The **BEPS** Monitoring Group

Submission to the OECD on the Public Consultation Document

WHAT IS DRIVING TAX MORALE?

These comments have been prepared by the BEPS Monitoring Group (BMG). The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. These comments have not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. They have been drafted by Sol Picciotto, with contributions from Jeffery Kadet, Tovony Randriamanalina and Attiya Waris. We appreciate the opportunity to provide these comments and are happy for them to be published.

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Introduction

This discussion draft (the DD) updates previous OECD research of 2013 on tax morale in individuals and, additionally presents a new business section, using data from a survey of multinational enterprises (MNEs) conducted in 2016 to discuss business tax morale in developing countries.

Our concern is international corporate taxation especially in relation to developing countries. In our view, the inclusion of the data from the 2016 survey of business into the work on tax morale of individuals is unhelpful and makes the draft report incoherent. In addition, there are surprising omissions from the report, particularly the lack of any discussion of the attitudes to tax of key groups such as wealthy people and tax advisers. Our comments will focus mainly on the second chapter on business, and especially its policy recommendations.

More generally, however, it is of key importance in our view to understand that the motivation to pay tax is not 'intrinsic', at least in the sense of some kind of innate motivation of individuals. Tax is at the heart of the social contract or solidarity of citizens of a state, and there is plenty of evidence that its legitimacy, and hence the willingness of citizens to pay it, rests on notions of tax fairness. We are surprised that these issues are largely ignored in this DD, and will comment further on them below.

The business survey data are not relevant to 'tax morale'

The concept of tax morale is defined in this DD as 'the intrinsic motivation to pay taxes'. The intention is to go beyond tax compliance, to uncover the deeper motivations of taxpayers. However, the survey conducted in 2016 concerned business attitudes to tax certainty, and the data from that survey that are included and discussed in chapter 2 have no relevance to the 'intrinsic motivation to pay taxes'.

Although large corporations are sometimes referred to as 'taxpayers' there is clearly an enormous difference between the attitudinal and motivational factors that affect the behaviour of individuals, and the institutional context in which large corporations take decisions about tax. It could certainly be relevant in evaluating business attitudes to tax to consider the behaviour of key individuals who are concerned with corporate tax decision-making, such as tax advisers and company directors and managers. This could include evidence about their attitudes to tax planning practices, their appetite for aggressive tax positions, and their approach towards managing tax risk. It could also encompass evidence of the effects of equity-based compensation on the incentive for such company directors and managers to minimize corporate taxation so as to maximize earnings per share, stock prices, and, most importantly, the value of that compensation. And it could also include evidence over the past several decades of how some tax advisors have been motivated through high fees to 'sell' their clients increasingly aggressive tax schemes. Perhaps the best published example of this is the over $55 million paid by Caterpillar to PwC for its Swiss tax strategy.[1]

However, the business survey conducted in 2016, although completed by individuals, did not include any questions about their attitudes and motivations towards payment or avoidance of tax. Indeed, the bulk of questions dealt with the respondents' views about the desirable or undesirable features of tax systems, and not their attitudes to paying tax. Those directed at decision-making focused on investment decisions and did not explore attitudes towards tax planning or tax avoidance.

Inclusion of this data has the effect of shifting attention from the attitudes and motivations of those responsible for tax compliance to their concerns and perceptions about the defects in how tax rules are formulated and enforced. There are certainly valid concerns about the problem of uncertainty of tax rules, to which we return below, but it is inappropriate to take at face value those expressions of concern as evidence for motivations towards tax compliance.

Relevant evidence is available, but not discussed in the DD

The main reason given in the DD for including the 2016 survey data is the lack of other data. It may be the case that there are no large data-sets from opinion or attitude surveys relating to corporate tax practices, but there are good reasons for this. Large-scale questionnaires are not likely to be a source of good or reliable data about the tax planning practices of corporations, especially MNEs. The questionnaire subjects are harder to anonymise, and partly for that reason are more likely to give answers that are less than truthful, especially when some of their practices are of dubious legality. Hence, other types of data are more appropriate.

Some such data are available, in particular for a group of taxpayers that are important, especially in developing countries: wealthy people and families, sometimes described as

[1] See the Majority Staff Report of the U.S. Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, 1 April 2014, available at https://www.hsgac.senate.gov/imo/media/doc/Caterpillar's%20Offshore%20Tax%20Strategy%20(4-1-14,%208-28-14%20FINAL).pdf.

high-net-worth individuals (HNWIs). Surprisingly, the DD gives little or no attention to this category, although they have been the focus of considerable debate and also of research in recent years. Improving taxation of HNWIs has been recognised as a key element in domestic resource mobilisation and the Addis Tax Initiative, and consideration of the tax morale of this group is an important element of those efforts. HNWIs as a group perhaps fall between individuals and 'business', especially if the latter is considered to consist mainly of corporations. We suggest that a separate chapter should be written on this category.

