

# Group of Twenty

Combating international tax avoidance and evasion



<b>Forum</b>	Group of Twenty
<b>Issue:</b>	Combating international tax avoidance and evasion
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## Introduction

Base erosion and profit shifting (BEPS) are a series of “tax planning strategies used by multinational enterprises to exploit gaps and mismatches in tax rules and avoid paying taxes” (OECD). Nowadays, BEPS poses an enormous threat to most countries’ economies, particularly for developing nations that depend on corporate income tax. While recently cases of well-known enterprises practicing BEPS have made the headlines and attracted public attention, these practices were, in most cases, completely legal, perpetrated by companies who took advantage of tax laws or rules that are not properly coordinated between states and that hasn’t been recently updated. Reports have shown that practices of BEPS cost states around 100-240 billion USD in lost revenue every year. This number represents a much greater loss than it seems, especially since this money could have been used for other purposes, such as improving infrastructure, building schools or buying medicine. Seeing that one of the Group of Twenty’s (G20) three main objectives is to promote financial regulations that reduce risks and prevent future financial crises, it is this committee’s responsibility to find long and short-term solutions to combat the issue of international tax avoidance and evasion.

## Definition of Key Terms

### Base erosion and profit shifting (BEPS)

Strategies used by multinational enterprises to take advantage of gaps, mismatches and lack of coordination in tax rules and laws across countries to avoid paying taxes.

### Organization for Economic Co-operation and Development (OECD)

Forum where various governments collaborate to develop certain policies to promote economic growth.



### **Multinational enterprises (MNE)**

Businesses that hold assets, have employees, develop goods or provide services in two or more countries

### **Tax evasion**

Deliberately avoiding paying taxes.

### **International taxation**

The establishment of the tax on an individual or business based on the tax laws of various countries or the international aspect of a nation's tax laws.

### **Hybrid mismatch arrangements**

“Arrangements which exploit differences in the tax treatment of instruments, entities or transfers on cross-border trade and investment” (Chrenko)

### **Earnings before interest, taxes, depreciation and amortization (EBITDA)**

Method used to measure a company's ability to generate cash and general health, financially speaking.

### **BEPS Minimum Standard**

The four actions that every member of the BEPS Inclusive Framework (141 jurisdictions) have committed to implementing.

### **Base erosion**

Minimizing a company's taxable profits within a jurisdiction by using financial measures, as well as tax planning techniques.

### **Profit shifting**

Technique used by MNEs to reduce their tax payments

### **Aggressive tax planning**

“A tax scheme that reduces the effective tax rate of a particular type of income to a level below the one sought by fiscal policy for this income” (Alm, 2014).



## Tax Haven

A jurisdiction where foreign investors face a low “effective” rate of taxation.

## General Overview

The Group of Twenty (G20) is a strategic multilateral platform that connects some of the world’s biggest developed and emerging economies. The forum was created in 1999 in response to the global financial crisis of 1997-1999. The members of the G20 are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States, and the European Union. Together, these countries make up 80% of the world’s GDP, 75% of international trade and 60% of the planet’s population. Since the economic crisis of 2008, the members of the G20 have arranged annual summits where the countries’ leaders meet to discuss and create policies to reach international financial stability.

Seeing that, due to various factors, such as multiple economic crises over the years and the recent COVID-19 recession, international tax evasion and BEPS practices have continued to take place and will, most likely, only increase around the world, the Group of Twenty, alongside the Organization for Economic Co-operation and Development (OECD), established the OECD/G20 BEPS Project. This is a cooperation between both organizations as we develop solutions to combat the issue of international tax evasion and avoidance. As of October 2021, 135 countries had joined the OECD/G20 BEPS Project. As part of this program, the OECD and G20 have established 15 steps that will provide countries with a set of rules and instruments, both internal and external, to address tax evasion. The fifteen actions are tax challenges arising from digitalization, neutralizing the effects of hybrid mismatch arrangements, controlled foreign company, limitation on interest deductions, harmful tax practices, prevention of tax treaty abuse, permanent establishment status, and transfer pricing (actions 8-10), BEPS data analysis, mandatory disclosure rules, country-by-country reporting, mutual agreement procedure, and multilateral instrument.

### Action 1. Tax challenges arising from digitalization



Nowadays, the global tax system and its foundations face a serious challenge due to the reliance on intangible assets, scale without mass and the centrality of data. The presence of these aspects has been strengthened by digitalization. Technological advancements have also made it easier for multinational enterprises (MNEs), to shift their profits into jurisdictions with no or low taxes, thus enabling tax evasion. This issue is currently the top priority for the OECD/G20 BEPS Project. To solve it, the project's members have arranged various public consultations to engage with the taxpayers and will conduct analysis on the impact, mainly economical, of the implementation of the global tax system.

### **Action 2. Neutralizing the effects of hybrid mismatch arrangements**

The second action of the project is responsible for making recommendations in the design for domestic laws to subdue the effects of hybrid instruments and entities. Hybrid mismatch arrangements refer to transactions that take advantage of mismatches in the taxation laws of two or more countries, in order to avoid paying taxes. The OECD/G20 Project analyzes the domestic taxation laws in different countries and recommends changes that could be made to reduce or eliminate the existence of hybrid mismatch arrangements.

