax treaties, transfer pricing, aggressive tax planning and harmful tax practices.

Rethinking the corporate tax system is a challenging task. The OECD Committee on Fiscal Affairs, which brings together senior tax officials from all OECD member countries as well as Argentina, China, India, Russia and South Africa, has a wealth of knowledge and expertise to contribute in this respect.

Anticipating the G20 request, the Committee is currently implementing an integrated and holistic approach to address profit shifting and base erosion. These issues are being addressed from all angles, starting with a diagnosis grounded in hard data regarding the effects on effective tax rates of both government policies and taxpayers' aggressive planning. A comprehensive and balanced assessment of the facts is essential to develop sound policy proposals to prevent base erosion and profit shifting.

It is more important now than ever that taxpayers pay the right amount of tax at the right time and in the right place. ■

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