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Financing sustainable development

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The third way

The euro crisis runs on and on. It is odds on that Greece will leave the eurozone. The question is when? It is also looking increasingly likely that the other peripheral euro countries that are uncompetitive, have high debt levels, and suffer from low savings rates will have to leave the euro and restructure their external debt. Again, the question is when?

The euro crisis has been driven by loose monetary policies in the eurozone over the last decade. The periphery has made itself uncompetitive, savings rates have collapsed, costs have gone up, debt levels soared, and investment has been directed into areas such as real estate that were not economically viable.

Without a reversal of these distortions the periphery will struggle to grow and see debt levels rise substantially. Without growth there will be no solution to the European debt crisis.

There really are only three European solutions for the periphery to regain competitiveness.

First, Germany and the other core countries need to take steps to reverse the policies that led to the European crisis. They can cut consumption and income taxes in order to reduce savings and increase consumption. This would lead to a reversal of trade surpluses and an increase in inflation, the combination of which would allow the periphery to regain competitiveness and lower inflation related to the core and a weaker euro.

Second, the periphery can force austerity and tolerate higher unemployment for years to come.

Third, they can leave the euro and devalue. Euro-denominated debt would mean a halt to debt payments and a restructuring of debt.

Anyone who rules out two of these three ways automatically assumes the periphery will follow the third way. So which will it be, and when? ■

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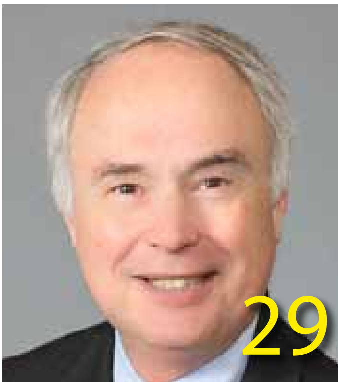

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Competitiveness - the key to growth in a strong Europe

Michel Barnier is the EU Commissioner for Internal Market and Services

We have gone through and we are still experiencing difficult times. I talked about these difficult times almost exactly one year ago, on 9 May 2011, when giving a speech to the students of the Humboldt university in Berlin, in which I mentioned the rise in populist movements throughout Europe which are pressing for a retreat behind national borders, in other words the end of the European project.

One year later, the recent elections in Greece and, to a lesser extent, in France, seem to confirm this trend.

I am convinced that we cannot combat the ideas of these movements if we show contempt for the people who vote for them. On the contrary, we must answer their questions and respond to their concerns by offering them a genuine plan.

"In Europe, in order to reduce the gaps in competitiveness, economic governance needs to be even more integrated"

Not by giving them less Europe, which is what the populists would like to see, but by giving them more Europe. A Europe which is bolder, more democratic and more human.

What are these voters telling us?

First of all, that their personal situation, or their prospects, have deteriorated considerably since the onset of the crisis. The figures are bleak:

- there is expected to be zero growth in Europe in 2012, and the euro zone is even expected to experience a mild recession of -0.3 % of GDP;
- the unemployment rate is rising, now exceeds 10 % on average in the Union, is sometimes much higher amongst young people, and is as high as 24.1 % in Spain;
- SMEs are still having trouble filling their order books and finding funds to launch new projects.

And yet this diagnosis is not enough in itself to explain why Europe and the governments in office are being rejected. We have to acknowledge that what has increased Greek or French voters' support for more extremist parties is doubt about the European response to the crisis. We have managed to avoid collapse through bold, strong measures, but citizens are finding it hard to understand what we intend to do in order to restore employment, growth and prosperity.

They wonder what the European economic strategy is in a world where the situation is improving in the USA and the emerging countries still have astonishingly high growth rates.

If we provide no convincing answer to this question, the temptation to retreat behind national borders and to resort to disunity will become stronger all the time. The single market will be populism's main victim, even though it is our greatest strength in a competitive world and our main asset for emerging from the crisis.

I would like to try to reply today to this question about the European economic strategy by setting out some ideas on what form our action could take. You will appreciate that these are my personal thoughts which do not commit the college of Commissioners.

In the short term, we must continue to repair our public finances and use all available levers to boost growth.

Sometimes consolidating public finances and boosting growth are viewed as opposites, and yet there is no contradiction between the two. Who can reasonably expect to produce growth through debt over the long term? And, conversely, who can expect to bring about a lasting improvement in public finances without strong and lasting growth?

The consolidation of public finances is a priority. In the space of a few months we managed to define our course and adopt common rules which we must definitely keep and apply resolutely.

The new 'fiscal compact', which was patiently negotiated by 25 member states, and the financial stability mechanism, which will become operational in July 2012, are essential steps for restoring stability and confidence. The unwavering commitment of the German government to support the Commission's proposals in this area has been essential.

But there can be no lasting fiscal consolidation without growth. And together with growth, the confidence of citizens.

That is why our common strategy of fiscal consolidation must go hand in hand with a genuine European growth initiative. Under the leadership of José-Manuel Barroso, the Commission has been working on this for several months.

This initiative would involve using all the growth levers at our disposal.

We must commit to structural reforms to assist enterprises and citizens in order to make our economies more dynamic. This is a pre-condition for growth in the medium term.

The efforts that many countries are making in order to modernise their economies, for example the decisions taken by Mario Monti over recent months, and the efforts to modernise the labour market, with a move towards more flexibility in order to adapt to economic conditions, but also towards more security for workers, must be encouraged. And, as these efforts bring upheavals that can weaken standards and social structures in a period that is already fraught with difficulty, citizens must be brought on board, especially through the social dialogue. We also need to maintain basic public services which create a social bond and spread competitiveness.

These national efforts must go hand in hand with European reforms to make life easier for the 500 million consumers in Europe and to enhance the competitiveness of the 22 million enterprises that operate on our large market. This is the objective of our Single Market Act of April 2011, with the simplification of the public procurement rules, especially for SMEs, the creation of the European patent, which would lead to a seven-fold reduction in the costs of protecting innovation in Europe, or the full application of the Services Directive, which could produce an extra 1.5 percentage points of growth in Europe by 2020.

The second growth lever consists of directing the savings of Europeans towards productive investment. We have been less successful in this area than our partners despite the fact that we have genuine assets, in particular the savings surplus in certain countries.

That is why I have made a priority of strengthening the single market in financial services. This is a genuine potential source of economic growth.

The new European authorities now in charge of the supervision of banks, financial markets and insurance companies and our forthcoming proposals to improve the information and protection provided to individual investors can help to improve the allocation of capital between European countries.

But this is not enough. In addition to financial regulation, we must do our utmost to direct savings towards the financing of productive investments. For example, on 7 December 2011 I proposed European passports for funds that invest in young innovative SMEs and in social enterprises, and we are working on a European framework for venture capital. Another idea that could be explored is the creation throughout Europe of a European savings account for individuals with a guaranteed rate of interest, which would be used to finance loans to European SMEs.

Finally, the third growth lever, which we have been talking about for the past few months, is that we must use the full potential of the European public financing at our disposal, especially the following three options:

- the determined action of the European Central Bank, which is helping to gradually restore confidence on the financial markets;
- loans from the European Investment Bank, which accounted for €72 billion in 2010, which could be increased and which must be targeted even more towards the financing of innovative SMEs;
- and our proposal for project bonds, which are designed to finance transport, energy and telecommunications infrastructure projects.

This pragmatic growth initiative that I have just outlined is a mixture of short-term and medium-term levers, financing measures and structural reforms, national measures and European proposals.

All these measures are within our reach. I believe that they could all be rapidly endorsed.

Nevertheless, I would like to state clearly that this European growth initiative for the short and medium term, necessary as it is, will not be enough to put Europe back on the path to lasting growth, and to enable it to cope with the competition from China, India and Brazil, which are now almost continents in their own right.

We need to put in place right now the policies that will take control in the long term.

First of all, we need to tackle the question of competitiveness, which is the condition for a strong Europe in the world and also for lasting growth that is balanced between the countries of Europe.

In Europe, in order to reduce the gaps in competitiveness, economic governance needs to be even more integrated.

The assessment that Europe is in a position of relative decline in the world is nothing new. The same assessment was made when the Lisbon Strategy was launched over ten years ago. And when we adopted Europe 2020 two years ago.

But we are also faced with a new challenge: the challenge of widening gaps in competitiveness between member states.

To take just one example, according to Eurostat, average labour costs in France are now 12% higher than in Germany. Over the past ten years, average labour costs have risen by about 40% in France, compared with 18% in Germany.

Some people might think these gaps in competitiveness are acceptable: they might not see them as a problem, especially for Germany, whose rising exports translated into growth of 3% in 2011 and an unemployment rate of just 5.6 %.

Let me be quite clear: anyone who thinks that is misguided. In fact, such gaps in competitiveness are quite simply unsustainable in a monetary union. We form one and the same team, and if the difficulties faced by certain members are not dealt with rapidly, they cannot fail to affect the other members. Including Germany, which is intrinsically linked to the 16 other member states of the euro zone, and 60% of whose exports go to the other member states of the EU.

So how can our gaps in competitiveness be reduced?

Certainly not by hampering our most competitive economies, as it is Europe as a whole which, would in this case, lose competitiveness. On the contrary, we should benefit collectively from our best practices and make progress by allowing each one to find its specific sectoral position.

"If Europe is to be strong in the world, we need to develop a long-term competitiveness strategy"

By putting in place enhanced European economic governance alongside the budgetary governance.

First of all, I believe that is vital for us to give thought to the relative competitive position of each of the European economies. What are the sectors in which each country has competitive advantages and added value? What are the promising areas in which each of them wishes to invest? These questions have to be answered from the outset.

Secondly, we must fully exploit the existing framework, especially the new economic governance tools, such as the 'European semester' of coordination, and the national reform programmes, in order to help each country to develop the sectors in which it considers itself to be competitive.

We must also make better use of the other policies, especially cohesion policy. By reducing the gaps in our competitiveness, we shall increase our social and territorial cohesion. If we count the European funding and the national co-financing, we are talking about an average of €65 billion of investment per year. In many member states, especially those that joined the EU in 2004, that means more than half of all public investment!

Since the start of the crisis, €17 billion of this funding have been redirected towards sectors such as research and innovation, SMEs and labour market policies for the most vulnerable people. We must maintain our efforts and use the Structural Funds to consolidate comparative advantages, especially by investing in infrastructure and by training workers for the sectors that are considered to be the most promising.

Lastly, if economic governance is to be effective and is to reduce gaps in competitiveness, it must be based on the solid foundation of an effective single market. We need to deepen our internal market. Concrete proposals have been made in the "Single Market Act". On the invitation of the European Council, we are preparing new ones.

I am referring, in particular, to the need to develop a genuine digital single market, and to our E-commerce Action Plan of 11 January 2012. We also need to improve occupational mobility between the member states by improving the recognition of professional qualifications, especially by establishing a European professional card.

The deepening of our internal market, the mobility of workers and, above all, the introduction of genuine European economic governance, should make it possible for us to reduce the gaps in competitiveness between our countries.

But we must also tackle the shared problem of our competitiveness in relation to the rest of the world. It will be hard for us to adjust our costs in order to compete with countries such as China or India. But we can remain, or become once again, an area of production if we focus on innovation.

If Europe is to be strong in the world, we need to develop a long-term competitiveness strategy.

In certain countries of Europe, fortunately not all of them - and especially not Germany - industry is declining, not just traditional industries such as textiles and steel, but also, increasingly, the high-tech sectors.

For example, whereas the telecommunications industry was still dominated by European and US firms ten years ago, only four of the eight main Western firms of ten years ago still exist[1]. Over the same period, two Chinese firms, Huawei and ZTE, have become global champions.

This does not have to be the case! If we wish to continue to be a major player with a seat at the top table where decisions are taken, we need a common vision and strategy for our position in the new world that is emerging. This strategy then needs to inform all our policies, at national and Community level. This strategy must take the form of a modern industrial policy for Europe. If we don't do this, Europe's destiny will be decided on Wall Street or in Beijing. And we will be condemned to become subcontractors or consumers of products produced by others.

Let us not forget that Europe was created out of an industrial policy! By proposing the pooling of coal and steel, Jean Monnet and Robert Schuman had an intuition that these common industries would make another war impossible. But also that they would create an unbreakable bond between Europeans. And that the common interest in being together would make people want to be together.

A few years later, we found the will to create a common food and agriculture policy which today generates more jobs than the automobile sector.

60 years after the beginnings of European integration, I think that the time has come to think about new common investments, which should be targeted at the new

information technologies, biotechnologies, transport and clean energy.

In order to do so, we have identified, under the leadership of Antonio Tajani, key enabling technologies (KETs), such as nanotechnologies, micro- and nano-electronics, advanced materials or industrial biotechnology.

These technologies are known as 'systemic' because they can be used to develop new goods and services. For example, in order to produce electric cars, it is necessary to invest in advanced materials for batteries, photonics for low-energy lighting or industrial biotechnologies to reduce tyre resistance.

How can we promote these technologies?

In my view, we need to tackle the issue in four ways at the same time:

First of all, we need to create the right conditions for innovation. In 2009, 135,000 patents were submitted to the European Patents Office, compared with 161,000 in Korea, 315,000 in China, 348,000 in Japan and 459,000 in the United States. We need to promote innovation in Europe! I referred earlier to our proposal for a European passport and our determination to create a European framework for venture capital, which will make it possible to direct resources towards innovative SMEs. I also hope that we shall reach final agreement in the next few weeks on the single European patent.

We also need to invest resolutely in research. It is not inevitable that young researchers who have qualified at European universities will leave Europe. We must tackle this problem by giving our universities the resources they need and, in certain cases, greater autonomy.

Thirdly, we must give our firms the resources they need in order to invest in research and development and in the development of prototypes:

- We can do this by borrowing, which is legitimate provided that it is targeted at sectors that improve our competitiveness and that directly benefit future generations. This is the logic behind project bonds.
- We can also do this by targeted public funding in areas that are identified as being of strategic importance. In the outside world, the United States, China and Korea invest heavily in order to support certain of their strategic sectors, and even go as far as to grant subsidies to European firms to set up production plants on their territory.

As already initiated by Joaquin Almunia, we must adapt our rules on state aid so that they continue to play their role of ensuring fairness between member states, while making it possible to conduct strong policies for providing state support to underpin the guidelines that we adopt together. For example, by raising the notification thresholds, speeding up procedures and making more frequent use of the derogations that can be applied to aid designed to promote major projects in the common European interest.

Lastly, in the area of trade policy, we must show openness but must not be naive. We cannot accept the fact that the EU is one of the most open trading areas in the world while our firms have difficulty entering other countries' markets. We are open, in our own interests, but we are not naïve.

That is why my colleague Karel de Gucht and I proposed, on 21 March 2012, a regulation which makes it possible to impose reciprocity in public procurement on any countries that do not already practise this principle.

All the points that I have mentioned should make it possible for us to build a strong Europe that can compete economically with tomorrow's giant powers.

However - and I shall conclude on this point - this strong Europe that we need cannot be restricted to the economic sphere. European leaders and the European Parliament must now have the courage and the boldness required to integrate the economic, industrial and budgetary progress achieved in the perspective of a political union, just as Angela Merkel has suggested. This will require, first of all, a shared vision between European leaders, and especially, but not exclusively, between the leaders of Germany and France.

But a strong Europe will also, and above all, need more input from citizens, who often see Europe as a democracy "out there", far removed from their concerns. It is up to us to bring this democracy back to earth and to make it relevant to people's lives.

In order to achieve this, we need more grassroots democracy, especially through greater involvement of regional and local authorities in European decision-making and through the proper functioning of the new European Citizens' initiative, which since 1 April 2012 has allowed citizens to submit a legislative proposal to the Commission if it has the support of one million citizens. But we must bring this grassroots democracy alive through debate, especially using the new mass interactive communication tools offered by the internet.

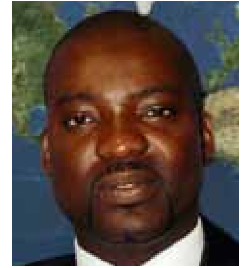
And we shall also need more democracy at the top, which will eventually take the form of a president of the European Union who is both president of the European Council and president of the Commission.

This is how we shall build a Europe that is strong in economic and political terms. And it is how we shall show those voters who are tempted to vote for populist and anti-European parties that a retreat behind national borders would lead us nowhere and that is through Europe alone that we can continue to defend our positions and values in tomorrow's world. ■

1. Point made by Olivier Coste in his article 'Industrie des télécoms : l'inquiétant déclin de l'Europe' (Worrying decline of Europe in the telecommunications industry), published in the newspaper Les Echos on 17 January 2012

This article is based on a speech given at the ceremony to award the Charlemagne Prize to Wolfgang Schäuble in Aachen, 16 May 2012

EU-Africa trade dispute: it's sustainability, stupid



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Introduction

How would a win-win sustainable development perspective in EU and Africa relations differ from the current focus on zero-sum commercial calculations which have so far undermined important dialogues between the partners? As the EU and Africa approach the January 2014 ultimatum for 18 EPA rejectionist states to sign up or lose market access to the EU, the Rio sustainability conference of June 20-22 offers a timely opportunity for urgent reassessments on both sides. Transcending rigid positions and embracing more sustainability-focused dialogues can open up new vistas for EU-Africa economic and development partnership. To achieve this, a more progressive outreach anchored in the sustainability agenda of the Rio+20 summit is urgently needed.

"Transcending rigid positions and embracing more sustainability-focused dialogues can open up new vistas for EU-Africa economic and development partnership"

The deadlocked Economic Partnership Agreement (EPA) negotiations between the EU and Africa's regional Economic Communities (RECs) have shown inconsistencies in EU policies and also the fragmented nature of Africa's regional integration schemes. Both partners will also not present a joint intercontinental position at the Rio summit as envisaged under the Joint Africa EU Strategy, an unfortunate knock-on effect from the EPA dispute.

Transcending rhetoric

Sustainability can be defined as an approach to policy which seeks durable outcomes through prioritising actions that are most likely to promote socially inclusive, economically sound and environmentally optimal ends within the longest possible time horizon. Since the original Rio Earth summit of 1992, global policy makers in Europe, Africa and elsewhere have embraced the centrality of the environment and wider sustainability dialogues as a cross-cutting agenda in distinct policy spheres.

Twenty years on from the original conference, this year's Rio+20 summit will gather global leaders to discuss the future of sustainable development in a context where "pure" environmentalism as a standalone concern has largely given way. Disappointingly though, implementing sustainability as a pragmatic, holistic and progressive approach based on mutual solidarity among industrialised, emerging and developing countries continues to rank very low among several policy priorities.

In theory, sustainability considerations significantly shape international policies, including in trade, investment, environmental regulation, and development cooperation. Yet, the official rhetoric often fails to match the practical actions on the ground when it comes to pursuing policies and priorities most likely to promote global sustainability. In recent years also, a global economy in melt down is further testing the resilience of global development partnerships as zero-sum calculations take explicit priority over greater solidarity.

In Europe, official pronouncements notwithstanding, a broad consideration of sustainability and its opportunities is still not sufficiently reflected in the real world actions and policies framing development and trade relations with Africa. For developing economies in Africa also, a twentieth century mindset still dominates deliberations on sustainability, seriously setting back prospects of devising adequate responses to complex and evolving twenty-first century challenges.

In truth, the changing nature of sustainability in the new global economy makes the traditional distinction between 'high' and 'low' polluters anachronistic. To the extent that it is paid only lip service in real world decision-making, the indivisibility of global public goods, including the common environment, remains a growing but little acknowledged fact of international life. Climate concerns, environmental vulnerability and failure to generate sustainable employment and equitable growth will become mutually reinforcing negative feedback loops capable of undermining African and global poverty eradication efforts. Attention to these interconnected issues ought to occupy a more central place in EU-Africa trade dialogues if both sides are to achieve more mutually beneficial outcomes.

Building sustainable economic partnerships

The Economic Partnership Agreements (EPAs) are a scheme devised to create a Free Trade Area (FTA) between the EU and the African, Caribbean and Pacific (ACP) group of States. Negotiations on them began in 2002 to replace the previously subsisting Preferential Trading Agreements and bring them in line with the World Trade Organization rules.

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Based on reciprocity and non-discrimination, the EPAs will re-establish the trade preferences and barriers removed in the middle 1970s in an attempt to help developing countries in trade with the EU and the rest of the world.

Even the Cotonou Partnership Agreement (CPA) of 2000 which anchors the overall EU-ACP relations sets out a strong development focus, with *"poverty reduction/eradication, sustainable development, and progressive integration of the ACP countries into the world economy"* as its core rationale. Yet, a critical analysis of the important sustainability dimensions of this agreement has been absent from the discussions so far. This essay partly fills that gap.

Much concern has been raised in recent years about the potential negative impacts of the EPAs on the ACP countries, and economic sustainability in African in particular. EPA demands include elimination of tariffs on a full 80 percent of African imports from the EU. Only about 10 out of 47 African countries have signed on to the deal on offer, with the rest rejecting. EPA optimist argue that African states and their Regional Economic Communities can expect major benefits, including a 10 percent increase in overall ACP exports to the EU. Agricultural exports (excluding meat and cotton) and textile products are also forecast to grow by 40 percent.