### **Action 3. Controlled foreign company**

Many taxpayers have the opportunity of stripping the tax base of the country that they live in and place the income into a foreign company controlled by themselves, which allows them to avoid taxation. In order to solve this issue, controlled foreign company (CFC) rules have been created since 1962. Action 3 of the project, makes certain recommendations on the creation of CFCs. These recommendations would allow the jurisdictions that adopt them to effectively prevent taxpayers from shifting income into companies established in other countries in an inappropriate manner.

### **Action 4. Limitation on interest deduction**

Multiple multinational corporations might receive favorable tax results through the adjustment of the debt levels in a group entity. Because of this, the project has created a set of rules that “linked an entity’s net interest deductions to its level of economic activity within the jurisdiction, measured using taxable earnings before interest income and expense, depreciation and amortisation (EBITDA)” (OECD, “Action 4 - OECD BEPS”). This solution has three main elements: “a fixed ratio rule based on a benchmark net interest/EBITDA ratio; a group ratio rule which may allow an entity to deduct more interest expense depending on the relative net interest/EBITDA ratio of the worldwide group” (OECD, “Action 4 - OECD BEPS”) and specific rules to tackle certain risks and issues.



### Action 5. Harmful tax practices (BEPS Minimum Standard)

Since action five is one of the BEPS minimum standards, all members have confirmed that they will implement action five and will participate in the annual peer review process. As part of action five, the OECD/G20 has created the Forum on Harmful Tax Practices (FHTP). The FHTP's actions will focus on three main ideas. First, they will assess preferential tax regimes, in order to identify if and how these regimes facilitate base erosion and profit shifting, which could severely affect other countries' tax bases. Secondly, will conduct spontaneous exchanges of relevant information that, if remains unknown, might lead to BEPS cases. Finally, the FHTP will oversee substantial activity requirements in countries with no or very low taxes to assure a playing field.

### Action 6. Prevention of tax treaty abuse (BEPS Minimum Standard)

Action six focuses on preventing treaty shopping, which occurs when companies seek to take advantage of tax treaties between two contracting states, using a shell company based in a third country. To solve this problem, the OECD/G20 BEPS Project requires the 141 jurisdictions that are members of the BEPS Inclusive Framework to implement rules designed to make sure that only a country's true residents benefit from tax treaties. Such rules include limitations on benefits rules and principal purpose test rules. The project will also make sure that tax treaties between member states specifically say that they are implemented to prevent double taxation and not facilitate treaty shopping.

### Action 7. Permanent establishment status

Usually, tax treaties state that the business profits of a foreign company are only taxable in a country if that company has a permanent establishment to which profits are attributable in such country. Because of this, the definition of permanent establishment is crucial in ensuring that companies pay taxes to the jurisdictions that they are supposed to. Action seven calls for the creation of a joint definition of permanent establishment and, through the negotiation of a Multilateral Instrument (MLI), as the one implemented in 2016, has modified existing tax treaties to include the new definition.

### Action 8-10. Transfer pricing

Over the last years, transactions amongst the same MNE groups, also known as intra-group trade, have rapidly grown. Transfer pricing rules are responsible for establishing the characteristics for transactions within an MNE group, during which profits are allocated to some of the group's companies based in a different jurisdiction. Actions eight, nine and ten look to regulate transfer pricing outcomes



based on the MNE group's value creation. Regarding the issue of transfer pricing the OECD/G20 BEPS Project focuses on three main aspects, all addressed as a different actions.

### **8. Intangibles**

Due to the fact that most intangibles are mobile and their values are hard to assess, action eight focuses on transfer pricing problems with transactions involving intangibles. Base erosion and profit shifting have been greatly affected by the misallocation of profits generated through these transactions.

### **9. Risks and capital**

As stated on the official website for OECD, the work conducted in action nine "considers the contractual allocation of risks, and the resulting allocation of profits to these risks, which may not correspond with the activities actually carried out. Moreover, Action 9 addresses the level of returns to funding provided by a capital-rich MNE group member, where those returns do not correspond to the level of activity undertaken by the funding company" (OECD).

### **10. High-risk transactions**

Action ten focuses on analyzing and controlling other high-risk transactions that may be carried out by MNEs.

### **Action 11. BEPS data analysis**

Action eleven focuses on collecting, analyzing and displaying data about the fiscal and economic impact of tax avoidance and the effects that the actions taken by the OECD/G20 BEPS Project are having.

### **Action 12. Mandatory disclosure rules**

Tax authorities around the world face many challenges. However, one of the main struggles that they encounter is not having relevant and timely information on aggressive tax planning strategies. Action twelve establishes a series of recommendations for jurisdictions to implement mandatory disclosure rules about aggressive tax planning strategies, as well as rules that counter international tax schemes.