Consideration of the research that has been done on HNWIs would point to different sources of evidence that would also be relevant to business. Thus, qualitative research methods are being used, for example the recent study by the UK tax authority, HMRC (2019).[2] It is clear from that research that for most wealthy people it is the role of wealth and tax advisers that is key to their attitude towards payment of tax. Hence, it is important to consider the attitudes towards tax of the various categories of wealth and tax advisers. Surprisingly, the DD does not include any consideration of this aspect. Considerable attention has been devoted in recent years to the role of 'enablers' in both tax evasion and avoidance. Although the methods involved are in some respects different, there are considerable similarities between the techniques used for international tax evasion and avoidance for HNWIs and MNEs. In particular, both exploit the disjunctures and mismatches in international tax rules and take advantage of the international tax haven and offshore secrecy system. The creation of these complex structures to avoid or evade tax entails the expenditure of considerable resources and ingenuity, and the existence of a body of professionals willing to engage in these practices is an important feature of tax morale, or maybe more correctly, the lack of tax morale.

Tax fairness and tax morale

Inclusion of a chapter on HNWIs would also cast light on an important aspect of the tax morale of individuals that is surprisingly hardly mentioned in the DD: perceptions of the fairness of tax systems. The DD begins by presenting a framework proposed by the World Bank for understanding the interlinked elements of tax morale as based on trust, which in turn depends on 'the degree to which the tax system, including the approach to facilitation and enforcement, is characterized as fair, equitable, reciprocal and accountable'. Yet the DD includes no discussion at all of the effects on tax morale of perceptions of fairness in the tax system.

There is extensive evidence that the issue of fairness is a central concern of citizens everywhere about the nature of the social contract that is at the heart of taxation. The OECD's own recent survey of public opinion *Risks That Matter 2018* shows that in every single country over half of respondents, and on average almost 70%, answered Yes, or Definitely Yes to the question 'Should the government tax the rich more than they currently do, in order to support the poor?'. This was a survey of OECD countries, but the rate of agreement to that proposition is unlikely to be lower in developing countries where inequalities are generally far greater, and public services much worse. Regrettably, neither the World Values Survey nor the regional barometers from which the data in this DD are derived include a question about tax fairness, only the former has one about redistribution being a characteristic of democracy (Annex A, Table A2).

[2] HMRC (2019). *Researching the drivers of tax compliance behaviour among the wealthy, and ways to improve it.*

The continuing relevance of tax certainty

It should be recalled that the business survey was conducted in 2016, in the aftermath of publication of the main outputs from the G20/OECD project on base erosion and profit shifting (BEPS). The need for the survey was suggested by the concerns expressed by business tax advisers that the reforms resulting from the BEPS project would greatly increase complexity and uncertainty in international tax. In our view these concerns were well-founded, although both our analysis of the reasons and our suggested remedies differed from those of business tax advisers.

The aim of the BEPS project, as stated by the G20 leaders, was to reform international tax rules to ensure that MNEs declare income and pay taxes 'where their economic activities occur, and value is created'. This should mean ending the incentives to devise complex corporate structures to avoid taxes. However, the BEPS project recommendations mainly patched up the existing rules, and generally greatly exacerbated their complexity. This was because they failed to tackle directly the central question of establishing clear methods and criteria for the allocation of income of MNEs. The lack of clear allocation rules feeds the suspicions of other taxpayers that large and highly profitable MNEs are not paying their fair share.

In this context, the pressures from business for greater certainty took the form of a drive to establish mandatory binding arbitration. As we have consistently pointed out, this tackles the problem at the wrong end. The aim should be to prevent the continued growth of disputes, the majority of which concern transfer pricing, by ending the ad hoc and subjective approach that has become embedded in the OECD Transfer Pricing Guidelines. These require an individual analysis of the 'facts and circumstances' of each MNE and all its affiliates, to identify and then to attribute to each of them profits in line with those of comparable independent entities. This doesn't have to be done just once by each MNE and all its affiliates, but rather must be done multiple times since all analysis and pricing must be done separately for each product produced by the group and for each service line or other business conducted by the group.