Deadlocked after more than a decade of unsuccessful negotiations, criticism of the EU's EPA approach in Africa has intensified in recent times. Some studies show that ACP countries will lose on average about 70 percent of tariff revenues on EU imports in the long run. Other commentators focus on the inability of domestic producers to withstand European competition.

EPA rejectionists also point to the European preference for a tight negotiation timetable as evidence of reckless insincerity that seems aimed at dividing-to-rule African interlocutors, in the process exacerbating centrifugal pressures within Africa's eight officially recognised RECs. Also, concerns have been expressed about the likely disastrous impact of EPAs on forests, biodiversity and rural communities in the absence of more transparent Sustainability Impact Assessments which prioritises equitable development outcomes.

In a broader perspective, Africa's robust growth of about 5 percent annually over the last decade has been in spite of – not as a result of – successful regional integration. A disproportionate share of recent trade expansion is dominated by an externally-oriented extractive sector. As the World Bank explained in a 2012 report, Africa loses billions in potential trade earnings as it falls short of its vast promise in cross-border business.

Indeed, concerns that Africa's recent economic rise is fragile is directly connected to the failure of African integration schemes to boost intra-regional trade and overcome structural constraints such as infrastructure and interconnectivity. Africa lacks integrated regional markets that can support greater economy of scale, foster product diversification, and expand the political space for regional climatic and sustainability undertakings.

On the more positive side, there exist opportunities to sustain and upscale Africa's recent economic upturn through a closer and coherent integration of its fragmented markets as well as through renewed focus on a greener economy. More dynamic economies in Sub-Saharan Africa could also identify sectors where they can flexibly take advantage of growing South-South trade while leveraging sustainability as a comparative advantage.

However, if the EU's EPA offers are forced through by the January 2014 ultimatum, they risk undermining both integration and green progress. As a study by Trade Law Centre for Southern Africa (TRALAC) argues, EPAs have fostered an unusually critical review of African integration agendas themselves, revealing important gaps between the political ambitions and economic reality that underpin them.

In general, recent trade negotiations with Africa have focused excessively on liberalization for goods trade whilst issues that really matter for the enhancement of African trade performance, including intra-African trade and quality of exchanges with the rest of the world, are ignored. Even as recent EU policy proposals highlight the vital role of the private sector in future development partnerships, it will be ironic if EPA missteps undermines these dynamic engines of growth in Africa's non-commodity sectors.

The core challenge remains how to foster greater diversification in African productions, while supporting the emergence of regional champions that can lead the way in realising comparative advantages, including in biofuel, solar and other renewable energy sources.

Furthermore, it will be vital to pay closer attention to the climate-security nexus as Africa faces proliferating instabilities. A sustainable African outlook will be impossible as long as the scourge of renewed conflict remain unaddressed. If rising instability is left to fester, the most likely scenario for Africa over the coming decades is one of modest economic growth existing alongside political and social upheavals, potentially compromising sustainable development outcomes.

A major point of weakness has emerged in especially West Africa/Sahel and the Horn of Africa regions where growing instability blocks critical regional integration and economic growth arteries. Here, a toxic combination of conflict, food vulnerability and environmental fragility are rapidly taking hold. If unchecked, they will reverse much of the modest gains of recent years.

To be sure, Africa's trans-border insecurities have recently proliferated on a scale not seen since the conflict-ridden 1990s. These dynamics hardly conduce to sustainable development, but an increasingly inward-looking EU also represents a key concern especially as the Union turns away from a once promising security partnership with Africa's continental body post-Libya conflict. The EU has mostly restricted itself to verbal condemnations and symbolic sanctions amidst the raft of military coups and an Islamist takeover in northern Mali which threaten to destabilise

whole regions. Certainly, a renewed EU engagement focused on sustainable security and stable development is needed in these contexts.

What should be done?

First, the EU should promote sustainability through genuinely inclusive global policies. Beyond the soaring rhetoric, the EU EPA negotiations should play closer attention to what environmentally conscious corporate actors, their ideas and green innovations can add to make the EPAs deliver for all signatories. Corporations such as Unilever and Phillips (both Dutch) and Marks and Spencer (UK), along with other European businesses, are currently engaged in an advanced process of environmental partnership and corporate social responsibility which directly involves suppliers in Africa and elsewhere. Rather than leaning on EPA rejectionists in a way that potentially compromises the prospects of African private sectors, the EU should instead emulate a partnership approach modelled on these private sector pioneers in order to ensure consensual and durable EPA outcomes.

Crucially, these corporate green leaders are already offering leadership in areas where governmental action seems behind the curve. Examples include their structured dialogues on the sideline of official deliberations at Rio, with the objective of synthesising new innovations into policy ideas capable of complementing national and global level initiatives.

Second, the EU must reach for more than just symbolic leadership. Current EU policies need to evolve towards practically linking sustainable development to wider policy areas. Recent EU policy pronouncements feature a strong rhetorical commitment to sustainability – from the Europe 2020 green targets to the sustainable development objectives in the Agenda for Change ratified by the European Council on 14 May 2012.

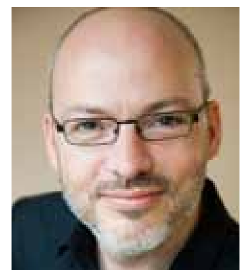
In Cancún in December 2010, the EU also supported enthusiastically a commitment by developed countries to mobilise jointly US$100 billion per year by 2020 to promote mitigation and adaptation actions in developing countries. Yet, the assumption that the EU's share could be about one third of this amount seems overly optimistic given the sovereign debt crisis and pressures on the EU's overall budget. Alternative funding sources from the private sector and carbon markets area also doubtful in the deteriorating global economic climate.

Furthermore, the EU's overall emission has grown at the same time that countries like the United States are reducing their levels of pollution. Without real movement towards addressing policy contradictions in interconnected spheres, the EU risk becoming a laggard in the green debate. The EU must urgently meet its sustainability challenges as part of efforts to build a dynamic European economic model fit for the 21st century.

Finally, Europe *can help shape a vision of the future*. Many separate fulcrums of the European policy architecture also need to work in tandem to promote a more sustainable global vision. Addressing global poverty and rising vulnerabilities, the European Parliament in a recent declaration regarding the effects of the global financial and economic crisis reaffirm *"the EU's obligation to assist developing countries in coping with the burdens of the global economic crisis and climate change"*.

Yet, such commitments have been repeatedly watered down during the lengthy process of translating the EU Commission's modernisation proposals into laws governing EU development cooperation. Recent EU initiatives such as the April 2012 Sustainable Energy for All Summit in Brussels have also provided little added value beyond the high-profile publicity that surrounds them. On the road to Rio+30 in 2022, a more forward looking EU should move beyond imperfect compromises to shape a more substantive vision of sustainability at both the European and global levels. ■

Whatever a society can do, it can also finance: financing sustainable development



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Since the Rio Summit of 1992 the imperative of sustainable development has become widespread. Today, as we arrive at the Rio+20 Summit, significant progress has been made in only four of the 90 environmental goals. These are eliminating the use of substances that deplete the ozone layer; the removal of lead from fuel; access to water; and research to reduce pollution of the marine environment. Yet progress in the most important goals agreed to at Rio, including on climate change, desertification and drought, is slow if not completely absent. We are facing an ongoing climate crisis and the non-attainability of the Millennium Development Goals. Over the last two decades,

the average amount of CO_2 in the earth's atmosphere has shown a steady rise of nine percent since 1992[1].

To sum up, 20 years later, despite having internationally agreed goals, the world is still on an unsustainable path. The main reason for this is not a lack of political will as such but rather unused possibilities of finance.

An abundance of money and ideas

Create sustainable investment opportunities for private capital

There is a big amount of private money waiting for sustainable investment, provided it is lucrative. This is currently the case for few sustainable investment opportunities. However, green investment could be made widely profitable and thus become attractive for private investors. One field-tested tool for this are feed-in tariffs: a targeted subsidy that obliges energy suppliers to buy electricity produced from renewable resources at a fixed price. These guarantees ensure the support of all viable renewable energy technologies and investment security.

> **"... the world is still on an unsustainable path. The main reason for this is not a lack of political will as such but rather unused possibilities of finance"**

Here the International Monetary Fund (IMF) has a role to play[2]: the IMF has the ability to create its own reserve currency - the so-called Special Drawing Rights (SDRs) - when its members tell it to do so. In April 2009 the G20 instructed the IMF to create new SDRs worth US $250 billion. The Stiglitz Report[3] also claimed a greater role for SDRs in the international monetary system, with a regular and automatic issuance.

A global sustainable development fund financed by an innovative use of these SDRs could provide the money needed to implement feed-in-tariff legislation. Inflation would be avoided because SDRs are given against performance, namely the production of renewable energies. This can immediately introduce a huge supply of solar and wind energy in less developed countries. In this field alone a market for private investors worth several hundred billion a year could emerge.

Don't be afraid of planning and governing

A CEO needs to have plans – and plans that can evolve. Governments as well. As Ha-Joon Chang succinctly puts it[4]:

> *"Suppose that a new CEO arrived in a company and said: 'I am a great believer in market forces. In this fast-changing world, we should not have a fixed strategy and should maintain maximum possible flexibility. So, from now on, everyone in this company is going to be guided by ever-changing market prices.' What do you think would happen? Would his employees welcome a leader with a vision fit for the twenty-first century? Would the shareholders applaud his market-friendly approach and award him with a pay rise? He wouldn't last a week.*
>
> *People would expect a new CEO to say something like: 'This is where our company is today. That is where I want to take it in ten years' time. In order to get there, we will develop new industries A, B and C, while winding down D and E. In order to develop our subsidiary in industry A, we will have to cross-subsidise it with the profits from existing businesses. In order to expand our business in industry C, we will need to increase our Research & Development investment in the next five years.'"*

Best practices of companies and best policies of states are both required. Companies can contribute their creative ideas and innovative solutions. Some have introduced environmental profit and loss accounts. However, the pool of green corporate champions is small. Yet while companies act at the micro and accordingly grassroots level, governments operate essentially at the macro or rather gross level.

We can't seriously leave our environment and the well-being of present and future generations in the hands of single companies and consumer groups. We can't seriously leave it to chance to either destroy or protect and support the environment and people's well-being. We can't seriously leave it to a patchwork of volunteer initiatives if we want to have a chance to be successful and efficient.

Why take an inefficient roundabout route via incentives when it is more effective to ban harmful practices directly? For example, Ireland will introduce a plastic bag tax in 2013. But a complete ban on plastic bags was successfully implemented by Rwanda, Los Angeles and other cities in the United States. Spain has made the installation of solar cells obligatory for new houses and renovations. The top-runner policy from Japan mandates the most resource-saving products to be the legally binding minimum standard.

Use states' capacity for steering

Public investment is needed because there is not always a super return or an attractive economic profit, yet the investment is highly important for ecological and social reasons.

Take as an example public transportation, which is essential for environmentally friendly mobility: since its privatisation in many countries rural areas have become more and more excluded. The quality has gone down and prices have gone up. It has become unattractive and unaffordable for many people.

Therefore concerted public investments and well-targeted subsidies are invaluable, in public transportation as well as in renewable energies, energy and resource efficiency and social infrastructure. Good healthcare, good education, good shelter as well as communication and freshwater supply needs to be reclaimed as basic rights for all. In the same way, harmful subsidies, such as to the coal, gas and oil industries must be removed.

The International Labour Organisation[5] estimates: *"The transformation to a greener economy could generate 15 to 60 million additional jobs globally over the next two decades and lift tens of millions of workers out of poverty."* As social

dumping is not a way forward, a social protection floor must also be put in place[6].

Public investment needs to be directed especially into weaker economies, so as to promote progress and distribution of wealth. Financing can be drawn from an expanded role of already existing development banks like the European Investment Bank and from specialised green and social development banks. Public procurement is also a strong means to promote sustainability, as public authorities from the local to the global level have a huge spending capacity.

Make the erosion of public finance history

Governments' failure to effectively respond to social and environmental problems is also due to a global tax race to the bottom: tax competition has driven down rates of corporate tax and top brackets personal income tax. Since the European Union expansion, this process has especially accelerated in the flat-single-rate tax regimes of Central and Eastern European member states.

Massive tax avoidance has been tolerated, resulting in lost revenues which could be used for sustainable development - a major obstacle in both the North and the South. Developing countries lost between US $775 billion and US $903 billion in 2009[7] because of accounting practices of multinational companies and the use of tax havens by them as well as elites in the developing world. There can be no fiscal health so long as enormous amounts of trade and investment flows are channelled to tax havens.

Measures taken to address this issue remain unnecessarily ineffective. The OECD standard for tax transparency, for example, implies that tax havens are only obliged to provide information upon request. This leads to the paradox that a suspicion has to be provided before - and so without - information. In lieu thereof, an automatic exchange of tax information between states would be effective and technically realisable.

In addition, the United Nations Committee of Experts on International Cooperation in Tax Matters under the Economic and Social Council (ECOSOC) could simply be upgraded to an intergovernmental body. It's a pity to leave multilateral agreements as unsealed gentlemen's agreements. To be effective, they must, of course, be enforceable by international courts.

Financial assets are more than three times the size of the global Gross Domestic Product. In other words, financial assets are more than humanity produces in a period of over three years; the total value of the world's financial stock has increased from US $175 trillion in 2008 to US $212 trillion by the end of 2010[8]. This is in spite of the financial crisis and has even surpassed pre-crisis heights. This economy is stupid, isn't it?

Yet the economy doesn't need to stay stupid. It doesn't need to be rigid - just fair. Taxes are simply taxes, not expropriation. The reduction of corporate taxes and of taxes on higher incomes that we have observed for so long has to be reversed. Achieving a reduction of debt could be a piece of cake. There is no reasonable cause for the huge income gaps we have among the population. The argument that some people work harder than others and therefore have earned their wealth simply does not hold.

Taxes can be implemented unilaterally. They are, of course, more efficient if they are coordinated across jurisdictions so as to minimise tax competition and tax avoidance. Wealth taxes, a common assessment basis for corporate taxes, and a ceiling for tax reduction are useful means. The whole world does not necessarily have to implement these means simultaneously – alliances of vanguards or regional policies such as for the eurozone are also an option.

Taxes are a much more sustainable source of finance than private capital flows, which come and go quickly. As the Tax Justice Network[9] emphasises:

> *"Tax is the most sustainable source of finance for development. […] To meet the Millennium Development Goals, OECD countries have been urged to raise their levels of aid to 0.7 percent of gross national income – but this is as nothing when compared to potential tax revenues."*

The missing key: democratic leadership

Evidence shows that progress is still much weaker than needed, even though we are not short on money and ideas. Businesses are playing a recognisable role at Rio+20, while governments often fail to agree and implement policies for sustainable development. No single state or bloc of countries appears to want to go ahead.

It is what the political scientist Ian Bremmer has described as the G-zero world as opposed to the G20. The main obstacle remains single interest policies instead of policies for the common good of sustainability. Do we have to live with it or can we overcome? In any case, at least we have values and means which we can follow.

Fair play – responsibilities are common but differentiated

Fair play includes burden-sharing between rich and poor countries. Priorities are, of course, reflected in public budgets more than in declarations and action programmes.

One fair way is a universal fiscal equalisation scheme: best policies have already proven to be effective. Germany has, for example, a system of financial income adjustment between federal states, in order to compensate for regional and structural inequalities. Such a model would be consistent with the International Covenant on Economic, Social and Cultural Rights.

The second crucial pillar builds on the polluter pays principle: Those countries that are most responsible for climate change and have benefited from the damage have to compensate for the costs. Their climate debt has to be paid off over the coming years and decades[10].

Ombudspersons for future generations

If we want an environmentally friendly and socially just world, these need to be the leitmotifs of decision making at all levels – globally, nationally and locally. This would

be the key role of ombudspersons elected by the United Nations and national parliaments. The World Future Council is working to have ombudspersons established under the Rio+20 Summit's major theme of Institutional Framework for Sustainable Development (IFSD). Precedents already exist in Hungary, Israel and Wales.

Ombudspersons are essential to strengthening the leitmotifs of ecological and social well-being for present and future generations. They can ensure a long-term agenda in policy making. They need to become the CEOs for sustainability. ■

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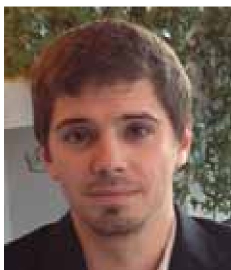

Public procurement: untapped potential for sustainable economic development

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Strategic government spending can trigger market demand for sustainably produced goods and services that meet or exceed environmental and social standards. When done properly and sustainably, public procurement; ie. sustainable public procurement (SPP) creates synergies between innovation, market growth and sustainable development.

Strategic government spending can trigger market demand for sustainably produced goods and services that meet or exceed environmental and social standards. When done properly and sustainably, public procurement; ie. sustainable public procurement (SPP) creates synergies between innovation, market growth and sustainable development.

A wide-range of sectors, products and services are potentially impacted by employing SPP and an even bigger impact is possible when well-thought-out public-private partnerships (PPPs) and other private finance initiatives (PFIs) are used to invest in public infrastructure. Examples include water supply and sanitation, low-carbon energy and transport, and green buildings.

A win-win situation is possible for everyone as social and environmental goals are met along with economic ones. SPP also makes sense from a business perspective. Research on business investments during the 2006-2010 period found that companies with investments incorporating environmental, social and governance (ESG) factors, performed better than those who did not. The best sustainability investors in Europe and the US outperformed others by respectively 1.6%

and 2%.[1] Another Harvard study found that sustainability performance can actually be a strong driver that delivers a stable competitive advantage.[2] In corporations considered sustainable, the board of directors is often responsible for sustainability and incentives for top officials are linked to the company's sustainability performance. One conclusion when comparing high and low-sustainability companies is that the former put more focus on long-term value creation than short-term financial performance.

Interestingly, regardless of evident country-level differences, sustainable investments appeared relatively resilient during recent economic turbulence in several OECD countries.[3] Government stimulus packages, which included green investments in most parts of the world, played a role. In total, the world spent about 3.3 trillion USD on fiscal stimulus, of which 513 billion USD was spent on green investments. The largest part (64%) was spent on energy efficiency (buildings, transport, grids), followed by water-related investments (16%) and renewable energy (8%). Green stimulus is not sufficient, however. It needs to be structured so that it attracts private capital.

Longer-term policy support to encourage markets to invest in sustainable economic development is important and fiscal instruments such as public procurement can be employed to this end. Procurement of infrastructure, for example, can encourage green industrial growth by prioritizing spending on sustainable products and services in which technology learning and supply chain improvements can still drive down costs and add considerable value.

Size and impact of sustainable public procurement

Government purchasing adds up to substantial sums, accounting for as much as 45 % of government budgets. In most countries, government procurement of goods and services accounts for 15% to 20% of GDP. In 2011, OECD countries spent on average 12% of GDP on procurement. While procurement in the United States stood for about 12% of GDP, this was 17% of GDP in the EU. When procurement contracts of state-owned utilities are included, estimates can go up with 2% to 13% of GDP.[4]

The importance of procurement in the national economy rises in developing and emerging economies to about 25% to 30% of GDP.[5] In 2011, it was estimated that procurement in China accounted for about 20% of GDP. In India, this was even 30% in 2008.[6] Procurement in Vietnam is positioned in between and represented at least 25% of GDP in the last decade.[7]

With such economic clout, procurement decisions can influence design, production and business practices by specifying that the goods and services they buy are designed, produced and delivered with the environment and society in mind. Moreover, economic advantages accompany the environmental and social benefits.

A good example is the Energy Star label, which was originally developed by the EPA as a voluntary program for purchasing energy-efficient products. It developed into an international standard and saved 19 billion USD on utility bills in the US in 2008 alone. Similarly, the North American domestic market for green electronics, including computers and mobile telephones, emerged when the United States government began buying green in the early 1990s. Introduced in the US Federal Purchasing Regulations in 2001, the Electronic Product Environmental Assessment Tool (EPEAT) covers more than 60% of the US market. This tool evaluates and ranks computers, notebooks and monitors based on 23 environmental attributes.[8]

"Government purchasing adds up to substantial sums, accounting for as much as 45% of government budgets"

In Europe, public procurement helped launch markets for organic food and drink, fuel efficient vehicles and sustainable timber products. Public sector demand for such Fair Trade Mark food subsequently increased by 11% per year from 2003 to 2008.[9] In general, governments are reporting notable cost and efficiency gains through their SPP policies. Seven European Union member states report a 10 to 12% reduction in energy and fuel costs by leasing green electronics and vehicles. Governments have also used SPP to reduce their carbon footprints.[10] In addition, it is estimated that by 2009, SPP reduced the costs of procurement by 5.7% in the UK.[11]

Green procurement requires a thorough understanding of material inputs, processes and impacts. A variety of tools and methods are available. One method is to integrate life-cycle costing (LCC) in procurement decisions. While many procurers already use LCC in certain decision-making processes, capital costs constraints inhibit it from becoming mainstream in calculation methodologies. This is especially the case in developing economies. Another SPP measure is to include social and environmental standardization when preselecting suppliers or in technical criteria of procurement tenders. It is also possible to use specific product lists, which are regularly updated to support innovation in product technology and design.