### **Action 13. Country-by-Country reporting (BEPS Minimum Standard)**

Action 13, one of the BEPS minimum standards, requires all MNEs to present a country-by-country (CbC) report. The report should establish the allocation of the MNE's income, taxes, profit



and overall economic activity in the different jurisdictions in which it operates. Tax administrations in these jurisdictions receive the CbC reports to further occupy for the development of BEPS risk assessments and high-level transfer pricing.

#### **Action 14. Mutual agreement procedure (BEPS Minimum Standard)**

As multiple enterprises conduct business in various jurisdictions, disputes between jurisdictions over who can tax which type of income often arise. Action 14 of the OECD/G20 BEPS Project aims to tackle this issue. Action 14, one of the Project's minimum standards, uses 21 elements and 12 best practices to assess a state's legal and administrative framework based on the following key elements: preventing disputes, availability and access to mutual agreement procedure (MAP), resolution of MAP cases, and implementation of MAP agreements.

#### **Action 15. Multilateral instrument**

Action 15, takes into account the results from the Project and, through the establishment of the Multilateral Instrument, gives countries' a solution to solve issues or loopholes in tax treaties. "The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("Multilateral Instrument" or "MLI") allow governments to modify existing bilateral tax treaties in a synchronised and efficient manner to implement the tax treaty measures developed during the BEPS Project, without the need to expend resources renegotiating each treaty bilaterally" (OECD). So far, 99 jurisdictions have signed the MLI, which covers over 1,800 bilateral treaties.

## **Major Parties Involved**

### **Organization for Economic Co-operation and Development**

The Organization for Economic Co-operation and Development (OECD) is a non-governmental organization (NGO) that serves as a forum for various countries and jurisdictions to discuss and establish common international standards, based on evidence and data, to find a solution for various social, economical and environmental issues. The OECD focuses mostly on the gathering, presentation and analysis of data, as well as on advising jurisdictions on the creation of public policies. In 2013, the OECD and the Group of Twenty initiated the 15-point Action Plan as their BEPS Project. As mentioned



above, this project is the main solution that the G20 and the OECD have to combat the evasion and avoidance of international tax.

### Mexico

According to a research report released by Professors Andreas Bühn and Friedrich Schneider, between 1999 and 2010, Mexico was the country with the highest size of tax evasion as a percentage of their official GDP. Mexico's tax evasion size was 6.8% of the official GDP. Even though this percentage has significantly decreased since the establishment of the BEPS program in 2013, with Mexico's percentage in 2016 of tax evasion being 2.6% of official GDP, it is still ranked by the OECD as the country (out of the 38 OECD countries) with the highest level of tax evasion.

### United States of America

The United States of America (USA) is the country with the lowest size of tax evasion as a percentage of its official GDP, with only 0.5%. However, being one of the world's biggest economies, it is also the nation with the highest corporate tax losses. Every year, the United States loses an estimate of 188.8 billion USD due to tax evasion.

### Guyana

Guyana is the jurisdiction with the highest revenue loss due to tax avoidance, losing 6.97% of its GDP. Guyana is tied in this statistic with Chad and followed by countries such as Malta, which loses 4.59% of their GDP, and Comoros, which loses 4.42%.

### Switzerland

Switzerland is considered by many to be one of the biggest tax havens in the world. This is mostly because Switzerland's laws offer low rates of taxation for foreigners and, due to their 1934 banking secrecy laws, have made it illegal to divulge any information. Because of this, Switzerland makes up 4.12% of the world's offshore financial market. Many MNEs conduct BEPS practices in Switzerland.

## Timeline of Key Events

1934	Switzerland enacts banking secrecy laws
1962	First CFC rules enacted



1982-2002	Latin American debt crisis
1997-1999	East Asian financial crisis
1999	Group of Twenty founded
2008	Global financial crisis
2010	European crisis
2013	OECD/G20 BEPS Project begins
2016	Multilateral Instrument (MLI) to amend tax treaties is negotiated and enacted
2020	COVID-19 recession

## UN involvement, Relevant Resolutions, Treaties and Events

- OECD/G20 BEPS Project, 2013
- UN Practical Portfolio “Protecting the Tax Base of Developing Countries through the use of General Anti-avoidance Rules”, 2019
- Addis Ababa Action Agenda, July 2015
- UN Handbook on Avoidance and Resolution of Tax Disputes
- OECD/G20 BEPS Project reports and peer-review reports

## Previous Attempts to solve the Issue

The most successful previous attempt to solve the issue is the OECD/G20 BEPS Project (outlined above), which has been organized and carried out by the Group of Twenty in cooperation with the OECD. However, other parties and organizations have also attempted to solve the issue, most notably the United Nations through the discussion of the project on repeated occasions and the creation of the Committee of Experts on International Cooperation in Tax Matters as a subsidiary of the United Nations Economic and Social Council (ECOSOC).



## Possible Solutions

So far, the application of the fifteen actions outlined in the OECD/G20 BEPS Project have proven to be successful in reducing the threats and losses caused by the evasion and avoidance of taxes. Because of this, it is clear that the application of the project needs to continue and any jurisdiction that is still not applying them shall be urged to do so. However, the project most likely requires some revisions and can definitely be improved in some areas in order to find an even better solution to the issue and further decrease the number of losses caused by the practice of BEPS strategies.

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