To apply 'functional analysis', tax authorities need staff with a range of skills, who not only are familiar with the legal and economic techniques needed to interpret and apply the TPGs, but also understand the taxpayer's business model and industry segment well enough to analyse the documented transfer pricing model, choice of method and selection of comparables. This need to conduct a functional analysis creates a severe information asymmetry, since a company will always know more about its own business and its sector than any outsider, especially tax authorities who have little background in the industry of the MNE and no detailed knowledge of the taxpayer's operations. Matching the resources available to MNEs is impossible for tax authorities even from developed countries, which are often under-resourced. The problem is far greater for developing countries, especially the poorest.

The response to this real problem proposed in the DD, based on the views of MNE tax advisers from the 2016 survey, seems to us in key respects misconceived. The concerns identified by the DD in relation to international tax are 'inconsistency with international standards, lack of expertise in the tax administration, and a lack of understanding of the business structures of MNEs' (p. 35). We would characterise the problem quite differently. In our view its roots lie in the complexity of the approach developed by the OECD and its emphasis on ad hoc and subjective judgments requiring detailed knowledge of the taxpayers' business models. There is ample evidence that this approach has failed in the OECD countries over the past 20 years. It has not only resulted in a rising tide of conflicts and disputes but has also increasingly failed to stem the revenue losses from tax avoidance.

Indeed, the 'independent entity' principle underpinning the OECD approach creates a perverse incentive for tax advisers to devise complex and opaque structures for MNEs. This has greatly contributed to the vicious cycle of growing mistrust between tax authorities and MNEs that has undermined tax morale.

Another aspect involves the common refrain heard from the CEOs and other officers of virtually all MNEs: 'We pay all the taxes we legally owe.' First, over the past 20-30 years, almost all countries have adopted territorial taxation systems, greatly facilitating BEPS behaviour. Second, MNE boards of directors and managements almost universally believe that they must maximise returns to shareholders. These two factors, along with the significant equity-based compensation factor noted above, have created a strong motivation for MNE boards and managements to seek out and adopt tax strategies, often having no business objective other than tax minimisation, that shift profits out of the countries where business operations are conducted and into zero- or low-tax countries. The adoption of territorial taxation systems, each of which has different rules, has greatly encourage efforts to find ways to arbitrage those rules and pay significantly less tax in the process.

Hence, it seems exactly the wrong approach to suggest that developing countries should adopt the current failed approach. Furthermore, to attempt to remedy its defects by 'capacity building' to train staff in poor countries to apply these methods seems a waste of scarce resources. The *reductio ad absurdum* of this approach is shown in Box 2.2 which lauds examples of 'harnessing business and industry expertise' to help tax authority staff to understand the business models which they are expected to analyse in determining the appropriate level of tax to be paid by these same companies.

We do not advocate an adversarial approach to tax enforcement by tax authorities, but the emphasis in the DD on voluntary codes for business[3] and 'cooperative compliance' is misplaced in view of the current state of international tax rules. In our view the key to an effective tax system is to design rules that are simple and easy to administer, and hence reduce the compliance costs for business.

A better approach

Fortunately, a better approach is being proposed. The latest public consultation document in the BEPS project Action 1 on *Addressing the Tax Challenges of Digitalisation of the Economy*, issued in February 2019, puts forward a new approach to allocation of the income of MNEs based on simplified methods of apportionment. This is evident especially in the third option presented under pillar 1, which originated in a submission from the G24 group of developing countries, a version of which was included in the submissions for the public consultation. A similar approach has now been put forward for public comments by India's Central Board of Direct Taxes.[4] The European Commission, in its plan for *Fair Taxation of the Digital Economy* of March 2018, also proposes adoption of an apportionment approach.

This is not the place to discuss these issues in any detail. We have put forward in our other reports,[5] mainly in relation to the BEPS project, our analyses of the defects of international tax rules and the reasons for the complexities and uncertainty that they create. These problems are far from being resolved, but in our view there may now be some hope that a

[3] The DD states that 'the OECD intends to work with BIAC to assess the impact of the BIAC principles in developing countries.' This appears to refer to the BIAC *Statement of Tax Best Practices for Engaging with Tax Authorities in Developing Countries* of 2013 mentioned in Box 2.3. However, although there is a media release about this on the BIAC website, the Statement itself cannot be found.

[4] *Proposal for amendment of the rules for profit attribution to a permanent establishment*.

[5] Available at https://www.bepsmonitoringgroup.org/

way can be found to restore some clarity and greater simplicity to the system. We urge the OECD to reach out to business to cooperate in this endeavour to set international tax rules on a more secure foundation.