In the USA for example, LCC analyses are used in the environmental attributes that are required for the procurement of some target products. These specifications are set out by Executive Orders and Federal Acquisition Regulations for the procurement of target products, and need to be followed by federal agencies. To enable an uptake on the state level, the Environment Protection Agency (EPA) has designed a voluntary Environmentally Preferable Purchasing (EPP) program. This program provides procurers with tools, checklists and guidance to implement SPP without adding more red tape. On average, however, the weight of LCC is still rather limited. For example, in the EU, the main criterion is still the purchasing cost.[12]

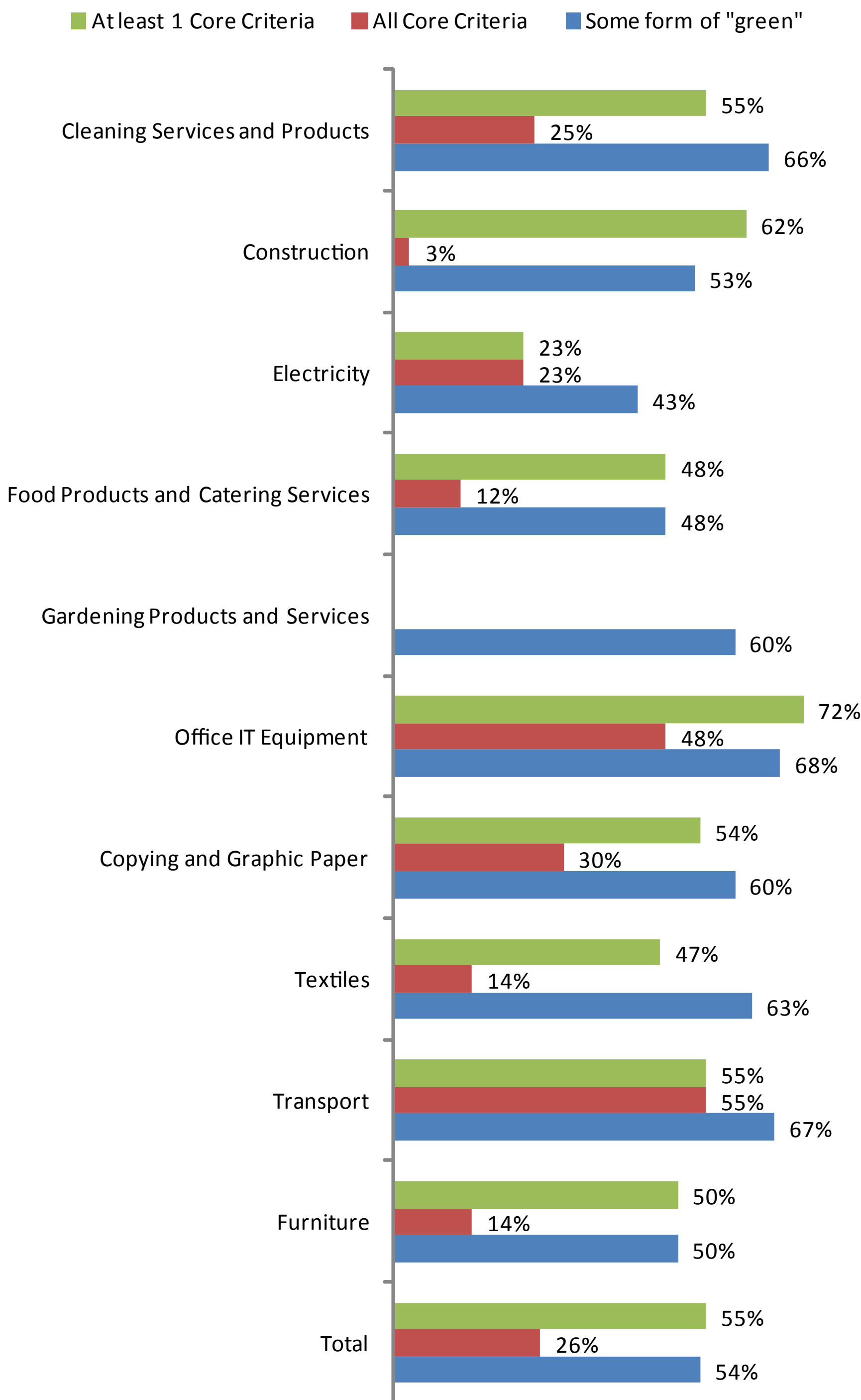
Public Private Partnerships for infrastructure procurement

Governments also need to procure large infrastructure projects, which are costly and difficult to fund solely with government revenues. Shifting government priorities, population growth, climate change risks and other

environmental stresses as well as constrained revenues put pressure on public infrastructure programs. No country is exempt. In the aftermath of the financial crisis, heavily indebted economies are politically forced to austerity. Rapidly growing economies, from their side, often have urban areas with rapid population growth, hence putting pressure on existing infrastructure to expand. Furthermore, economies in transition often see Official Development Aid slowly decreasing when they reach the GDP level of a lower middle income country. Finally, budgetary constraints are particularly acute in countries with stretched government budgets and least-developed countries.

Infrastructure development is always necessary and governments are looking for ways to proceed when adequate money is not available in government coffers. For example, in Vietnam the share of infrastructure procurement has been consistently between 8% and 10% of GDP in the last decade.[13] Because of the aforementioned budgetary constraints, governments have sought alternative purchasing contracts such as public-private partnerships (PPPs).

Inclusion of green procurement per product group (by number of contracts) in the EU 2009-2010



Source: The uptake of Green Public Procurement in the EU27, Centre of European Policy Studies, Brussels, February 2012, Annex B

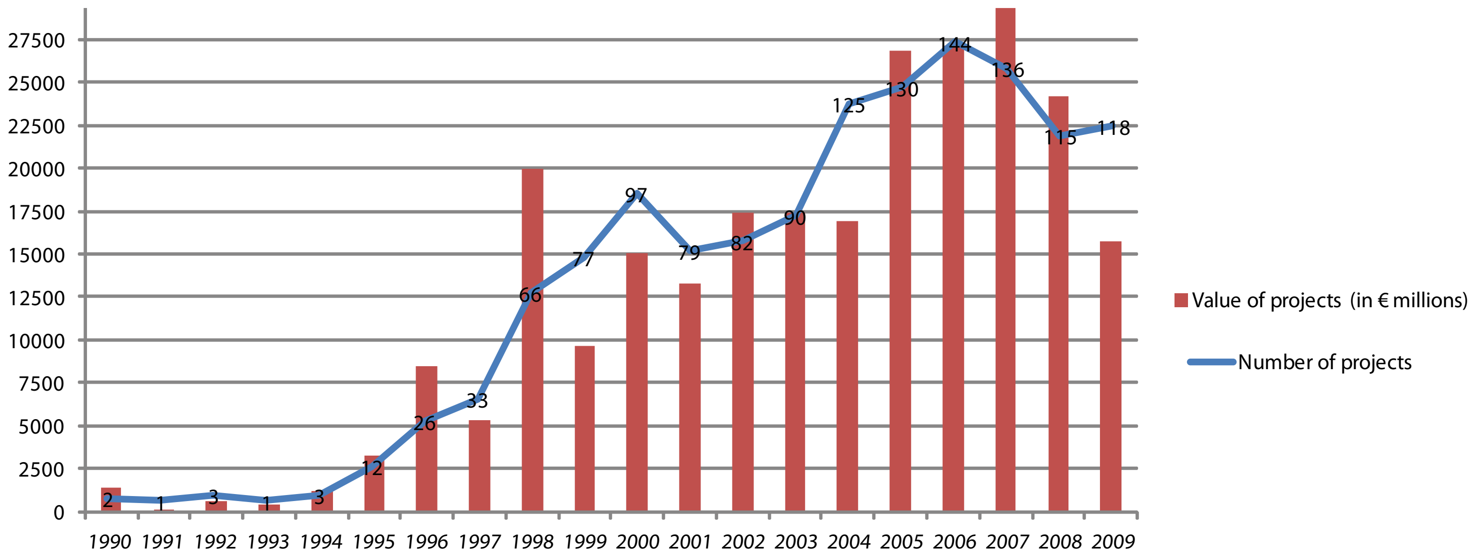
In such schemes, the design, finance and construction of public assets are undertaken by private enterprises who are then commissioned to maintain the project for 15 to 30 years after construction. While PPPs were initially restricted to public infrastructure in the form of roads, railways, prisons, government buildings, power generation, or water and waste treatment facilities, these arrangements have increasingly moved into the provision of social infrastructure and related services, such as schools, hospitals and other health services.

As PPPs become increasingly popular, their drawbacks become more obvious. Accountability and transparency issues are distorted under PPP models of financing and agreements, as private sector funding components fail to appear on public spending records. Similarly, evaluation is made more difficult as private sector data on profits, costs, or lessons learnt can be considered issues of commercial confidentiality and less easily accessible.

PPPs are yet to deliver on their potential for long-term sustainability. To reach sustainability goals, a rethinking of business and contractual models is needed. This includes not only a greater integration of sustainable procurement and sustainable investment principles into PPP agreements and contracting processes, but also a consideration of the potential for PPP procurement to serve as a vehicle for green growth.

On the other hand, private financing initiatives (PFIs) offer more transparency and accountability when governments maintain greater control over the performance of the asset. Enterprises are paid for their investment in predefined instalments, conditional upon the performance of the asset, over the lifetime of the contract. Similarly, energy service contracts - where enterprises

Evolution of European PPPs per annum



Source: Kappeler, A & Nemoz M (2010, July). Public–Private Partnerships in Europe - before and during the recent financial crisis. European Investment

Use of life cycle costing (LCC), total cost of ownership (TCO) and purchasing cost, EU 2009-2010

Mostly evaluation on LCC/TCO
Sometimes evaluation on LCC/TCO, sometimes on purchasing costs
Mostly evaluation on purchasing costs

	Mostly evaluation on LCC/TCO	Sometimes evaluation on LCC/TCO, sometimes on purchasing costs	Mostly evaluation on purchasing costs
Central government	9%	29%	62%
Regional government (ie. county, region, province)	3%	31%	66%
Local government (eg. municipalities)	5%	32%	63%
Independent regulator (eg. telecommunications, water, energy)	6%	24%	70%
Other (semi) public authorities and organisations	13%	35%	52%
Total	6%	30%	64%

Source: The uptake of Green Public Procurement in the EU27, Centre of European Policy Studies, Brussels, February 2012.

cover capital costs which are repaid over the contract term from cost savings generated by the energy efficiency measure - can be used to implement utility upgrades in energy efficiency, renewable energy and water efficiency. It can also be cost effective to long-lease electronic equipment, vehicles and furniture. Here, maintenance, repair, upgrading and replacement costs are carried by the suppliers. Cooperative contracts and central purchasing platforms for the collective negotiation of government purchases can also offer sizable bulk discounts.

"Public procurement can influence markets, drive innovation and facilitate efficient, green industrial growth"

Sustainable public procurement and green growth

Public procurement can influence markets, drive innovation and facilitate efficient, green industrial growth. The tipping point at which public sector demand provides sufficient scaling for green private sector innovation will vary by sector according to government policy and economic activity. As demonstrated by Figure 1 (inclusion of green procurement per product group) above, sectors receive varying levels of green procurement inputs, while individual product groups or sectors may be more easily 'greened' than others, depending on factors such as their technology or market maturity.

Comprehensive strategic policies are needed, however, to tap into the large market potential, where regulation, R&D investment, or incentives may be necessary to overcome barriers and stimulate growth and innovation. Businesses require a secure demand to achieve economies of scale, and to be able to plan ahead. Simply put, private sectors are able to create value, only when governments provide this long-term, stable policy environment.

Governments can build on other successful procurement programs, which include, among others, the use and progressive upgrading of sustainability standards, life-cycle costing, the development of coherent and transparent procurement methods, product listing strategies and the inclusion of sustainable investment principles when private capital is involved.

While some governments already perform relatively well on SPP, there is much space left for improvements and progress. In case of PPPs, governments in general have not yet taken a strong leadership role on social and environmental issues. However, in case they do provide the correct incentives, the private sector will take the risk to invest in and innovate for sustainable development. Considerable gains are possible. Public procurement can be used to advance growth and to implement national policies on energy and climate change.

In its work on public procurement, IISD – a non-profit research organization – promotes sustainable development and good business simultaneously. It discusses the monetary cost and benefits of SPP and explores the efficiency of alternative procurement models - including those that integrate private capital - to foster innovation, reduce costs and create competitive advantages in green growth.

IISD has been working to improve the uptake of SPP policies by engaging with governments and the private sector to conduct SPP preparedness assessments and launch pilot projects to exploit the synergies between economic and sustainability performance.

Among others, through its leadership in the International Initiative on Procurement and Green Growth, IISD explores the necessary enabling conditions that allow for the harnessing of co-benefits. ■

IISD's work on sustainable public procurement can be found at www.iisd.org/markets/procurement

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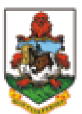

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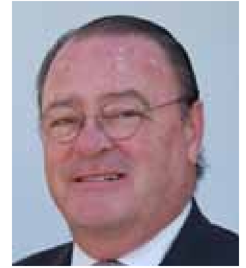
Sustainable development: a success story



Pedro Menéres Cudell is President of Banco Espírito Santo Cabo Verde

This article is about a success story. I will do this first hand and in a small but significant way. It is a success story which I can testify and, to an extent, claim a small contribution to the achievement.

As an entrepreneur and manager of a multinational corporation with strong and enduring connections to the Portuguese world, I have been able to witness the winds of change and the significant influence that companies, countries and international organisations policies have had on the development of Cape Verde and other Portuguese speaking communities and its peoples. Our experienced group has been following the evolution of those trends and we have been an active partner in the development of North-South and South-South relations.

"Cape Verde is an extraordinary country, an example for Africa and the World"

Cape Verde is a Small Island Developing State (SIDS) and I recall that when we first studied the opportunity of establishing our operations, Cape Verde appeared to have all the ingredients for a failure:

- Lack of natural resources;
- Lack of a developed, competitive and independent economy;
- Lack of geographical dimension and at the mercy of the elements;
- Lack of accessibility to Europe and Africa itself, and;
- Lack of a continuous and cohesive territory.

Almost everything seemed to be missing, except for the courage, determination and strength of its people, moved by a unique culture in which language played a decisive role in integrating the Cape Verde nation and advancing external relations with the community of Portuguese speaking countries.

Cape Verde is an extraordinary country, an example for Africa and the World.

Today, Cape Verde plays a crucial role in the development of South-South relations because it has vindicated its strategic position, its geographical importance in the Atlantic, because it has proven to be an open and free society driven by change and a strong determination to improve. Cape Verde is a role model due to the grandeur of its people, a well established peace, and an exemplary democracy. Cape Verde has been showing the world that, despite the insufficiencies resulting from its insularity, it does not lack character, will, creativity, universality and winning spirit.

As you may be well aware, Banco Espirito Santo Cabo Verde is a member of the Planet Earth Institute National Committee which is a platform that brings together the efforts from government organisations, scientific community, companies, universities and civil society in favour of a better and broader action for the environment, biodiversity and geo-diversity in Cape Verde.

The establishment of the Geopark on Fogo Island is a project of enormous importance locally, regionally and globally. The stunning volcanic landscapes of Fogo Island, along with its potential to foster eco-tourism activity in a region in a developing stage have been this project's backdrop. And it is a powerful example of the use of adversity for development and how local populations can be major players in driving their future. This is the lesson of the Fogo population and their effort to achieve the rank of a UNESCO Geopark for their island. So, adversity can lead to development and contribute to turn this island in a real *"case study"*.

We have in mind the Mauritius' Declaration and we are aware of the challenges that we face. We strive every day to create conditions, in the critical areas for the region's sustained development, namely in the following fields:

- Energy where we are contributing through the renewable industry's investment, in an effort to reduce the energy vulnerability;
- Biodiversity where we sponsor programs and projects in order to build terrestrial and marine protected areas;
- Culture where we support the Cape Verde culture, domestically and abroad, promoting cultural industries, namely music and gastronomy, both essential to the development of tourism;
- Marine resources where we promote the need for sustainable management of marine resources, most specially those related to fishing industry;
- Agriculture and rural development where we support projects intended to promote agriculture competitiveness through the long-term advancement of efficient systems, diversification and value-added

activities, and to ensure food security, particularly through research and development;

- Transportation and safety where we support leading projects in technology and technical assistance for the development and management of transport infrastructures to meet international requirements, including those related to safety, and to minimize environmental impacts. The international airports located on the three islands of Santiago, Boavista and Sal are projects co-financed by Banco Espirito Santo, and they were built serving these parameters.

Our commitment to these and other social and human development projects is part of the DNA of Banco Espirito Santo Group.

Nowadays, more than ever, we are aware that the financial sector has a fundamental role in implementing sustainable development in business and global processes. We strongly acknowledge that economic growth is deeply connected to social cohesion and the protection of the environment. Thus, in our core business we strengthen our scope at the sustainability level.

Having integrated sustainability into our business model we have been contributing proactively to the building of a sustainable future. This has allowed us to overcome contemporary challenges.

This extremely positive experience deserves to be shared and it is our objective to take it to geographies where we operate and where our business is present.

Cape Verde is on the route to success in a path for the future. It is an honour for us to participate with you in this challenge of sustainable change. The future is green; green for hope and green for nature. The future will be what we make of it today. Today's meeting of is the proof that we can.

So be it. It is in our hands to shape tomorrow. ■

This article is based on a speech given by Pedro Menéres Cudell at the United Nations (New York) 13th May 2011, Planet Earth Institute, Cape Verde National Committee CSD19 High-level Meeting

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Rio+20: an interview with the Secretary General of the International Chamber of Commerce, Jean-Guy Carrier

On June 20-22 governments, the private sector, NGOs and a host of other interest groups will converge in Rio de Janeiro to take part in the United Nations Conference on Sustainable Development.

Marking the 20th anniversary of the 1992 United Nations Conference on Environment and Development (UNCED), in Rio de Janeiro, and the 10th anniversary of the 2002 World Summit on Sustainable Development (WSSD) in Johannesburg, the event, known as Rio+20, presents an opportunity to take stock of what it has achieved, what is underway, and what still remains to be addressed in the realm of sustainable development.

Led by ICC Secretary General Jean-Guy Carrier, an ICC delegation of over 350 business and industry experts will be in Rio to ensure that the voice of business is heard during discussions, which will focus on two main themes: How to build a green economy to achieve sustainable development and lift people out of poverty, including support for developing countries that will allow them to find a green path for development; and how to improve international coordination for sustainable development.

What do you hope will be accomplished at Rio?

Jean-Guy Carrier: We meet in Rio at a time when the world is facing multiple and interlocking crises relating to climate change, food, water, energy and of course the global

economy. These all portend significant threats to economic growth due to continually rising natural resource demands, increasing environmental and economic costs of resource development, and the evident commodity price correlation among food, steel, timber and oil, and resulting price volatility.

"The challenges the world faces call for an integrated, strategic approach"

In Rio, governments have a game-changing opening to transform market failures into market opportunities. It is an opportunity to change this pathway and reaffirm the view that a sustainable economic transformation generates multiple and mutually-reinforcing benefits that include: sustained economic growth and job creation; healthier and wealthier populations; greater resource efficiency and biodiversity; cleaner air, water and natural environments; and expanded access to more secure energy supplies.

Rio+20 offers an opportunity to provide confidence for the private sector to scale up investment and innovation to achieve a green economy by providing a global framework for guidance, including enabling conditions and a global level playing field.

Business is suffering from a crisis of confidence created by volatile economic conditions. One negative consequence of this has been to delay business investment at a time when jobs are badly needed. The environmental crises also present similar challenges, they both stem from complex issues that lead to a lack of confidence and leadership, which hinders private investment. The first step is therefore to try to restore confidence and stabilize the world economy in order to reduce volatility and encourage business investment.

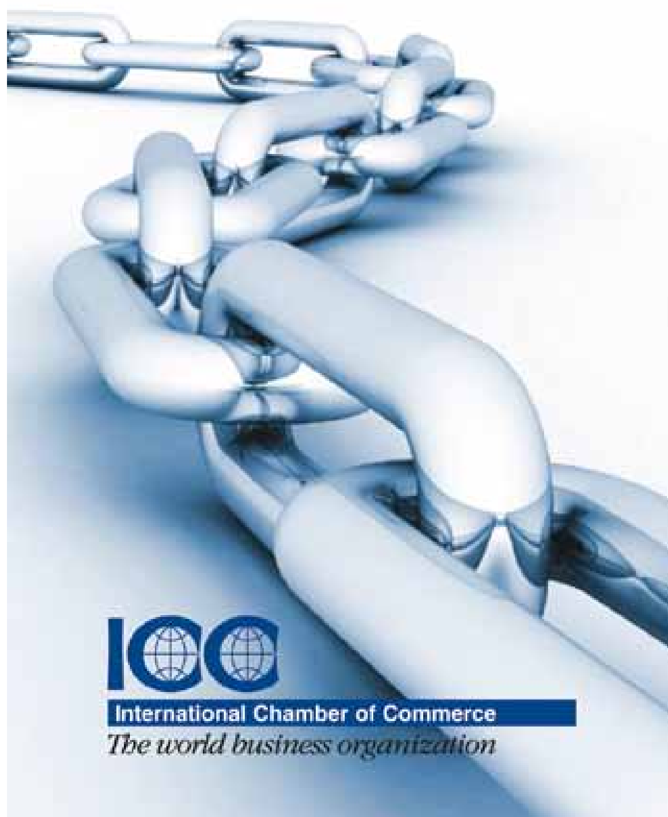
Which area do you think can have the biggest impact?

Jean-Guy Carrier: The challenges the world faces call for an integrated, strategic approach. In order to meet the sustainability challenge we must fully harness two key tools that have lifted millions of people out of poverty: trade and investment. Trade and investment can serve as global accelerators of green growth and, provided governments avoid protectionism and work cooperatively to establish the right frameworks, can serve as accelerators of a green economy.

While prosperity can, in some instances, heighten environmental pressures, without prosperity to meet the needs and aspirations of a growing world population, there is even less chance that economic, social or environmental challenges can be met.

Why must business have a voice in shaping sustainability policy?

Jean-Guy Carrier: Businesses are the innovators and developers of new, more sustainable products and services, often able to make progress more swiftly than governments.



However, sustainable development and the greening of our economies is a shared responsibility that requires collaborative action between all actors in society – business, governments, civil society, and consumers. No one group of stakeholders is able to address economic, developmental and environmental challenges alone and more needs to be done to increase cooperation.

Using voluntary codes such as the ICC Business Charter for Sustainable Development, the private sector has demonstrated considerable success in integrating sustainability into its practices while engaging with all stakeholders.

How is business currently contributing?

Jean-Guy Carrier: While approaches and pace may differ, more and more companies are integrating environmental

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concepts into their balance sheets and making commitments to reduce their environmental footprint by building efficiency measures into their production systems, products and services.

"ICC's new Green Economy Roadmap outlines ten conditions for the transition towards a green economy which could provide the potential building blocks for a green economy roadmap"

The starting point for strengthening business contributions is to augment national sustainable development efforts that build on compliance with national laws – in associated business planning and management systems and in implementation wherever a company operates. These can incorporate, and be reinforced by, a number of additional voluntary approaches, including:

- Partnerships with governments, inter-governmental organizations and NGOs
- Voluntary codes like the ICC Business Charter for Sustainable Development or the Global Compact
- Voluntary sector approaches such as the chemical's sector's *"Responsible Care"*
- *"Soft law"* approaches, like the OECD Guidelines for Multinational Enterprises
- Reporting initiatives, such as the Global Reporting Initiative (GRI)
- Standards and guidance, such as ISO 14000 and ISO 26000

To become a functional economic system, the Green Economy needs to become ingrained in global markets, and operationalized in business balance sheets. Economy-wide approaches should be adopted that include receptive markets for delivering business value and commercially-viable products and services along the value chain.

A major enabler for business to contribute to sustainability is the establishment, and support of, clear and flexible regulatory and voluntary policy frameworks by governments. In addition, we welcome partnerships with governments and other stakeholders to invest in sustainability solutions that will lead to the next generation of products and services in the evolution of a Green Economy.

How is ICC helping businesses to integrate the environmental, social and economic pillars of sustainable development into their practices?

Jean-Guy Carrier: Voluntary codes such as the ICC Business Charter for Sustainable Development, have provided thousands of companies around the world, large and small, with the basis for sound environmental management to integrate the three pillars of sustainable development (social, economic and environmental). ICC's Framework for Responsible Environmental Marketing Communications, Guide to responsible sourcing, Model Contract for Technology Transfer and Incoterms® Rules - a set of internationally-recognized trade terms used worldwide for the sale of goods – are just some of ICC's tools for trade that can help companies implement a sustainable development strategy.

Since the action plan known as Agenda 21 was agreed at the Rio de Janeiro United Nations Conference on Environment and Development in 1992, ICC has also actively participated in all sessions of the UN Commission on Sustainable development, remaining a committed, major partner and the voice of global business in main intergovernmental processes on issues such as the green economy, climate change, sustainable consumption, production or biodiversity.

ICC strongly encourages corporate responsibility initiatives in the belief that responsible, long-term oriented entrepreneurship is not only the driving force for sustainable economic development, but is crucial for providing the managerial, technical and financial resources needed to respond to the social and environmental challenges we face in today's globalized world.

One objective of Rio + 20 is looking at country-specific green economic strategies. What is a *"green economy"* and what do you consider to be critical accelerators for green growth?

Jean-Guy Carrier: *"Green"* or *"Green Economy"* is a term principally used by policymakers. At present there is no single agreed definition, set of indicators or financial measurements for what exactly the *"Green Economy"* is.

For business, a *"Green Economy"* is one in which economic growth and environmental responsibility work together in a mutually reinforcing fashion while simultaneously supporting progress on social development.

ICC's new Green Economy Roadmap outlines ten conditions for the transition towards a green economy which could provide the potential building blocks for a green economy roadmap. The conditions are:

- Social innovation
  1. Awareness
  2. Education and skills
  3. Employment

- Environment innovation
  4. Resource efficiency and decoupling
  5. Life cycle approach

- Economic innovation
  6. Open and competitive markets
  7. Metrics, accounting, and reporting
  8. Finance and investment

- Mutually enforcing cross-cutting elements
  9. Integrated environmental, social and economic policy and decision making
  10. Governance and partnerships.

"A set of commonly underlined principles for national green economy roadmaps may be a way forward to act as a bridge between national priorities and a global level playing field"

Just as countries are at different stages of development with a diversity of national circumstances and societal priorities, we can expect there will be numerous *"green economies"* in both the public and private sectors. For business, the critical question will be how this diversity interacts in global markets and regulatory frameworks.

There is no one-size-fits-all approach and, particularly on short-term priorities, actions may differ (eg. developing vs. developed country). A set of commonly underlined principles for national green economy roadmaps may be a way forward to act as a bridge between national priorities and a global level playing field.

How will ICC work continue after Rio?

Jean-Guy Carrier: As the creators of model contracts, guidelines, and other tools that help structure private-public partnerships, post Rio, ICC will be working with partners to scale up action to help business access and structure infrastructure projects, with a focus on building green or low-carbon infrastructure. ■

ICC rules for the use of domestic and international trade terms

New ICC G20 Business Scorecard reveals 'incomplete' G20 performance

The International Chamber of Commerce (ICC) this month launched the ICC G20 Business Scorecard, measuring progress on the G20's response to business recommendations, at a consultation between government officials and business leaders on the outlook for the G20 Summit in Los Cabos, Mexico (18-19 June 2012).

The Scorecard, unveiled at an ICC consultation in Washington DC hosted by the Center for Strategic and International Studies (CSIS), marked G20 performance as 'incomplete' in three out of four policy areas evaluated: trade and investment, green growth, transparency and anti-corruption, and financing for growth and development.

The aim of the Scorecard is to generate a balanced and reliable measurement of the G20's performance in response to business recommendations that have been put forward to G20 leaders, in particular on ICC priority issues including trade and investment.

> *"At a time when governments are struggling with excessive debt, multilateral trade liberalization would create jobs and drive economic growth,"* said ICC Secretary General Jean-Guy Carrier. *"Countries can create enormous economic opportunities when they enhance cross-border trade and investment flows."*

On trade and investment the Scorecard gives the G20 a score of 'incomplete', based primarily on its failure to help advance the Doha Round of trade negotiations.

> *"The Scorecard is a useful tool for business to monitor the G20's progress on the trade agenda,"* said Carrier. *"If the G20 leadership were to break the stalemate in WTO negotiations or to build a multilateral framework for investment, advances would be reflected in a significantly higher score."*

ICC upholds that if the G20 has better information on how its

actions are interpreted by the business community this will help it set priorities, honour commitments, measure its own progress over time and identify deficiencies that deserve greater attention. In parallel, the business community should work more closely with the G20 to promote economic growth and job creation.

> *"Today's consultation is part of the business community's effort to play an increasingly influential role to support G20 actions to foster economic growth, promote open trade and investment, build a more stable financial system and improve the environment for doing business,"* said Harold McGraw III, ICC Vice-Chairman and Chairman and CEO of the McGraw-Hill Companies.

The Washington consultation featured discussions with Mr McGraw, Michael Froman, the US G20 Sherpa and Deputy National Security Adviser for International Economic Affairs, Arturo Sarukhan, Mexico's Ambassador to the US, and Alejandro Ramirez, CEO of Cinepolis and chair of the Mexican organizing committee for the 2012 G20 Business Summit.

Participants addressed key topics from the G20 policy agenda, including global financial recovery, financial regulation, international financial institution reform and the role of the Financial Stability Board. The G20's broader policy agenda was also addressed, including trade and investment, energy, green growth, anti-corruption and financing for development.

> *"For the past two years, ICC has canvassed the global business community and worked with G20 host countries to produce a set of business policy priorities. This meeting provided an important opportunity to share our views, gauge government responses and learn about G20 priorities for the upcoming Summit,"* Carrier said.

The Scorecard is an important tool for business. Business leaders with better information on whether the G20 has recognized business input and how it has carried through on specific business recommendations are better able to adjust future recommendations and engagement with the G20.

To achieve the Scorecard results, ICC evaluated the G20's progress according to 54 business recommendations made since 2008. Subsequent editions of the Scorecard will be adapted based on shifting priorities and G20 actions. The Scorecard evaluates the G20's response to business recommendations based on three criteria:

1. Recognition: Has the G20 addressed an issue raised by business?

2. Action: Has the G20 taken action on this issue?

3. Adequacy: Is the G20's response or action adequate in addressing the issue?

An 'insufficient' score indicates the G20 has not addressed the issue at all. An 'incomplete' score signifies it has at least taken notice of the subject, however with little or no action taken in response. A 'progress' score shows that the G20 has acted in line with the business recommendation, while 'pass' means it has effectively addressed the business recommendation.

In addition to trade and investment, the Scorecard evaluated G20 work on green growth with an 'incomplete' score; its actions on transparency and anti-corruption as 'incomplete'; and its initiatives in terms of financing for growth and development with a 'progress' score.

The Scorecard was unveiled at an ICC consultation in Washington DC hosted by the Center for Strategic and International Studies (CSIS)

> *"A lot of work remains to be done in getting business issues addressed by the G20, but the progress so far is very encouraging. Business is already bolstered by the response it has received from the Mexican government in preparation for the G20 Summit and from Michael Froman at the consultation in Washington today,"* McGraw said.

ICC has been providing input to the G20 since 2008 and now plans to issue the Scorecard yearly ahead of each Summit to help drive business priorities. ICC in 2011 established the ICC G20 Advisory Group, which now comprises approximately 30 CEOs, as an official platform for providing business input to the G20.

ICC, along with partner organizations including the World Economic Forum, has developed policy recommendations to the G20 in preparation for the G20 Summit. These policy recommendations cover the four themes of the Scorecard categories, as well as others. ■

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The Alien Tort Statute's impact on the business community

Bill Reinsch is the President of the National Foreign Trade Council

The Supreme Court currently has before it *Kiobel v. Royal Dutch Petroleum*, a civil lawsuit brought under the Alien Tort Statute (ATS), alleging that Shell aided and abetted the Nigerian government's human rights violations in the Niger Delta. The case and Court's impending decision, expected this summer, will have a significant impact on the business community both in the United States and potentially, around the world.

For those not familiar with the ATS, it is a single sentence in the US Judiciary Act of 1789, which reads: *"the district courts shall have original jurisdiction of any civil action by an alien for a tort only, committed in violation of the law of nations or a treaty of the United States."* Despite the absence of legislative history, it is clear that the ATS establishes US federal jurisdiction, but lacks specificity about causes of action.

The *"law of nations"* in 1789 did not envision a broad range of torts: to allow aliens to recover in US courts for acts of piracy, violations of safe conducts, and interference with the rights of ambassadors. The law was dormant for about 200 years until a Paraguayan national living in New York found himself in the same jurisdiction as the Paraguayan police official who had tortured and killed her brother in Paraguay.

In *Filartiga v. Pena-Irala* the Second Circuit agreed with Ms Filartiga that torture, like piracy does violate the law of nation as currently understood and awarded more than $10 million for the torture and wrongful death of her brother. The *Filartiga* ruling established that the ATS could be used to bring civil suits for torture and wrongful death of a non-US citizen that occurred outside the United States. By extension other torts such as arbitrary detention, extrajudicial killing, slavery and genocide, which are broadly accepted norms of customary international law.

After *Filartiga* plaintiffs initially targeted foreign officials for human rights violations, but by the 1990s the ATS was being used to bring suits against multinational corporations for aiding and abetting human rights violations by governments of countries where they did business. Since then over 80 corporate ATS cases have been filed.

None have been won by plaintiffs and only two have been settled. Many of these cases have been class actions filed by NGOs representing groups of plaintiffs, sometimes in conjunction with members of the American trial bar. A major example is what is known as the apartheid suit, now known as *Balinjtulo v. Daimler et al*. This suit was originally brought in 2001 against more than 60 multinational corporations for aiding and abetting human rights violations by the South African apartheid regime. The suit asked $5 billion and was filed by a South African NGO, the Khulumani Group, and American trial lawyers Ed Fagan and Michael Hausfeld. Eleven years later it remains in Federal District Court in New York. The *John Doe v. ExxonMobil* case involving Indonesia has been litigated the same length of time.

In 2004, in *Sosa v. Alvarez-Machain* the Supreme Court held that while the ATS does not create a private right of action, the courts could hear claims when a defendant has violated norms that are *"universal, obligatory and specific."* The Court went further and argued that causes of action should be limited to those with the *"definite"* content and acceptance among civilized nations *"such as the 18th Century paradigm familiar when the law was enacted."* The Court then cautioned the lower courts to take foreign policy consequences into consideration and not to freely recognize expansive claims under the ATS.

"The law was dormant for about 200 years until a Paraguayan national living in New York found himself in the same jurisdiction as the Paraguayan police official who had tortured and killed her brother in Paraguay"

Sosa left unsettled the issue that came to the Court in *Kiobel*: does international law extend liability under the ATS to non-state actors like corporations? And secondarily, are non-state actors liable for aiding and abetting the acts of *others*, such as foreign governments in whose jurisdiction they are conduct business? In 2010, the Second Circuit ruled in *Kiobel* that ATS liability does not extend to corporations, putting them in conflict with the DC Circuit and the Ninth Circuit and laying the basis for Supreme Court consideration.

In an amicus brief supporting the defendant in the *Kiobel* case, the National Foreign Trade Council (NFTC) argued that while we believe the Second Circuit's ruling should be upheld, the fact that over 95 percent of corporate cases under the ATS involve allegations of aiding and abetting, the Court should rule on the standard for that charge, specifically that *"aiding and abetting liability requires pleading*

and proving purpose to facilitate the direct violator's unlawful conduct, not mere knowledge of that conduct." Our intent was to encourage the Court to adopt a *"purpose to facilitate"* standard for aiding and abetting that would rule out the most frivolous ATS cases.

The impact on the US business community

US business has been frustrated, at least since the Court's 2005 decision in *Sosa* by the prospect that lengthy and expensive lawsuits may be lodged against corporations on an ill-defined universe of grounds. Lawsuits under the ATS have significant tangible and intangible costs to corporate defendants. Some of these costs, such as legal fees, are easily quantified while others, such as reputational damage are less easily quantified. Second-order costs, such as opportunity costs to developing economies, are simply not quantifiable, but no less real.

Any real assessment of the costs of ATS lawsuits would also assess the benefits. Who gains when a company is sued under the ATS? Does the threat of ATS lawsuits affect corporate behaviour? Does the possibility of being sued increased corporate sensitivity to human rights or does it disincline them to invest in countries whose governments have poor human rights records? Is the impact of the ATS exclusively at the level of the firm or are there macro-economic consequences?

The most obviously quantifiable cost of defending against an ATS claim is the substantial legal fees for outside counsel incurred. This is especially true because of the length of these suits. The South Africa apartheid case was filed in 2001 and is still in Federal District Court 11 years later. *Doe v. ExxonMobil* has been in court the same amount of time. Given the quality of legal representation in these cases, the cost is in well into the hundreds of thousands of dollars. One must add to the cost of outside counsel the time of in-house counsel and government affairs and other executives in preparing the defence to arrive at a full accounting of the monetary cost.

There have been efforts, notably several years ago by the Peterson Institute for International Economics, to quantify the macro-economic effect of a proliferation of ATS lawsuits. The Institute estimated that a further proliferation of ATS suits would in fact result in US companies divesting from targeted countries. The result could be the loss of as much as $55 billion of foreign direct investment. Beyond the loss of profit from the divestment, also lost would be the exports entailed by those investments. The Institute estimated that it could cost the US economy roughly $10 billion with the potential dislocation of 400,000 jobs[1].

This may be a hypothetical worst-case scenario, but in an increasingly competitive globalized economy and given the domestic imperative for job-creation, seemingly cost-free impediments to foreign investment and commerce such as the ATS necessarily warrant close, quantitative scrutiny.

Reputational cost

Less easily quantified, but equally costly is the damage to brands of companies accused of committing or aiding and abetting crimes against humanity. This is obviously a greater cost for consumer products companies than extractive industries. We take it as an article of faith that being seen to be a good corporate citizen has a positive value in the marketplace. That is certainly true for companies in highly competitive consumer markets. As with individual persons, once a consumer products company has suffered reputational damage, it is difficult and costly to recoup.

There is also potential cost in equity markets where there is risk of divestment. This is especially true given the proliferation of US state and local statutes mandating divestment by public pension funds and other government assets from companies with a commercial connection to a targeted country. The template of these laws and proposed legislation is to identify *"scrutinized companies"* that have such a connection and to divest their equities. Companies so identified have an increased risk of becoming defendants in ATS cases and of being the target of a consumer boycott.

The cost to host countries

There is clearly a potential impact of ATS cases on foreign direct investment (FDI) in developing countries where the US government may have an interest in increasing FDI. There are also cases where there is no official US policy to increase foreign investment, but the absence or departure of investors may have negative political consequences.

Take Ecuador as an example. One year ago, Chevron was found guilty by an Ecuadorian court of despoiling the environment and damaging the human rights of indigenous populations. The court fined Chevron $18 billion. The case began as an ATS suit in the United States and was transferred to Ecuador under the *forum nonconveniens* doctrine. The verdict confirms Ecuador's reputation as a poor FDI destination. The country ranks 130th in the world for ease of doing business and the World Economic Forum ranks Ecuador 105th out of 139 countries on competitiveness.

But Ecuador's petroleum reserves and fragile democracy constitute a US national interest, one which would be well served by economic stability. The lawsuit against Chevron, and especially the Ecuadorian court's judgment, militates further against the country's long-term prospects to the detriment of regional stability.

The need to discourage ATS lawsuits to be able to attract foreign investment was on dramatic display in the early stages of the apartheid ATS suit at a time when the newly-elected South African government hoped to attract major foreign investments to create jobs in a country with a real unemployment rate of about 35 percent. Then-South African President Thabo Mbeki said of the lawsuits:

> *"In the recent past the issue of litigation and civil suits against corporations that benefitted from the apartheid system has sharply arisen. In this regard, we wish to reiterate that the South African government is not and will not be a party to such litigation.*
>
> *We consider it completely unacceptable that matters that are central to the future of our country should be adjudicated in foreign courts which bear no responsibility*

for the well-being of our country and the observance of the perspective contained in our constitution of the promotion of national reconciliation[2]."

Because so many developing countries have a significant and often compelling appetite for direct investment by multinational corporations, the deterrent effect of the ATS on FDI, combined with the sovereignty sensitivities of recipient countries, makes an authoritative ruling by the Supreme Court all the more important.

While developing countries may vie for foreign investment, we must take account of those who regard the role of multinational corporations in developing countries to be ipso facto nefarious. For example, Terry Collingsworth, an advocate of vigorous use of the ATS, has cited the NFTC among others as having *"unleashed an aggressive campaign to immunize trans-national corporations from the reach of the ATS … Despite their embrace of codes of conduct, and their espousal of the rhetoric of 'corporate responsibility,' in the sole instance where there is the prospect of a binding legal standard, the corporate community is absolutely adamant that something must be done to relieve them from the application of the ATS."* Mr Collingsworth goes on to cite corporations' *"powerful resistance to introducing the rule of law to the global economy.[3]"*

Collingsworth is of course wrong. The business community does require certainty about the rules of the road as it performs the highly useful function of investing in and trading with developing countries. The ATS as currently construed, and as dramatically illustrated by the division in its interpretation by Federal Circuit Courts, is a major source of uncertainty, which has the potential of retarding the very development of the rule of law in the global economy.

Status of the *Kiobel* case

On March 5, 2012, 10 days after hearing oral argument, the Court ordered the case reargued, this time on extraterritorial application: *"whether and under what circumstances the ATS allows courts to recognize a cause of action for violations of the law of nations occurring within the territory of a sovereign other than the US"* This was a key issue during oral argument. In his first question,

Justice Kennedy said *"no other nation in the world permits its courts to exercise universal civil jurisdiction over alleged extraterritorial human rights abuses to which the nation has no connection."* Justice Ginsburg reiterated Kennedy's question, and Justice Alito said *"there's no particular connection between the events here and the US,"* and Chief Justice Roberts followed by asking *"If there is no other country where this suit could have been brought, isn't it a legitimate concern that allowing the suit itself contravenes international law?"*

Finally Justice Alito summarized the facts of the case and asked *"what business does a case like that have in the courts of the United States? ... There's no connection to the United States whatsoever."* Justice Kennedy contrasted *Kiobel* to *Sosa* where plaintiff and defendant were both *"walking the streets of New York."* Oral argument largely bypassed the question of aiding and abetting liability, although in one exchange counselor Sullivan answered Justice Kagan by saying *"you can't just find an act out there are fan out to anyone in the entire world, including consumers pumping gas in Ohio and say there's been an act of international law violation."* There ensued a brief exchange between Justice Kennedy and Ms Sullivan about the knowledge standard vis-à-vis a purpose standard.

"We cannot know what issue the Court will rule on let alone how it will rule. Should it uphold Kiobel, however, it most likely follows that corporate officials would be sued as individuals"

Numerous amicus briefs were filed in both sides in the Court's February session on *Kiobel*. Two of the United States' most important allies, the UK and the Netherlands said in their brief: *"There is no international norm applicable to corporations for violations of the human rights offenses here."* As defence counsel, Kathleen Sullivan argued, *"A corporation involves many stakeholders beyond the perpetrators. It was established at Nuremberg that it is individuals who are liable for human rights offenses."*

In questioning about corporate liability, the defence argued that international conventions apply to governments and natural persons, but not to corporations. This led to a discussion of whether corporations are natural persons with the defence arguing that human rights conventions and the Torture Victims Protection Act are careful to speak about *"natural person,"* thereby excluding corporations.

We cannot know what issue the Court will rule on let alone how it will rule. Should it uphold *Kiobel*, however, it most likely follows that corporate officials would be sued as individuals. So, having moved on from the original question of corporate liability, the Court became seized of extraterritoriality and ordered a rehearing on that issue, setting a briefing schedule through the end of June. ■

1. Hufbauer, Gary Clyde and Mitrokostas, Nicholas K, "Awakening Monster: The Alien Tort Statute of 1789," Institute for International Economics, Washington, DC, 2003.
2. May 16, 2002 letter from the South African foreign minister, Nkosazana Zuma to Secretary Colin Powell, in which President Mbeki was quoted.
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Business company formation matters in Cyprus

Irina Loutchina is a Director at Costas Tsirides & Co LLC

Cyprus has dynamically placed itself on the map for the most attractive holding regimes worldwide. The Cyprus holding company is one of the most highly regarded investment vehicles globally. Offering the lowest corporate tax rate in the EU, ensuring compliance with EU requirements as an EU member state as well as committing to the OECD requirements against harmful tax practice, featuring a substantial number of double tax treaties with other states and boasting one of the most business-friendly and reliable legal frameworks, are some of the reasons behind Cyprus' evolvement into an ideal holding and investment destination.

Furthermore, the Cyprus tax system although simple and modern is very competitive in the field of international taxation and is fully harmonized with the EU Directives and Code of Conducts of Business.

"... the Cyprus tax system, although simple and modern, is very competitive in the field of international taxation"

We can indicate the following factors as important for location of a holding company:

- Tax treatment of inward and outward dividends
- Tax treatment of capital gains arising from sales of subsidiaries
- Taxation of consolidated profit
- Reputation of jurisdiction where the holding company was formed
- Cost of incorporation and maintenance
- Cost of audit of consolidated accounts

Tax treatment of dividends

Dividends from subsidiaries of a Cyprus holding company

Reduced or zero withholding tax rates can be achieved when extracting dividends from underlying subsidiaries of a Cyprus holding company, through the mechanisms of either:

- An applicable double tax treaty;
- The provisions of EU Directive 90/435/EEC ('the Parent/Subsidiary Directive')

Where the investment is outside the EU or where the conditions of the Parent/Subsidiary Directive are not satisfied, Cyprus can rely on its vast double taxation treaties network. The rates applicable through Cyprus' double taxation treaties concluded with other States are shown in Table A.

Incoming dividends taxation

Dividends received by a Cyprus holding company from a Cyprus subsidiary are exempted from any taxation in Cyprus.

Dividends received from outside Cyprus are normally exempted from any taxation provided certain conditions are met. The conditions for dividend tax exemption are very flexible, as such, exemption is almost always obtained, thus resulting in the zero taxation of foreign incoming dividend in Cyprus.

Outgoing dividends taxation

Legal entitites or non-residents receiving dividends from a Cyprus company are not subject to any withholding taxes in Cyprus when such dividend income is distributed.

Tax treatment of capital gains

Capital gains taxation

There is no capital gains tax in Cyprus other than that tax on capital gain arising from the disposal of immovable property in Cyprus or from the disposal of shares in a company which owns immovable property in Cyprus.

The disposal of shares, securities and debentures is exempted from any taxation.

Capitalization

As there are no thin capitalisation restrictions under Cyprus tax laws, a Cyprus company can be very highly leveraged. Any arm's length interest paid to its lender shall be entirely deductible against its taxable income.

Tax treatment of consolidated profit

There is no Controlled Foreign Company rule. There is no income tax on consolidated profit in hands of a Cyprus holding company. This simply means that a profit centre could be in Singapore or Hong Kong (both jurisdictions are

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COSTAS TSIRIDES & CO LLC is a multidisciplinary firm offering a large variety of legal services covering all aspects of the law.

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Furthermore, understanding the need and tendency in the business field towards globalization and in order to be able to offer its clients the same level of personal service and expertise not only in Cyprus but also around the globe, the firm has become a member of an international association of independent law firms.

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applying territorial taxation principle where non-Singapore or non-Hong Kong source income is not a subject to income tax in Singapore or Hong Kong), or even a 'tax heaven' like Belize where all profit is earned but consolidated in the hand of Cyprus company and show in consolidated profit a loss account and balance sheet without incurring any tax liability in Cyprus.

In other cases Cyprus features an EU-lowest 10% corporate tax rate over its taxable profits.

Reputation of jurisdiction
Cyprus has been a full member of European Union since May 1, 2004.

The legal system is based on and is similar with the English legal system.

Procedure and cost of incorporation and maintenance
Another attractive feature of Cyprus as jurisdiction for foreign investors is the cost of company incorporations and maintenance which is relatively low.

Registration of a Cyprus holding company is around €2,500 including registered office, secretary, incorporation set and legal fees. As from 2011 an annual maintenance fee should be paid to the Registrar of Companies in the amount of €350.

"The legal system is based on and is similar with the English legal system"

Most of the services providers do offer the efficient service of sale of a shelf company and in this case all the documents could be prepared within one working day.

In case if the company is incorporated from the stage of the approval of name it takes around seven working days for the completion of the procedure of incorporation.

Nominee service is available at additional cost.

Annual accounting and audit fees
Annual accounting and audit fees of a Cyprus holding company are approximately 25%-30% lower than in continental Europe.

- We can also mention other advantages:
- No withholding tax on royalties for use outside Cyprus
- No withholding tax on interest
- Credit relief available for foreign withholding tax unilaterally
- Ability to carry forward losses indefinitely
- Group relief rules available
- Flexible and tax efficient reorganization provisions
- Wide network of double tax treaties

Therefore, the following circumstances constitute ideal situations for the incorporation of a Cyprus holding company, either as an intermediate holding entity or as an ultimate holding company:

- For groups investing outside of Cyprus and expecting dividend income streams, which will in most cases be tax exempt when shares are held by a Cyprus holding company;
- To hold subsidiary companies that might be sold in the future, the disposal of which will not be taxable in the case a Cyprus holding company holds the shares in these subsidiaries;
- To harness the tax benefits of the withholding tax provisions found in the extensive double tax treaties network of Cyprus and the EU Parent-Subsidiary Directive;
- To enjoy the benefits of no taxation over the payment of dividend, interest and royalties in most cases;
- To enjoy the benefits of no taxation over transactions in securities, making it an appropriate vehicle for funds;
- Where it may be important to achieve a tax free unwind of the holding company at some stage in the future.

Additional benefits under the Cyprus tax system

Interest income received

Under the Cypriot tax legislation a distinction is made between interest income received in or being closely related to the ordinary course of business of the company and interest income earned outside the ordinary course of business of the company.

In accordance with the above, interest income earned in or being closely related to the ordinary course of business is not treated as interest for tax purposes but rather as income from trading activities and as such it is subject to Cyprus corporate income tax at the rate of 10%. Interest income deriving from group financing activities is treated as interest income closely connected to the ordinary course of business of a company.

On the other hand, interest income earned outside the ordinary course of business of a company is subject to 20% special contribution for the defence of the Republic tax.

This recent increase of the rate for defence contribution on the payment of actual dividends or in the case of deemed distribution, from 17% to 20% will apply for the years 2012 and 2013.

At the same time it should be noted that no defence contribution is payable in case the dividend is paid to non residents.

	Paid from Cyprus			Received in Cyprus		
	Dividends %	Interest %	Royalties %	Dividends %	Interest %	Royalties %
Non-treaty countries	0 [1]	0 [1]	0 [1,2]	n/a	n/a	n/a
Armenia[20,23]	0	0	0	0	0	0
Austria	10	0	0	10	0	0
Belarus	5 [18]	5	5	5 [18]	5	5
Belgium	10 [6]	10 [6,19]	0	10 [8]	10 [6,19]	0
Bosnia & Herzegovina[32]	10	10	10	10	10	10
Bulgaria	5 [23]	7 [6]	10	5 [23]	7 [6,24]	10 [24]
Canada	15	15 [5]	10 [6]	15	15 [4]	10 [5]
China	10	10	10	10	10	10
Czech Republic	0 [29]	0	10 [32]	0 [29]	0	10 [32]
Denmark	10 [8]	10 [6]	0	10 [8]	10 [6]	0
Egypt	15	15	10	15	15	10
France	10 [9]	10 [10]	0 [3]	10 [9]	10 [10]	0 [3]
Germany	10 [8]	10 [6]	0 [3]	10 [8]	10 [6]	0 [3]
Greece	25	10	0 [12]	25 [11]	10	0 [12]
Hungary	0	10 [6]	0	5 [8]	10 [6]	0
India	10 [9]	10 [10]	10 [16]	10 [9]	10 [10]	15 [15]
Ireland	0	0	0 [12]	0	0	0 [12]
Italy	0	10	0	15	10	0
Kuwait	10	10 [6]	5 [7]	10	10 [6]	5 [7]
Kyrgystan[20]	0	0	0	0	0	0
Lebanon	5	5	0	5	5	0
Malta	15	10	10	0	10	10
Mauritius	0	0	0	0	0	0
Moldova[27]	5 [28]	5	5	5 [28]	5	5
Montenegro[26]	10	10	10	10	10	10
Norway	0	0	0	0 [13]	0	0
Poland	10	10 [6]	5	10	10 [6]	5
Qatar	0	0	5	0	0	5
Romania	10	10 [6]	5 [7]	10	10 [6]	5 [7]
Russia	5 [17]	0	0	5 [17]	0	0
San Marino	0	0	0	0	0	0
Serbia[26]	10	10	10	10	10	10
Seychelles	0	0	0	0	0	5
Singapore	0	10 [6,25]	10	0	10 [6,25]	10
Slovakia	10	10 [6]	5 [7]	10	10 [6]	5 [7]
Slovenia[26]	10	10	10	10	10	10
South Africa	0	0	0	0	0	0
Sweden	5 [8]	10 [6]	0	5 [8]	10 [6]	0
Syria	0 [8]	10	15 [31]	0 [8]	10 [4]	15 [31]
Tadzhikistan[20]	0	0	0	0	0	0
Thailand	10	15 [21]	5 [22]	10	15 [21]	5 [22]
Ukraine[20]	0	0	0	0	0	0
United Kingdom	0	10	0 [3]	15 [14]	10	0 [3]
United States	0	10 [10]	0	5 [9]	10 [10]	0
Uzbekistan[20]	0	0	0	0	0	0

1. Under Cyprus domestic legislation there is no withholding tax on dividends, interests and royalties paid to non-residents of Cyprus.
2. In case where royalties are earned on rights used within Cyprus there is withholding tax of 10%.
3. 5% on film and TV royalties.
4. 0% if paid to a Government or for export guarantee.
5. 0% on literary, dramatic, musical or artistic work.
6. 0% if paid to the Government of the other state.
7. This rate applies for patents, trademarks, designs or models, plans, secret formulas or processes, or any industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience.
8. 15% if received by a company controlling less than 25% of the voting power or by an individual.
9. 15% if received by a person controlling less than 10% of the voting power.
10. 0% if paid to a Government, bank or financial institution.
11. The treaty provides for withholding taxes on dividends but Greece does not impose any withholding tax in accordance with its own legislation.
12. 5% on film royalties (apart from films broadcasted on television).
13. 5% if received by a person controlling less than 50% of the voting power.
14. This rate applies to individual shareholders regardless of their percentage of shareholding. Companies controlling less than 10% of the voting shares are also entitled to this rate.
15. 10% for payments of a technical, managerial or consulting nature.
16. Treaty rate 15%, therefore restricted to Cyprus legislation rate.
17. 10% if dividend paid by a company in which the beneficial owner has invested less than €100,000.
18. If investment is less than €200,000, dividends are subject to 15% withholding tax which is reduced to 10% if the recipient company controls 25% or more of the paying company.
19. No withholding tax for interest on deposits with banking institutions.
20. Armenia, Kyrgyzstan, Tadzhikistan, Ukraine and Uzbekistan apply the USSR/Cyprus treaty.
21. 10% on interest received by a financial institution or when it relates to sale on credit of any industrial, commercial or scientific equipment or of merchandise.
22. This rate applies for any copyright of literary, dramatic, musical, artistic or scientific work. 10% rate applies for industrial, commercial or scientific equipment. 15% rate applies for patents, trademarks, designs or models, plans, secret formulae or processes.
23. This rate applies to companies holding directly at least 25% of the share capital of the company paying the dividend. In all other cases the withholding tax is 10%.
24. This rate does not apply if the payment is made to a Cyprus international business entity by a resident of Bulgaria owning directly or indirectly at least 25% of the share capital of the Cyprus entity.
25. 7% if paid to bank or financial institution.
26. Montenegro, Serbia and Slovenia apply the Yugoslavia/Cyprus treaty.
27. The treaty is effective from 1 January 2009.
28. This rate applies if received by a company (excluding partnership) which holds directly 25% of the shares. 10% rate applies in all other cases.
29. This rate applies if received by a company (excluding partnership) which holds directly at least 10% of the shares for an uninterrupted period of no less than one year. 5% applies in all other cases.
30. Cyprus continues to apply the Yugoslavia treaty of 29 June 1985 in relations with Bosnia and Herzegovina. In practice Bosnia and Herzegovina generally continues to apply the Yugoslavia treaty.
31. 10% on literary, dramatic, musical, artistic work, films and TV royalties.
32. Pursuant to the protocol signed on 28 April 2009 between the Czech Republic and Cyprus, the former pledged that in the case that it signs with any other EU member State an agreement which will limit the taxation of royalties arising in the Czech Republic to a rate effectively lower than 10%, then that lower rate will automatically be applicable for the purposes of Article 12 of the New Treaty.
33. On 17 January 2011, Cyprus signed a tax treaty with Armenia to replace the existing treaty between the countries (namely the USSR treaty, which will continue in force until the respective internal ratification procedures are completed).

Furthermore the provisions for deemed distribution do not apply in cases where the shareholders of the company directly or indirectly are non-Cyprus resident.

Also pursuant to the recent amendments of the tax legislation, in respect of the deemed dividends calculation the company can deduct the acquisition cost of offices, factories, hotels, plants and machinery and Fixtures and fittings. This will be applied for the years 2012-2014.

"Interest paid by the Cyprus financing company to overseas creditors is not subject to any withholding taxes"

Thin capitalization rules

Cyprus did not incorporate any thin capitalisation rules under its legislation, essentially in the form of debt-to-equity restrictions.

Transfer pricing

There is no specific transfer pricing legislation currently in place, however, from a transfer pricing perspective, the arm's length principle has application, as defined by the OECD, in transactions between related/associated parties. The arm's length principle provisions are incorporated in the revised income tax legislation. From a back-to-back financing perspective, a minimum margin should be allowed, depending on the value of the loans to be put in place.

Interest paid by the Cyprus financing company to overseas creditors is not subject to any withholding taxes.

Royalties received in Cyprus

Net royalties income, after the deduction of any royalty payments or expenses and the allowance of any tax credit available, is subject to 10% corporate income tax, subject to the following recent amendments:

- 80% of the royalty income from patents and trademarks will be tax free.
- 80% of the profits from the sale of patents and trademarks will be tax free.

Gains on the sale of intellectual property

Gains deriving from the sale of intellectual property may arguably be exempt from corporate income tax, unless the said gain is deemed to be a result of the trading activities of the company.

Royalties paid are not subject to any withholding taxes provided the rights are exercised outside Cyprus.

Equally, the provisions of the EU Interest and Royalties Directive have application where the Cyprus company receives interest or royalty payments from an associated company established in another EU-member state, thus providing for an elimination of withholding taxes over the interest and royalty payments.

A unilateral tax credit is allowed with respect to foreign taxes paid.

Expenses are deductible provided they have been incurred wholly and exclusively for the production of income.

The implementation of the EU Mergers Directive enables tax neutral corporate reorganizations.

It is possible to carry forward losses indefinitely, and equally, group relief is allowed for the utilization of tax losses.

Therefore based on the above we can say that Cyprus may prove to be the ideal jurisdiction for the establishment of an investment vehicle in the form of an intermediary holding company thus allowing the investors reach their ultimate aim to maximize their return. ■

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Bermuda - leading the way in international internet payment solutions

Choosing a payment service provider to process payments for an online business is not an easy process and the task can be daunting, at best.

Certain pre-requisites come to mind when looking for a high-end payment gateway including PCI certification, strict internal and external security policies, technological flexibility, fraud management services, and of course, staff industry expertise and top customer service.

Today, however, business owners looking to expand outside their domestic marketplace require even more to compete internationally. The criterion listed above for a valued payment service provider is no longer enough for merchants to compete in the global marketplace.

British online merchants, for example, are facing international payment challenges as they look to expand across Europe. They are not able to grow their business efficiently using their current payment infrastructure.

In fact, according to a recent report commissioned by Chase Paymentech Europe and independent research firm, Dynamic Markets, 30 percent of 200 UK businesses questioned had international growth plans within the next couple of years. But they said they lack the payment systems to appropriately support potential European customers.
And, according to the report, 77 percent of UK companies who already trade internationally felt their payment systems were not set up to meet the demands of European customers.

This is a common issue that we see with many companies looking to do business outside of their own borders. Cross border sales require merchants to present and settle in various currencies. However, many domestic payment providers only have the capacity to enable presentment and settlement in their own local currency. And they do not offer the alternative payment methods that are frequently used in other territories.

Changing business models

Just as merchants are offering an assorted product mix in order to stay competitive and grow their business, payment gateways, which in their simplest form used to be the switch between the merchants and the banks for online credit card processing, are now offering other forms of online payment to satisfy their clients and help them expand internationally.

Those that differentiate themselves will gain market share and continue to lead the online payment space, while those that stick to credit card processing only, especially within the context of one market, will surely fall behind.

Apart from secure and reliable credit card processing, leading payment providers are providing other forms of payment through their platform such as debit card processing, regional payment forms such as iDEAL in the Netherlands, virtual cash in the form of Ukash and/or PaysafeCard, PayPal, inbound bank transfers, and payout solutions such as cheque and bank transfer issuing services and prepaid cards.

The top payment solution providers also have access to global banks, and facilitate the set up of your merchant account(s) with the bank(s), and provide premium fraud management tools and data with which to protect you business from fraud.

As well, we should see these payment providers start to adopt mobile payment capabilities, especially since the combined market for all types of mobile payments is expected to reach more than $600 billion globally by 2010, according to Juniper Research.

While we have not seen full market adoption in the mobile payment sector, several trends indicate the mobile payment market is expanding. According to ABI Research Inc, mobile online shopping in the US rose from $396 million in 2008 to $1.2 billion in 2009, indicating significant consumer interest.

"... business owners looking to expand outside their domestic marketplace require even more to compete internationally"

Embracing alternative online payment methods

We have seen robust growth in alternative online payment solutions for all online merchants in the past decade, and the alternative payment market continues to grow its share of the acquiring business.

Interestingly, just a decade ago, analysts and merchants did not hold up much hope for the alternative payment industry. Yankee Group analyst Christine Loebar told the *Ecommerce Times* in 2001 that alternative payment methods in the US, for example, were *"not gathering steam"*. She said it was a typical catch 22 in that consumers were reluctant to adopt a new web payment method if not widely accepted online, and merchants were reluctant to set up alternative systems until consumers were comfortable using them.

I should note here that emerging markets were ahead of the industrialized world in terms of alternative payment method

acceptance because credit card penetration is traditionally low in these markets, especially within South America and China. However, these markets were also slower to adopt online sales in general.

Today, merchants are embracing all sorts of alternative payment methods in an effort to acquire and retain their customers. It is more a question of which alternative payment methods to implement, as opposed to whether or not to use them at all.

"Today, merchants are embracing all sorts of alternative payment methods in an effort to acquire and retain their customers"

Consumers and merchants are driving the alternative payment option marketplace as they search for new ways to pay and get paid. For both, alternative payment offers convenience, flexibility and security. Merchants are finding that offering alternative payment options can lower their overall transaction costs, increase conversions, and create new revenue streams, while reducing chargebacks and fraudulent activity.

Meanwhile, consumers want the merchant to accept the payment method they want to use. We know that different demographic groups tend to gravitate toward different payment options. And while alternative payment methods certainly appeal to the under-banked and unbanked for obvious reasons, all types of consumers including those that hold credit cards, are adopting convenient alternative payment methods.

The economic downturn has also contributed to alternative payments use as credit cardholders are more conscious of their credit-based spending.

Nevertheless, credit cards will continue to be crucial to an online payment strategy, and, even though *"an improving economy will lead some consumers back to credit card products, which may slow the growth of alternative payments,"* according to Javelin Strategy & Research, alternative payments are also here to stay.

Working with the right payment provider

By partnering with an international, internet payment solutions provider that understands and provides credit card processing and alternative payment options, companies can continue to focus on their business, while leveraging key benefits such as access to new global markets and payment types via one source.

As an example, if merchants want to capture the Chinese market, they must support China Union Pay (debit) since it is the predominant payment card in China. Similarly, debit card use in Germany and Poland is much higher than credit card usage so merchants doing business in these geographies must have access to the local payment brands and currencies. (Local currency support increases the capture rate in local markets as many cards are issued for use only with local currency.) The right international payment provider can help.

Through a single integration, a good payment partner will enable merchants to work with various acquiring banks in different jurisdictions around the world for card processing (thereby lowering costs to entry) as well as enable them access to various payment types in multiple currencies, which lowers the costs and time associated with direct integrations to each payment method.

Gaining access to alternative payment options via one implementation is key. Not only is it a cost saver in terms of integration time and IT resources from the outset, but it allows the operator to spend less time on managing these payment infrastructures going forward.

One should remember, however, that it is never possible for one vendor to offer every global payment type. Online merchants need to zero in on what they require for their business and compare those needs against other payment requirements. Many payment solution providers, for example, do not facilitate direct merchant accounts for credit card processing, which means that the merchant will not have direct control of their funds. Other payment providers may not offer a full suite of fraud management tools... so it is important for a business to weigh out their needs.

But clearly, there is an expectation now for payment gateways to offer a full portfolio of payment solutions, especially from those companies doing business outside of their jurisdiction. Just as merchants are transforming consumer preferences by introducing added features and products/services, best-in-breed online payment gateways have shifted the thinking behind online businesses, and what they should expect from their payment solutions partner.

One example of a leading payment solutions provider is First Atlantic Commerce (FAC), (www.firstatlanticcommerce.com), which was founded in 1998 in Bermuda. FAC, still having its base in Bermuda, is a secure, PCI certified payment gateway that offers custom, online payment and risk management solutions to merchants and banks across the Latin American Caribbean Region, Europe and Mauritius.

A tiny 22 square mile archipelago located in the middle of the North Atlantic, Bermuda is, despite its size and remoteness, a sophisticated and well respected business jurisdiction hosting some of the largest insurance and reinsurance companies in the world. With a population of around 60,000, Bermuda has one of the highest per capita incomes in the world, one of the highest levels of internet access and a high number of mobile devices in use.

Home to many Fortune 500 companies, local ecommerce has also seen steady growth over several years with many companies and the Government transacting business electronically. Leveraging this sophistication, FAC can also provide international clients with the ability to transact and settle funds to a Bermuda based bank without the need to fully incorporate on the island via its Private Act of Parliament. ■

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International Tax

Why should business be interested in tax and development?

Tax risk management, corporate governance and the enhanced relationship

The mini-One Stop Shop for VAT - the start of something big!

OECD launches its Global Forum on VAT

Global Forum: real change towards international tax cooperation

OECD work on the resolution of international tax disputes

Base erosion and profit shifting

The OECD discussion draft on the definition of permanent establishment

Tax co-operation: beyond exchange of information on request

Initiatives in the transfer pricing area

Transfer pricing and the arm's length principle

Transfer pricing update

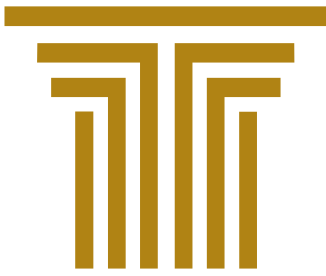
The impact of Financial Transaction Tax (FTT) on financial stability

Spain: the challenge to set an effective tax policy

Tax avoidance in Europe

The dangers of the new functional risk analysis

THE GLOBAL TRADE PLATFORM



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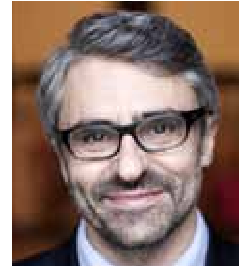
Why should business be interested in tax and development?



Pascal Saint-Amans is the Director, Centre for Tax Policy and Administration at the Organisation for Economic Co-operation and Development

Even the most casual reader of daily newspapers will have noticed that the column inches devoted to tax matters is expanding by the day, particularly since the onset of the financial crisis. Much of the attention concerns big business and high profile individuals and issues of fairness or even injustice over taxation. From much of the coverage, the reader is left with the impression that the battle lines are uncompromisingly drawn between big business on one side and the campaigning NGOs on the other, fighting out whether corporations are paying their fair share of taxes in developing countries.

Yet there is far more common ground between the two sides than one might expect. I witnessed this first hand at the latest meeting of the OECD's Task Force on Tax and Development held in Cape Town in May. The Task Force brings together representatives from the tax and aid communities from OECD and developing countries, business, international organisations and NGOs. This unique alliance aims to improve the climate in which developing countries can collect taxes fairly and effectively.

The different stakeholders in the Task Force agree on the fundamental challenges facing low income countries. Half of sub-Saharan African countries still mobilise less than 17% of their GDP in tax revenues, below the minimum level of 20% considered by the UN as necessary to achieve the Millennium Development Goals. Several Latin American countries fare little better. Moreover, regressive tax structures, the result of low direct and high indirect taxes plus tax evasion, weaken the legitimacy and credibility of tax systems and states more generally.

The shift away from tariffs and customs duties in favour of VAT is a difficult transition for developing countries to manage. Moving towards simpler, more equitable and more transparent tax systems and a broadening of the tax base is not easy but would reap benefits over time. Perceptions of corruption and weak capacity means that progress will be incremental. The reciprocal link with public expenditures is critical and the vicious circle of low tax morale leading to poor compliance needs to be broken.

The external environment poses new challenges, too. Competition between developing countries for investors can trigger a race to the bottom. Globalisation may also exacerbate these fiscal problems, as internationally mobile income and capital becomes more difficult to tax. Developing countries face challenges in designing and implementing effective transfer pricing and information exchange regimes and more generally in improving transparency.

In the Task Force both the NGOs and the business community have set out their concerns. NGOs are concerned that there is abusive exploitation of gaps in both domestic and international tax law by multinational enterprises, leading to profits being shifted out of developing countries to low tax territories, which erodes the tax base of developing countries. NGOs are equally concerned that many developing country tax administrations do not have the capacity to address such abuse.

"... investors are looking for certainty and predictability in tax matters and this means they have a clear interest in helping build the capacity of tax administrations in the developing world"

Businesses who are investors in developing countries care greatly about tax policy and administration. They need to know that they will not be treated in an arbitrary way or that corruption will threaten their investments and operations. More broadly, they have longer-term interests that depend on revenues being successfully converted into development outcomes - infrastructure, health and education, the factors which ultimately determine the quality of the investment climate.

Fundamentally, investors are looking for certainty and predictability in tax matters and this means they have a clear interest in helping build the capacity of tax administrations in the developing world. I often hear from businesses that they much prefer to deal with knowledgeable tax auditors, who apply relevant domestic and international tax principles in a consistent and fair manner. So the building of capacity is a shared priority for all stakeholders.

In international tax matters, business can help. In the work

that the OECD has begun in partnership with the World Bank and European Commission to build effective transfer pricing regimes in Rwanda and Colombia, business is playing a role by providing industry specific briefings to help tax administrations understand how the supply chains and costs structures operate in the mining industry for example. This basic industry knowledge underpins the tax administration's approach to understanding transfer pricing risks.

Business can also help in the area of tax incentives offered by developing countries to investors. Many countries, developed and developing alike, offer various incentives in the hope of attracting investors and fostering growth. Yet there is strong evidence that calls into question the effectiveness of some tax incentives, particularly tax holidays. Although business must maximize profits and minimize costs they should refrain from seeking or accepting exemptions not contemplated in the statutory or regulatory framework related to taxation, financial incentives, or other issues, as set out in the *OECD Guidelines for Multinational Enterprises*.

Even in controversial areas where business and civil society are unlikely to agree, on proposals put forward for country by country reporting, (for example, the proposals call for multinational enterprises to be required to report sales, profits and taxes paid in their audited annual reports and tax returns for each jurisdiction in which where they operate), business can engage positively. Some businesses are taking unilateral decisions to increase transparency. In 2011 Rio Tinto, for example, won PricewaterhouseCooper's *Building Public Trust* award for reporting taxes transparently.

There is clearly much more all stakeholders - government, business and civil society - can do to help developing countries. But there are grounds for optimism. Several countries, including Rwanda, El Salvador and Tanzania, have made significant advances, often in the most challenging governance environments. Of most importance, the call for action is increasingly coming from developing countries themselves. In Africa, the creation of the African Tax Administration Forum, driven, managed, and in due course to be operationally funded by Africans, is providing a key platform for peer learning, capacity development and dialogue on domestic and international tax issues. In the Americas, the Centro Interamericano de Administraciones Tributarias is a well established platform for regional action.

At the international level, the G20 is helping to focus external support for domestic resource mobilisation, helping to reverse an era of relative neglect of tax as a development priority. Under G-20 political leadership, the OECD hosted Global Forum on Transparency and Exchange of Information for Tax Purposes is making significant progress in addressing offshore non-compliance and the Task Force on Tax and Development can help with a broader range of capacity building concerns. ■

Tax risk management, corporate governance and the enhanced relationship

Grace Perez-Navarro is the Deputy Director, Centre for Tax Policy and Administration at the Organisation for Economic Co-operation and Development

The financial, economic and now debt crises have not only put the spotlight on tax reform to raise revenue but also on increasing tax compliance. Tax administrations are stepping up their enforcement efforts to ensure that companies are paying the tax legally due, and are increasingly focusing on cross-border transactions. They are also working more closely together through the OECD's Committee on Fiscal Affairs and Forum on Tax Administration (FTA) to identify trends in aggressive tax planning, devise responses and foster greater voluntary compliance.

More targeted initiatives such as JITSIC[1] allow for more co-ordinated efforts among participating countries. Further, there is increased interest in information sharing between tax administrations and more agreements are available under which to carry that out - over 800 such agreements signed since 2009.

The amounts at stake in some major tax disputes are measured in billions of dollars and can take years to resolve, which implies significant costs for both the taxpayers and tax administrations involved. Multinational enterprises (MNEs) also have to grapple with the increased reputational risks arising from the growing public attention being drawn to companies that pay little or no tax due to clever tax planning. Businesses and tax administrations need to adapt to this changing environment. Both are beginning to see the benefits of moving away from an adversarial relationship to one of co-operation.

The changing environment: increased disclosure requirements

Tax authorities are increasingly recognizing that traditional audits alone are inadequate to deal effectively with aggressive tax planning. Disclosure requirements are on the rise to assist tax administrations in managing this risk. The objective of these requirements is to ensure the availability of timely, targeted and comprehensive information to allow governments to identify risk areas in a timely manner so as to able to quickly decide whether and how to respond, thus facilitate a more risk based approach to tax administration activities. While this may increase compliance burdens for taxpayers, it also increases certainty to taxpayers and provides that certainty sooner than a traditional audit would.

OECD countries have established a variety of disclosure initiatives ranging from mandatory early disclosure requirements such as the requirements in the US and Australia to disclose uncertain tax positions, to questionnaires targeted at particular taxpayers and focused on particular areas of risk (eg. New Zealand), to penalty linked disclosures (e.g. Ireland, New Zealand).[2] The pace of change in this area is accelerating and we can expect to see more countries adopting similar approaches in the future.

Putting tax in the boardroom: the *OECD Guidelines for Multinational Enterprises*

The *OECD Guidelines for Multinational Enterprises*[3] are far reaching recommendations for responsible business conduct that 44 adhering governments – representing all regions of the world and accounting for 85% of foreign direct investment – encourage their enterprises to observe wherever they operate.

The *Guidelines* were updated in 2011 and include important changes to the tax aspects of the recommendations. First, the *Guidelines* encourage enterprises to *"comply with both the letter and spirit of the laws of the countries in which they operate"*. Second, they call on enterprises to *"treat tax governance and tax compliance as important elements of their oversight and broader risk management systems. In particular, corporate boards should adopt tax risk management strategies to ensure that the financial, regulatory and reputational risks associated with taxation are fully identified and evaluated."*

The *Guidelines* build on the work of the OECD's Forum on Tax Administration which, since its 2006 Seoul Declaration has been calling on businesses to make tax risk management an element of their corporate governance. Although these Guidelines are relatively new, the Forum on Tax Administration, led by Douglas Shulman, Commissioner of the United States Internal Revenue Service, is engaging with business to assess the impact of the guidelines on the behaviour of MNEs and the role of boards in tax risk management in particular.

The enhanced relationship: moving towards co-operative compliance

In 2008, the OECD's Forum on Tax Administration published the *Study into the Role of Tax Intermediaries* which was a response to growing concerns among the Forum's over 40 Tax Commissioners about aggressive tax planning and how to improve management of this significant risk. While the study's initial focus was on the role of tax intermediaries (eg. accounting firms, law firms or other tax advisory firms, financial institutions, etc), the study also focused on the importance of influencing the behaviour of the large corporate taxpayers who were the customers of the intermediaries and ultimately determined whether to adopt particular tax planning approaches.

The Study concluded that managing this risk effectively depended on early disclosure from taxpayers. To encourage this type of co-operative compliance from large corporate taxpayers would require tax administrations to operate using the following five attributes when dealing with all taxpayers: understanding based on commercial awareness; impartiality; proportionality; openness (disclosure and transparency); and responsiveness.

"MNEs... have to grapple with the increased reputational risks arising from the growing public attention being drawn to companies that pay little or no tax due to clever tax planning"

The Study describes this "enhanced relationship" between the taxpayer and the revenue body as one based on co-operation and trust, with both parties going beyond their statutory obligations. Adopting a cooperative approach to compliance does not mean that taxpayers will get a lower tax bill as a result of taking part in "enhanced relationship" programmes. What it does mean is that the taxpayer will get greater certainty, in shorter time frames and at lower cost in terms of compliance.

The purpose of this cooperative approach to compliance is to create a joint approach to improving tax risk management and overall tax compliance with benefits to both the tax administration and the taxpayer. Countries that have established cooperative compliance programmes include: Australia (Annual Compliance Arrangement); Ireland (Co-operative Compliance); Italy (Risk Management Monitoring); the Netherlands (Horizontal Monitoring); New Zealand (Co-operative Compliance Agreements); Spain (Large Companies' Forum), the United Kingdom (Large Business Strategy) and the United States (the Compliance Assurance Process).

The Forum on Tax Administration is currently undertaking an assessment of enhanced relationship programmes, which it expects to publish in May 2013, at its meeting in Russia. The preparation of the study is aimed at identifying lessons learned from experience to date with such programmes so as to continue to improve them.

It will also address the perception that cooperative compliance programmes somehow involve preferential treatment of the taxpayers involved, including examining the benefits to society in terms of the lower costs and more

secure tax revenues that result. The FTA will seek input from business as it assesses the developments over the five years that have elapsed since it published the *Study into the Role of Intermediaries*.

Looking ahead, we can expect to see other approaches to co-operative compliance from FTA members, which highlighted in their January 2012 Buenos Aires Communiqué:

An adversarial relationship between tax administrations and multinational corporate taxpayers serves neither of our purposes well and is contrary to our common goals, which are earlier and greater certainty, consistency, and efficiency. To this end, we agreed that we need to create innovate strategies for issue resolution that are less time and resource intensive for both while still promoting a climate that encourages compliance with the tax laws. ■

1. Joint International Tax Shelter Information Centre. JITSIC was formed in 2004 by Australia, Canada and the United States to supplement the work of their tax administrations in identifying and curbing cross border tax avoidance. Japan, China, France, Germany and Korea now also participate in JITSIC.
2. Tackling Aggressive Tax Planning through Improved Transparency and Disclosure (OECD 2011).
3. OECD Guidelines for Multinational Enterprises: Recommendations for Responsible Business Conduct in a Global Context (OECD 2011) http://www.oecd.org/document/28/0,3746,en_2649_34889_2397532_1_1_1_1,00.html

The mini-One Stop Shop for VAT - the start of something big!

Algirdas Šemeta is European Commissioner for Taxation, Customs, Anti-fraud and Audit

The strength of the single market, and the ease with which businesses can operate cross-border, are among the key determinants in how quickly the EU will return to economic growth. Yet, there is no denying that the complexity of the current EU VAT system is still an obstacle to intra-EU trade. Whether in dealing with tax administrations in different languages, or trying to understand the diverse national VAT obligations, businesses face too many deterrents against cross-border expansion, and too many costs and difficulties when they do operate elsewhere in the EU.

An important first step in addressing this problem has already been taken, however. Following a proposal from the Commission, member states agreed to a mini-One Stop Shop for certain enterprises. This will allow e-services, broadcasting and telecommunications businesses to declare and pay all the VAT they owe across the EU in their own member state, rather than having to do this in each and every member state in which they have customers.

So, the tax authority in the member state where the business is established will receive the VAT declaration and payment for activities in the other Member States, and will be responsible for forwarding it accordingly. Thus, the administrative burden of VAT will be significantly reduced for businesses.

The use of a One Stop Shop is not entirely new. Since 2004 businesses established outside the EU could nominate a member state through which they would declare and pay VAT due throughout the whole EU on their B2C supplies of e-services. However, by May 2011 there were just less than 750 businesses using this e-commerce scheme. This limited take-up can be explained with two reasons.

Firstly, the current rules for e-services mean that VAT is charged at the rate applicable in the member state of the supplier. With the standard rate of VAT being anywhere from 15% to (currently) 27%, compliant non-EU businesses have generally found it more profitable to establish in a member state with a low standard rate and to charge this rate to all private individuals for the e-services they supply in Europe. The e-commerce scheme would mean an end to this, as the businesses would be charged the VAT rate of the customers' country eg. 25% VAT in Denmark compared to 15% VAT in Luxembourg.

Secondly, there is no effective way of ensuring compliance. If a business located in California, for example, provides e-services to a private individual in Slovakia and does not register for the e-commerce scheme and pay Slovak VAT what can the national tax authorities do realistically?

The Commission is addressing this issue and has asked member states for a mandate to negotiate with third countries on this issue from a collective position of power. For the time being, though, compliance depends on the willingness of suppliers in third countries to assume their legal obligations.

At least from 1 January 2015, the first reason for not using the e-commerce scheme which is mentioned above disappears. From this date, all B2C supplies of e-services will be taxed at the place where the customer is resident. This is irrespective of whether it is an EU or non-EU business. So a customer

living in Copenhagen will be charged 25% VAT, regardless of whether the supplier is from Denmark, Luxembourg or the USA.

Furthermore this will help prevent the distortion of competition within the single market. No longer can the supplier's location influence the amount of VAT the customer pays. And any VAT rate advantages from setting up in a particular member state will be removed. This creates a fairer and more level playing field between competing businesses in the single market.

However, as the e-commerce scheme currently in place is only for non-EU businesses supplying directly to EU customers, there is a need to expand it for e-services being supplied cross-border within the EU. Hence, the start of a mini-One Stop Shop for e-services, broadcasting and telecommunications.

This promising start should be seen as just that – a starting point, far from the finishing line which we intend to reach. There are many businesses trading in the EU that will not be able to benefit from this simplification. Those selling goods to private individuals across borders, for instance, are not included in the mini-One Stop Shop.

Imagine that a Belgian resident decides to compare the online prices being offered by e-commerce traders elsewhere to those being offered in Belgium. A similar product is being sold over the internet from a UK company and the order is placed. The trader, having annual sales in Belgium below €35 000, can simply charge the UK VAT. He may find though that this sale pushes him over the €35 000 threshold, thereby requiring him to register for VAT in Belgium and charge the Belgian rate. In this case the supplier, assuming he is compliant and knowledgeable of VAT rules, may tell his potential customer that the administrative burden is simply too high for him to make the sale.

It is to prevent such scenarios that I would like to see the One Stop Shop system enlarged to cover more businesses. Indeed these problems are more acute for SMEs, which is particularly worrying. The importance of the role of SMEs in creating jobs and growth in Europe should not be underestimated, we must do all we can to create the right business environment for them.

In the Communication on the future of VAT, which I presented last December, the Commission said that from 2015 onwards there should be a managed broadening of the One Stop Shop over time. Obviously, it's a good idea to wait to see the success of the mini One Stop Shop before embarking on an expansion; and this we will do. We will also take into account Member States' questions on the importance of a wider One Stop Shop if we move towards a system of taxation at destination.

If VAT is to be charged at the rate set by the Member State where the customer is located, there needs to be some simple way for the supplier to fulfil his VAT obligations. For B2B supplies of services, that is generally achieved today through the reverse charge. In this case, the customer charges himself the VAT and then may deduct it according to the normal rules on the right to deduct. For the cross border supply of goods, the customer also charges himself VAT (an EU acquisition). The result is the same in that VAT is declared and accounted for by the customer.

For B2C supplies of goods or services, such solutions are not possible. I doubt that there would be any appetite for making private individuals responsible for collecting and paying VAT. Nor do I think this would be efficient from a revenue perspective. Instead, a far better solution is the setting up of a One Stop Shop.

"This promising start should be seen as just that – a starting point, far from the finishing line which we intend to reach"

All B2C businesses could then complete a single VAT return, detailing sales in each member state and paying the corresponding VAT to their own authorities. Clearly that is simpler than having to register and fulfil VAT obligations in every member state. Moreover, other measures could make it even simpler.

For instance, member states have different standard rates, different reduced rates and even sometimes zero-rates, all applied to a vast array of differing goods and services. Therefore, a solution is needed to ensure that businesses aren't overwhelmed trying to figure out what VAT rate to apply to their sale. For this reason, the Commission has proposed setting up an EU web portal on EU and national VAT rules, including clear and binding information on the list of goods and services not covered by the standard rates in each member state.

Turning now to B2B supplies, it would be better for the single market to have a VAT system in which supplies within a member state and supplies cross border could be taxed in a similar way. Within a destination system of VAT, there seem to be two obvious solutions.

A first option is to treat local supplies in the same way as cross border supplies. This would mean, in effect, applying a general *"reverse charge"*. There are advantages for businesses here, in that they can avoid having to charge and reclaim VAT, thereby reducing their administrative burden. Such a system would also put an end to carrousel fraud. However, it might create other types of fraud. Moreover, the loss of the fractionated system of VAT, whereby the vast majority of VAT is collected and paid by the largest and more reliable businesses, is lost. VAT in effect becomes more like a sales tax and certain member states fear a resulting loss in tax revenues.

A second option would be to treat cross border supplies in the same way as local supplies. This means that the supplier would charge, collect and pay the VAT. This is easier to do when the business is established in the member state where the tax is due, but not so easy elsewhere. If such an option was to be taken forward, a One Stop Shop would clearly

be necessary to avoid to high administrative burden for businesses.

The One Stop Shop has many merits. It can bring substantial simplification and cost reductions for both businesses and member states. But for it to work in practice, member states must trust each other to collect the VAT on their behalf. It needs to be asked whether that degree of confidence between the member states currently exists.

All these elements will have to be discussed during the review of the destination system of VAT. That will, undoubtedly, be an interesting and challenging debate. Of course, other solutions may also be examined in order to assess best way forward, and the Commission will discuss these in detail with member states and businesses. Indeed, a VAT expert group is being formalised specifically to take such discussions with businesses forward.

Several steps, both on a legislative and operational level, will need to be taken in the coming years to ensure the smooth functioning of the mini-One Stop Shop from 1 January 2015. This is a key VAT priority for two reasons. Firstly, the mini-One Stop Shop must be in place on time. Otherwise, businesses will have a hard time fulfilling their VAT obligations, through no fault of their own. Secondly, the success or failure will be a decisive factor for a possible extension of the mechanism over time and, more generally, for the overall design of the future EU VAT system. ■

OECD launches its Global Forum on VAT

Piet Battiau is Head of the Consumption Taxes Unit at the Centre for Tax Policy and Administration, Organisation for Economic Co-operation and Development

Value Added Taxes (also referred to as goods and services taxes) have become a truly global phenomenon. Such taxes were used in less than ten countries in the late 1960s. By contrast, over 150 countries now operate a VAT and its importance as a major source of revenue for governments continues to increase.

In the 33 OECD member countries that operate a VAT, the share of VAT as a percentage of total taxation has grown by more than 70% since the mid eighties, passing from 11.2% on average in 1985 to 19.2% in 2009. This makes VAT globally the third important source of revenue (figures for 2009) behind personal income taxes (25%) and social security contributions (27%) but far above corporate income tax (8%), specific consumption taxes (incl. excise duties; 11%) and property taxes (5%).

The importance of VAT as a source of government revenue is likely to increase further as countries deal with fiscal consolidation pressures in the wake of the economic crisis. A growing number of countries are looking at ways to improve the performance of their VAT, to increase its revenue raising capacity and to address inefficiencies.

Meanwhile, the economic globalisation creates increasing challenges for the application of VAT on international trade. Many of these issues are similar across countries and the scope for "learning from each other" is enormous.

In this context, the OECD's Committee on Fiscal Affairs (CFA) decided in May 2012 to launch its Global Forum on VAT as a platform for a structured global dialogue on the design and operation of VAT. The creation of this Global Forum is a logical step in the evolution of the OECD's work on VAT. This article gives a brief overview of this work and describes the role the Global Forum on VAT.

VAT in cross border trade: from the Ottawa Taxation Framework to the VAT/GST Guidelines

The development of internationally agreed principles for the application of VAT on international trade, particularly in the area of services and intangibles is a key priority for the OECD's Committee on Fiscal Affairs. Combined with the spread of VAT globally, the growth of cross border economic activities has increased the interaction between VAT systems leading to an increased risk of double taxation and unintended non-taxation. The most common causes of double (non) taxation are the use of different rules to determine the place of taxation and different interpretation of similar rules, different characterization of transactions and non-recoverability of tax.

Countries broadly agree that "taxation at destination" is the standard for applying VAT in an international context: no VAT is levied on exported products and imports are taxed in the importing country as if they had been domestic production. This principle is generally easily applicable for international

trade in goods. However, the strong growth of international trade in services has created particular challenges for VAT systems.

Services cannot be subject to border controls in the same way as goods, so administrative procedures for ensuring that the right amount of tax is paid in the right place are more complex and differ across jurisdictions. Since the late 1990s, governments and tax administrations recognised that greater coherence was required for the application of VAT in an international context.

The OECD first developed international standards on consumption taxation in the context of electronic commerce in 1998, which has become known as the Ottawa Taxation Framework. Destination based taxation of cross-border e-business was the governing principle of this framework. It has since then served as a basis for the European VAT-rules on e-business and telecommunication and broadcasting services, adopted in 2008. Also the World Trade Organization (WTO) and the Asia-Pacific Economic Cooperation (APEC) have adopted it as the standard for taxing electronic commerce.

However, evidence grew that VAT could distort international trade in services and intangibles more generally and the OECD therefore launched a project for the development of the OECD International VAT/GST Guidelines, as an internationally agreed standard for applying VAT to cross-border trade. Guidelines on the VAT treatment of business-to-business supplies of services and intangibles were adopted in 2010 and International VAT Neutrality Guidelines were adopted in 2011. A Commentary on the Neutrality Guidelines has been recently released for public consultation.

The OECD is now developing Guidelines on the VAT treatment of cross-border supplies of services and intangibles in specific scenarios, including transactions involving businesses that operate cross-border on the basis of a branch structure and transactions in connection with immovable property. This work is scheduled to be released for public consultation in early 2013. The OECD aims to finalise the International VAT/GST Guidelines as an internationally agreed framework for the application of VAT to international trade, in the course of 2014.

VAT policy design

VAT is a major source of revenue and the design of VAT regimes can thus potentially have a significant impact on a country's economic performance. An increasing number of countries are starting to consider reform of their VAT system as a result of the pressures for fiscal consolidation. It is a priority for the OECD to actively support countries in this exercise.

Economic analysis suggests that broadening the tax base, limiting the use of reduced rates and exemptions could increase output and social welfare. However, the political obstacles to raising and perhaps ultimately eliminating reduced rates and exemptions are often considerable. The OECD supports countries through policy analysis and by facilitating the exchange of experiences to strengthen national assessments of the desirability, or otherwise, of reforms.

The Global Forum on VAT

The global reach of VAT means that not only OECD countries but also much of the rest of the world has an interest in policy exchange and development of best practices for the design and operation of VAT. Brazil, China and India for instance are seeking to reform their VAT regimes to remove cascading and provide more uniform taxation of goods and services.

Notably at the OECD's 50th Anniversary Tax Conference on *"Challenges in Designing Competitive Tax Systems"* in June 2011, senior tax officials and decisions makers stressed the need for a real global dialogue involving all major players on the design and application of VAT.

"The Global Forum on VAT... will offer a platform for structured dialogue with non-OECD economies and other stakeholders"

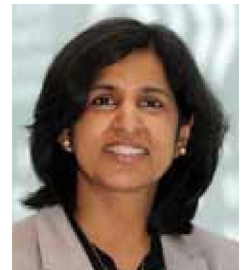
Against this background, the OECD's Committee on Fiscal Affairs decided in May 2012 to create a Global Forum on VAT. Like the OECD's Global Forums on Treaties and on Transfer Pricing, the Global Forum on VAT will play a key role for the OECD's cooperation with non-OECD economies on international taxation. It will offer a platform for structured dialogue with non-OECD economies and other stakeholders.

It will offer the opportunity for sharing policy analysis and experience, for identifying best practices and for strengthening international cooperation among industrialised, emerging and developing economies, and international and regional organisations. Businesses and academia will also be invited for discussions at Global Forum meetings.

The first meeting of the Global Forum on VAT will be held on 7-8 November 2012 in Paris. Participants will explore key policy trends and their impact for policy makers, tax administrations and businesses. They will discuss the design of efficient and equitable VAT systems and compare approaches. They will look at the challenges of applying VAT in an international context and consider the OECD International VAT/GST Guidelines that are being developed as a set of international standards for the application of VAT to international trade. They will share views and experiences about the challenge of administering and complying with VAT in practice.

These are exciting times for VAT professionals. The OECD's Global Forum on VAT now offers the opportunity for stakeholders across the globe to engage in a constructive dialogue around the development of international agreed standards and policies for the design and operation of efficient and equitable VAT systems. ■

Global Forum: real change towards international tax cooperation



Monica Bhatia is Head of the Global Forum Secretariat at the Centre for Tax Policy and Administration, Organisation for Economic Co-operation and Development

In times of growing economic uncertainty, international cooperation in tax matters has become a high priority on governments' agenda. The liberalization of financial markets has brought with it a significant increase in the flows of cross border capital and cooperation amongst tax administrations in sharing taxpayer information is key to ensuring effective ongoing tax law enforcement. With 109 members, the Global Forum on Transparency and Exchange of Information for Tax Purposes is the largest tax body in the world, mandated to ensure that all jurisdictions adhere to the same high standard of international cooperation in exchanging tax information.

"... the Global Forum... is the largest tax body in the world, mandated to ensure that all jurisdictions adhere to the same high standard of international cooperation in exchanging tax information"

The G20 has long been a strong proponent of the Global Forum's work and in 2009, in the wake of the global financial crisis, the G20 leaders called on the Global Forum to help secure the integrity of the financial system through the uniform implementation of high standards of transparency. In response to this mandate, the international standard on transparency and exchange of information was agreed by the Global Forum. This is set down in its *Terms of Reference*, which forms the basis of the in-depth peer reviews which it is charged with carrying out on all of its members and other jurisdictions that have been identified as being of interest to its work.

The Global Forum, which was fundamentally restructured at its meeting in Mexico in September 2009 to create an inclusive, truly global organisation where all of its members participate on an equal footing, is a diverse and balanced group with its membership comprising small jurisdictions, developing countries, major financial centres, the OECD economies and all G20 countries working together and sharing the same objectives. This has been the hallmark of its success to date.

The membership of the Global Forum continues to grow and in the current economic climate the value of the work carried out by the Global Forum is increasingly being recognised by governments, with interest in the membership at an all time high.

The work of the Global Forum is guided by an 18 member Steering Group and the high standards of transparency and exchange of information for tax purposes are met through a comprehensive, rigorous and robust peer review process conducted by teams of experts, independent assessors and overseen by a 30 member Peer Review Group.

The peer review process

The peer reviews examine the legal and regulatory framework of jurisdictions (Phase 1) and the actual implementation of the international standard in practice (Phase 2). The review outputs include determinations regarding the availability of any relevant information in tax matters (ownership, accounting or bank information), the appropriate power of the administration to access the information and the administration's capacity to deliver this information to any partner which requests it.

When jurisdictions report on changes that are likely to significantly address the deficiencies identified in the peer review, the Global Forum conducts supplementary reviews of these changes. Where the Phase 1 review concludes that elements which are crucial to achieving effective exchange of information are not yet in place in, it is recommended that the jurisdiction does not move to a Phase 2 review until it has acted on the recommendations to improve its legal and regulatory framework.

With 79 jurisdictions already reviewed, and 23 other reviews underway, the Global Forum is reaching the end of the Phase 1 reviews. The Phase 2 reviews, which will examine how a jurisdiction adheres to the international standard in practice, are being launched in the second half of 2012. These reviews will provide in-depth investigations into the procedures and resources available for the exchange of information. In contrast to Phase 1, overall ratings on jurisdictions' compliance with the standards will be provided once a representative subset of Phase 2 reviews is completed. It is expected that the first Phase 2 reviews will be published

in 2013 and that more than 50 Phase 2 reviews will be completed by the end of the same year.

Impact of the reviews

The quality of cooperation within the Global Forum has been extremely high, with more and more jurisdictions implementing policy and legislative changes that address the deficiencies identified in their reviews. The quality of cooperation is also attested by the growing number of jurisdictions asking for supplementary reviews which acknowledge the improvements they have made to date in light of the recommendations received.

The Global Forum has conducted 13 supplementary reviews with two more underway. As a result of supplementary reviews, six jurisdictions that were previously unable to move to Phase 2 have been able to progress as the changes introduced to their legislation improved elements critical to exchange of information.

The reviews completed so far demonstrate the genuine commitment that members are showing to the international standard as well as demonstrating a strong level of compliance with the process. Nonetheless, nearly all peer reviews to date also show that improvements are needed, with 32 reports concluding that one or more elements essential for the effective exchange of information are not in place. Where these deficiencies are serious, the move to the Phase 2 reviews have been put on hold.

All member jurisdictions have committed to using the results of the peer review process to guide changes and improvements in their tax policy regarding transparency and improved sharing of taxpayer information, and most of the jurisdictions have taken action to address recommendations immediately following their assessment. This is a testament to the remarkable success of the process and is translating into more effective compliance with the standard on the ground.

Enhanced cooperation between Competent Authorities

The Global Forum has also been working closely with the Competent Authorities responsible for exchange of information from each jurisdiction, in order to further facilitate a coordinated approach amongst jurisdictions. The first meeting of Competent Authorities, organised by the Global Forum, took place in Madrid in May earlier this year and brought together 186 delegates from 78 member jurisdictions and 6 international organisations.

The participants reaffirmed their strong commitment to effective information exchange and examined the best ways to improve their relationships. It was clear from the meeting that the competent authorities present are all "upping their game", putting more resources into their EOI operations and improving management systems and staff training.

Countering the erosion of developing jurisdictions' tax bases

As part of the Seoul Multi-Year Action Plan on Development, the G20 leaders requested the Global Forum to *"enhance its work to counter the erosion of developing countries' tax bases and, in particular, to highlight in its report the relationship between the work on non-cooperative jurisdictions and development".* In response, the Global Forum proposed concrete short and medium-term actions to ensure that developing jurisdictions can benefit from the Global Forum's work and have the training and expertise necessary to fully implement the international standard.

These actions include two pilot projects aimed at providing in-depth technical assistance to Ghana and Kenya, to help them implement the international standards which have been launched in cooperation with the World Bank and with support from the UK's Department for Overseas Development.

In the case of Ghana the German Development Co-operation is also supporting the work. Other assistance activities of the Global Forum include regional training seminars for personnel involved in exchange of information, preparing jurisdictions for their peer reviews, and providing manuals and toolkits to enhance information exchange.

In order to facilitate the coordination of technical assistance in the areas covered by the Global Forum, a Coordination Platform to enhance cooperation with international organisations and development agencies was launched in February, 2012.

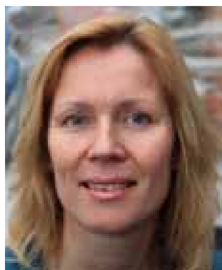
This is a secure website that is used by international organisations and development agencies to identify jurisdictions that need assistance, to locate partners for their own assistance activities and to promote awareness of upcoming events and training seminars related to tax transparency and exchange of information.

Continued support of the G20

At the most recent G20 summit of world leaders in Los Cabos, Mexico, the G20 commended the progress made by the Global Forum and reiterated its commitment to strengthen transparency and comprehensive exchange of information. Furthermore, the G20 reinforced the core message of the Global Forum and urged all countries to fully comply with the standard and implement the recommendations identified in the course of the reviews. The G20 further showed its support for the Global Forum by pledging to follow with attention the ongoing work of the Global Forum in this area.

The way forward: accelerated pace of change at a practical level

The Global Forum has clearly made significant inroads in furthering the cooperation of tax administrations and contributing to effective tax law enforcement. The pace of change will further accelerate as it begins examination into exchange of information in practice and enhances coordination between Competent Authorities. With the ongoing support from the G20 leaders, real results will be seen and felt at a practical level making tax administrations more effective in tackling tax evasion. ■



OECD work on the resolution of international tax disputes

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The globalisation of international trade and investment has created a world in which cross-border flows of goods, services, capital and technology have taken on enormous importance. In 2011, world merchandise trade was valued at USD 18.2 trillion and world commercial services exports were valued at USD 4.2 trillion.[1] Total foreign direct investment positions were also recently reported to total USD 20.7 trillion in 2010.[2]

Given the significance of these cross-border flows, there is a great deal at stake for governments as they seek to tax the income and gains these flows produce. This stake for governments is even more prominent in the current economic climate, where the worldwide economic crisis and the consequential rise of government debts spur the need to protect tax bases and make sure that all taxpayers contribute their fair share of tax.

"For taxpayers it is very important that the double taxation that arises from these controversies is resolved and that this resolution is achieved as speedily as possible"

In many cases, the provisions of a tax treaty based on the OECD Model Tax Convention (the OECD Model) or the United Nations Model Double Taxation Convention between Developed and Developing Countries (the UN Model) will limit the taxation of gains or income to make sure that taxpayers are not confronted with double taxation.

International tax disputes may arise, however, when there are disagreements between countries as to how a tax treaty should be interpreted or applied to specific international transactions or activities, or when a taxpayer considers that it has been subject to taxation contrary to the terms of a tax treaty. International tax disputes most frequently arise in the area of transfer pricing, where the issues involved are complex and the amounts at issue may be huge and may therefore lead to enormous costs for the taxpayers involved.

Article 25 (Mutual Agreement Procedure) of the OECD Model provides a mechanism for the resolution of such international tax disputes. Under Article 25, a taxpayer may present its case to the competent authority of its country of residence when it considers that it has been subject to taxation not in accordance with the provisions of the treaty. That competent authority is then obliged to endeavour to resolve the case by mutual agreement with the competent authority of its treaty partner, and the agreement so reached will be implemented notwithstanding any time limits in the domestic law of the two countries.

Whilst the mutual agreement procedure (MAP) provides a generally effective and efficient method of resolving international tax disputes, statistics for OECD member countries[3] show that there has been a steady increase in MAP caseloads over the last five years: OECD member country end-of-year inventory increased from 2,352 cases in 2006 to 3,328 cases in 2010, a rise of more than 40%.

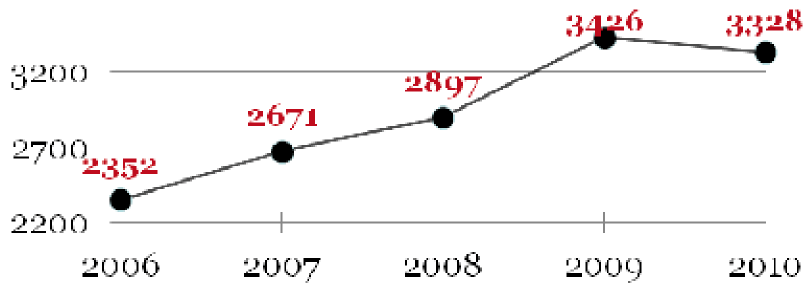
These statistics also indicate that over the same period the average number of months needed to resolve a MAP case had increased to 27.3 months in 2010 (from 22.1 months in 2006). And the caseloads are expected to increase even more, especially since a relevant number of governments have announced their intensified efforts to enforce and audit international tax issues.

For taxpayers it is very important that the double taxation that arises from these controversies is resolved and that this resolution is achieved as speedily as possible. In the current economic climate, where many businesses and individuals need to economize in order to stay alive, this is even more the case than five years ago. Implementation of the results of OECD work on the resolution of international tax disputes is a key way in which countries can balance the enforcement efforts they undertake with the interests of the taxpayers involved.

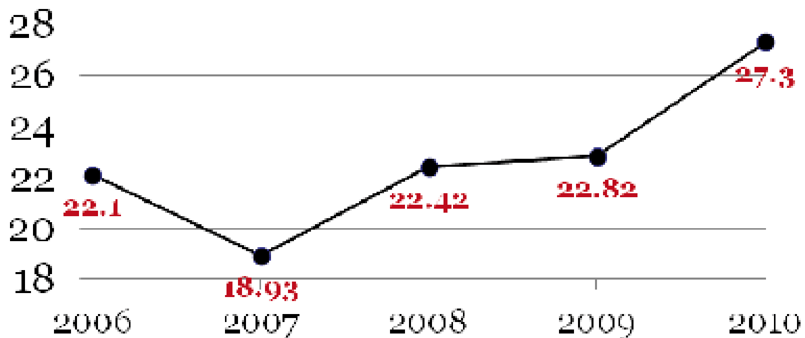
Since its *2008 Update*, the OECD Model has included a mandatory binding arbitration provision in paragraph 5 of Article 25. Under that provision, where competent authorities are unable to reach agreement in a MAP case within two years, any unresolved issues shall generally be submitted to binding arbitration upon the taxpayer's request.

MAP caseload of OECD member countries has increased by 41.5 % over the last 5 years

End of year inventories of MAP cases



Number of months to complete a MAP case



Arbitration provisions should be expected to increase the timeliness of the MAP procedure and reduce case inventories, but OECD member countries have continued to show a certain hesitance in adopting arbitration provisions. In fact, since 2005[4], only 17% of the treaties and protocols concluded by OECD member countries have included arbitration provisions. In this regard, it is significant to note that Article 25 of the 2011 Update of the UN Model[5] includes an optional arbitration provision (which contains certain differences with respect to the OECD provision intended to respond to the particular interests of developing countries and countries in transition).

The OECD is exploring how to encourage the wider use of arbitration, such as by monitoring the adoption and implementation of arbitration provisions, identifying barriers to adopting arbitration and/or the sharing of country experience with respect to design and practical implementation.

In 2007, the OECD presented its Manual on Effective Mutual Agreement Procedures (MEMAP)[6], a guide intended to increase awareness of the MAP process and how it should function. Developed by a working group of OECD member country competent authority officials based on their practical experience with the MAP, the MEMAP provides tax administrations and taxpayers with basic information on the operation of the MAP.

The MEMAP recommends 25 non-binding best practices to deal with particularities of the MAP process or procedural issues. At a roundtable organised by the OECD in January of this year, business representatives indicated that these best practices are often not adopted by competent authorities, leaving taxpayers to bear double taxation in cases that should be covered by the bilateral tax treaties. At a time when taxpayers are demanded to pay a fair share, it is also important that competent authorities show their willingness to resolve the controversies that lead to taxpayers paying more than their fair share.

On the fifth anniversary of the MEMAP, it may be a good time to evaluate whether the MEMAP is a mechanism that stimulates the implementation of swift and effective dispute resolution processes by governments or whether the mechanism should be changed, expanded or replaced in order to encourage governments to implement dispute resolution processes that are fit for purpose in a time when rising caseloads of international tax disputes are expected. ■

1. See World Trade Organization, "World trade figures for 2011, prospects for 2012", PRESS/658/Rev.1 (press release dated 10 May 2012) (available at: http://www.wto.org/english/news_e/pres12_e/pr658_e.pdf).
2. See International Monetary Fund, "IMF Releases Results from its 2010 Coordinated Direct Investment Survey", Press Release No. 11/479 (dated December 20, 2011) (reporting the release of the results of the IMF's 2010 Coordinated Direct Investment Survey) (available at: http://www.imf.org/external/np/sec/pr/2011/pr11479.htm).
3. MAP statistics for OECD member countries and certain non-OECD economies are available on the OECD website at: http://www.oecd.org/document/29/0,3746,en_2649_37989739_48115165_1_1_1_1,00.html
4. The OECD arbitration provision was first presented in draft form in 2005.
5. See paragraph 5 of Article 25 (alternative B) of the 2011 UN Model (available at: http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf).
6. Available at: http://www.oecd.org/document/45/0,3746,en_2649_33753_36156141_1_1_1_1,00.html or http://www.oecd.org/dataoecd/19/35/38061910.pdf.

Base erosion and profit shifting

Masatsugu Asakawa is the Chair of the OECD Committee on Fiscal Affairs and Deputy Vice-Minister of Finance for International Affairs, Japan

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.

"... the stage is set for meaningful improvements of the concrete tools the OECD already has to address 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.

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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The OECD discussion draft on the definition of permanent establishment

Jacques Sasseville is Head, Tax Treaty Unit at the the Centre for Tax Policy and Administration, Organisation for Economic Cooperation and Development

The concept of "permanent establishment" is the keystone of the existing tax treaty rules that govern the allocation of taxing rights over the business profits that foreign enterprises derive from a country. Almost all existing tax treaties include a definition of that concept based on Article 5 of the OECD Model Tax Convention.

The basic part of that definition is short and deceptively simple: *"For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on."*[1] That basic definition is completed by a list of examples,[2] a special rule applicable to construction sites,[3] a list of exceptions,[4] a deeming provision applicable to activities carried on through dependent agents[5] and a clarifying provision dealing with the application of the definition in the case of related companies.[6]

"The Working Party also intends to discuss the proposals included in the discussion draft with tax treaty officials from non-OECD countries"

Applying the different parts of that definition to the very different ways in which enterprises carry on business operations abroad raises a number of interpretation and application issues. The Commentary on Article 5 has been changed a number of times to deal with such issues.[7]

On 12 October 2011, the OECD Committee on Fiscal Affairs released a discussion draft entitled *"Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention"*.[8] The discussion draft deals with 25 distinct issues related to the definition of permanent establishment which were identified in previous OECD work, such as the work on business restructurings[9] and on the application to electronic commerce of the current treaty rules for the taxation of business profits,[10] in comments from OECD member countries and in comments from the OECD Business and Industry Advisory Committee (BIAC).

Work on these issues began in 2009 and was carried on by a Working Group set up by Working Party 1[11] to deal with these issues. The mandate of that Working Group, which included representatives from the tax authorities of most OECD countries and of some observer countries, was to provide additional guidance on the existing definition of "permanent establishment"; no changes to that definition were envisaged as part of the project.

The discussion draft includes a description of each issue examined by the Working Group together with a background analysis and the recommendation of the Working Group on the issue. In many cases, that recommendation takes the form of proposed changes to the Commentary on Article 5 of the OECD Model Tax Convention.

Comments on the discussion draft were received from around 45 organisations and individuals.[12] While these comments touch upon all the issues that were examined by the Working Group, the proposed changes to the Commentary that attracted the most comments are those dealing with the following issues:

- Meaning of "at the disposal"
- Main contractor who subcontracts all aspects of a contract
- Presence of foreign enterprise's personnel in the host country
- Meaning of "to conclude contracts in the name of the enterprise"
- "Home office" as a permanent establishment
- Time requirement for a permanent establishment

Many of these comments request an expansion of the guidance proposed in the discussion draft. In some cases, however, the comments reflect diverging views on some important aspects of the definition of "permanent establishment".

The comments were first examined at the February 2012 meeting of Working Party 1. The Working Party then decided that a special meeting should be held in September 2012 to discuss these comments in details.

The Working Party also decided that a public consultation meeting, to which all the persons and organisations who sent comments on the discussion draft would be invited, would be held immediately after that special meeting.

That public consultation meeting will allow a discussion of the controversial aspects of the proposals included in the discussion draft and of the areas on which additional guidance was requested through the comments received.

The Working Party also intends to discuss the proposals included in the discussion draft with tax treaty officials from non-OECD countries. This will be done at the next OECD Annual Tax Treaty Meeting, which will be attended by tax treaty officials from around 100 countries and international organisations. ■

1. Paragraph 1 of Article 5.
2. Paragraph 2.
3. Paragraph 3.
4. Paragraph 4.
5. Paragraphs 5 and 6.
6. Paragraph 7.
7. For example, the 2010 update to the Model Tax Convention included changes dealing with the application of the permanent establishment definition in the case of common telecommunication operations (see http://www.oecd.org/dataoecd/23/43/45689328.pdf).
8. Available at http://www.oecd.org/dataoecd/23/7/48836726.pdf.
9. In 2005, the OECD Committee on Fiscal Affairs mandated a Joint Working Group to carry on work on treaty and transfer pricing issues related to business restructurings (see http://www.oecd.org/document/11/0,3343,en_2649_37989760_38087051_1_1_1_1,00.html). At the end of 2007, having taken stock of the progress made to that point, the Committee referred the work the work related to the definition of permanent establishment to its Working Party 1 (see note 12 below).
10. In 1999, the Committee on Fiscal Affairs set up a Technical Advisory Group (TAG) on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits with the general mandate to "examine how the current treaty rules for the taxation of business profits apply in the context of electronic commerce and examine proposals for alternative rules". The final report of the TAG "Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce?" (available at http://www.oecd.org/dataoecd/58/53/35869032.pdf) included some suggestions for clarification of the definition of permanent establishment.
11. Working Party 1 on Tax Conventions and Related Questions, which is the Committee's subsidiary body in charge of changes to the OECD Model Tax Convention.
12. These comments are available at http://www.oecd.org/document/52/0,3746,en_2649_33747_49679284_1_1_1_1,00.html

Tax co-operation: beyond exchange of information on request

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Introduction

Offshore tax evasion is a serious problem for countries all over the world – small and large, developed and developing. Vast amounts of money are kept offshore and go untaxed when taxpayers fail to comply with their tax obligations in their home jurisdiction. The amounts of tax collected from offshore disclosure initiatives give an indication of the size of the issue.

For instance, between the 2009 London G20 Summit, when G20 leaders took action to end the era of bank secrecy, and the 2011 Cannes G20 Summit, in a relatively small number of countries such initiatives brought in more than €14 billion of additional tax. A multiple of this amount is still likely to be undisclosed.[1]

As the world becomes increasingly globalized and cross-border activities become the norm, tax administrations require a range of tools to ensure that taxpayers pay the right amount of tax to the right jurisdiction. It is against this backdrop that dramatic progress has been achieved over the last couple of years. We have moved from a world with limited ability to request information from financial centres to a world where all financial centres around the world have accepted and are implementing the standard of exchange of information on request.

The OECD's work on exchange of information on request and the peer review work of the Global Forum on Transparency and Exchange of Information are well known. The work of

the Global Forum ensures effective implementation of the standard both in law and in practise.[2]

Automatic exchange of information

Countries are also using strategies that complement information exchange upon request. One such strategy is automatic exchange of information. Automatic exchange of information involves the systematic and periodic transmission of "bulk" taxpayer information by the source country to the residence country concerning various categories of income (eg. dividends, interest, royalties, salaries, pensions, etc).

Automatic exchange of information as such is not new but there is now a growing interest in this form of exchange by many governments, NGO's, politicians and civil society. Also, at the international level, including at the EU, the OECD[3] and the G20 automatic exchange is high on the agenda.[4]

Further, the OECD's project on Treaty Relief and Compliance Enhancement (TRACE), which is designed to provide an effective system for obtaining treaty benefits, incorporates standardised systems of information exchange and, with the support of business, has made significant progress.

"Automatic exchange of information as such is not new but there is now a growing interest in this form of exchange by many governments, NGO's, politicians and civil society"

In a recent statement[5] France, Germany, Italy, Spain, the United Kingdom and the United States committed to working with other interested countries, *"the OECD, and where appropriate the EU, on adapting FATCA[6] in the medium term to a common model for automatic exchange of information, including the development of reporting and due diligence standards."* Business supports the attempt to create single international standards and avoid the proliferation of different systems.

The EU is engaged in revising its Savings Directive and recently adopted its Mutual Assistance Directive which also contains provisions on automatic exchange. The OECD and the Council of Europe recently revised the Convention on Mutual Administrative Assistance in Tax Matters which provides a basis for automatic exchange. It is now open to all countries.

The OECD has been active in facilitating automatic exchange for many years to support those interested in this form of exchange. The work has ranged from creating the legal framework for such information exchanges to developing technical standards and seeking to improve automatic exchange at a practical level.

In addition, the OECD has produced guidance on automatic exchange and provided training to countries interested in developing the necessary framework and operating automatic exchange on a practical level.

Results of a recent survey on automatic exchange conducted by the OECD show widespread use of automatic exchange of information regarding country coverage and income types, transaction values and records exchanged. Among the most frequently exchanged income types are: interest, dividends, royalties, salaries and pensions. Key findings include:

- Many countries, OECD and non OECD economies, receive information automatically from treaty partners;
- 85% of surveyed countries send information automatically to treaty partners (up to 70 partners in one case);
- The value of transactions reported to most countries in a year is measured in the euro billions and five countries each received information totalling in excess of €15 billion.

Automatic exchange as a tool to counter offshore non-compliance has a number of benefits. It can provide timely information on non-compliance where tax has been evaded either on investment return or the underlying capital sum. It can help detect cases of non-compliance even where tax administrations have had no previous indications of non-compliance. Other benefits include its deterrent effect, increasing voluntary compliance and encouraging taxpayers to report all relevant information.

While the work on automatic exchange has shown that it can be an effective tool for compliance, it has also identified some challenges and areas where more work needs to be done on both the practical and policy side. The true measure of success is not the quantity of information exchanged but the compliance that is achieved.

As technology continues to evolve, the applicable technical standards and processes must evolve and it is critical for governments to make sufficient investments in IT and related back-office functions to keep pace with the developments. Standardization of technical formats and the development of common reporting standards are important for both governments and business as it will lead to a reduction in the compliance burden.

Another key component in connection with automatic exchange of information is the need to ensure that information exchanged is kept confidential. This aspect has long been a key focus for the OECD and tax administrations in respect of all forms of exchange of information, not just automatic exchange, but it is particularly pronounced in the automatic exchange area.

To engage in exchange of information countries need a high degree of comfort that the information is kept confidential both in law and in practice and is only used for the purposes allowed under the applicable exchange instrument. The OECD recently published a guide, *Keeping it Safe: The OECD Guide on the Protection of Information Exchanged for Tax Purposes*.

Conclusion

Much is happening in the area of international tax co-operation as this brief overview has shown. These

developments will benefit not only governments but also business. Governments will better be able to enforce their own domestic tax laws and ensure that the right amount of tax is paid in the right jurisdiction. In addition, through the standardization of formats and common reporting standards, the cost of compliance will be reduced for both governments and business. With governments determined as ever to crack down on offshore tax evasion this work is likely to continue – so stay tuned. ■

1. See opening remarks by Angel Gurría, OECD Secretary-General, at the Fourth meeting of the Global Forum on Transparency and Exchange of Information for Tax Purposes (www.oecd.org/document/35/0,3746,en_2649_37427_48938403_1_1_1_37427,00.html)
2. See www.oecd.org/document/33/0,3746,en_21571361_43854757_44200609_1_1_1_1,00.html
3. See the OECD report on the practice of automatic exchange http://www.oecd.org/dataoecd/19/9/50630916.pdf
4. The June 2012 Los Cabos G20 Communiqué stated, "We welcome the OECD report on the practice of automatic exchange, where we will continue to lead by example in implementing this practice. We call on countries to join this practice as appropriate and strongly encourage all jurisdictions to sign the Multilateral Convention on Mutual Administrative Assistance."
5. Joint Statement regarding an Intergovernmental Approach to Improving International Tax Compliance and Implementing FATCA (see www.treasury.gov/press-center/press-releases/Documents/020712%20Treasury%20IRS%20FATCA%20Joint%20Statement.pdf)
6. Foreign Account Tax Compliance Act.

Initiatives in the transfer pricing area

Krister Andersson is the Chairman of the Tax Policy Group at BUSINESSEUROPE

In 2010, the OECD Committee on Fiscal Affairs launched yet another project in the transfer pricing area. This time it dealt with the transfer pricing aspects of Intangibles. On June 6, 2012, Working Party No. 6 issued for comments a discussion draft on this subject. This initiative followed the report on transfer pricing aspects of business restructurings (Chapter IX of the Transfer Pricing Guidelines) which was published on July 22, 2010.

In this article, I will comment on why these initiatives have been taken and also give some perspectives on the taxation of intangible assets.

Reasons behind the initiatives

The need for updated guidelines in a fast changing world clearly has its own merits. In a world of increased international activities and with business models changing, there is every reason for the OECD to take initiatives in this area. The risk of economic double taxation, or of unintended double non-taxation, is obvious. Both tax authorities and businesses need to have clear and uniform rules applied in as many countries as possible.

It appears, however, that the initiatives for a review of the rules often come from large member countries in the OECD area and not from the Secretariat of the OECD or from smaller countries. Large economies tend to have high statutory corporate tax rates and they may not always maintain their competitiveness in the global arena. Due to the relatively high corporate tax rates, they are also more susceptible to relocation pressures. One such example is Germany which has been exposed to relocation of services and production to countries in Eastern Europe and also to Asian countries. Such relocation often entails business restructuring. Germany was therefore one of those countries that felt that the transfer pricing rules in connection with business restructuring should be reviewed in an OECD context.

In the German debate, arguments were presented that businesses should of course be allowed to structure their business activities as they see appropriate. The tax consequences might, however, entail taxation of profits forgone due to the relocation.

"After an extended period of deregulation and opening up of markets, taxation may perhaps be the only remaining instrument to impose barriers"

Such a taxation regime would certainly imply considerable obstacles to the relocation of production, and it would be a barrier to cross-border restructurings. The valuation methods were also discussed at length (as they are likely to be also in the project on intangibles) but any assessment of the impact of such tax rules or of valuation methods on investment, growth, and competitiveness was absent. Instead, arguments about the need to protect the revenue base were vocal.

We should not forget that when taxation started to gain attention at the OECD, some 45 years ago, it was basically

handled as a trade issue. Clearly, taxation of profits forgone, however defined, would not promote cross-border activities, and it would lower the welfare for all countries involved. After an extended period of deregulation and opening up of markets, taxation may perhaps be the only remaining instrument to impose barriers. This is however, usually not openly discussed.

The outcome of the project of business restructuring refuted claims of taxation of profits forgone but the intentions from some governments in this process are reasons for continued concern about attempts to regulate markets and impose obstacles to a free flow of goods, services, and capital.

"... an impact assessment of various proposals could serve as a useful tool for steering the discussions in the right direction"

The new project, *Taxation of Intangibles*, raises similar concerns. For a country experiencing difficulties in its domestic tax rules for the taxation of international activities and income, it is always tempting to encourage the OECD to review transfer pricing rules in such a way that an onerous outcome for the individual country is mitigated if all countries can be persuaded to adhere to such rules.

It is of utmost importance that the OECD resists such demands and that the OECD Secretariat instead embarks on an open discussion of the implications for OECD countries and non-OECD countries of proposed tax changes. Here, an impact assessment of various proposals could serve as a useful tool for steering discussions in the right direction. A transparent and inclusive dialogue with all governments as well as stakeholders is essential in this respect.

Countries with numerous property rights and intangibles of significant value obviously fear that these rights could move to low tax jurisdictions. A country like the Netherlands has responded by allowing the so called Patent (Innovation) box and the UK is likely to follow suit. The US appears to see such large risks from relocation of intangibles that they would like to see also smaller countries engage in a project of how to handle taxation in connection with a transfer of intangibles.

In the discussion drafts, valuation technics once again has become a main issue. It is claimed that a particularly useful tool for assessing the value of the intangible is the discounted value of projected future cash flows attributable to the intangible or intangibles transferred.

That would mean that the present value of future cash flows attributable to the intangible being valued, after proper adjustment for taxes, is assumed to be the value or arm's length transfer price of the intangible.

One must ask oneself what such a valuation would mean for cross-border activities and free trade. We witness such a valuation every day on the stock market. The stock price reflects the discounted stream of expected future dividends.

Given the recent volatility of stock market valuations, one could assume that few individuals would like to pay tax on these values, in particular if there is no adjustment for next day losses. Taxation based on estimated future cash flows would at least require full loss-offset, perhaps even on a daily basis, but tax rules are not defined in such a way. If only value gains are taken into account, but with no downward revisions, the tax burden would be high.

How will intangibles be treated if assessed according to such a method? They are likely to be valued on transfer only and not continuously. The risk of assessing a wrong value is obvious and the risk would therefore serve as an obstacle to relocation of intangibles. If not properly designed and implemented, the OECD would add to cross-border obstacles and trade barriers.

It is in every country's interest to ensure that the revised TP guidelines do not add to obstacles to free trade and cross-border activities. Short term revenue implications must not be allowed to result in a de facto reregulation of markets.

The two recent tax projects in the transfer pricing area, regarding business restructurings and intangibles, raise important issues of motivation and justification from member states in the OECD. Clear definitions and implementation are in everyone's interest but there are also aspects of inter-country allocations of production and property rights, and therefore tax revues, that need to be addressed and assessed. This has not always been the case in the OECD tax policy work.

Taxation of intangibles

Several aspects deserve special attention when reviewing the taxation of intangibles. The definition of an Intangible is one of these. It is very important to find a clear and generally accepted definition of what is an intangible property. Without such a definition, the risk of inconsistent interpretation and application of the arm's length principle is evident, with double taxation as the ultimate consequence. The arm's length principle as set out in Article 9 of the OECD Model Tax Convention (MTC) and the OECD Transfer Pricing Guidelines (TPG) is a natural starting point for identifying a suitable definition.

The arm's length principle seeks to mimic terms and conditions between independent parties. This suggests that any definition should try to capture value deriving from intangibles that constitute *assets* in the meaning that two independent parties would agree to transfer the ownership and control of them. A definition that does not evolve around the concept of an asset (or property) would deviate from what can be observed in the marketplace and would thus not be coherent with the arm's length principle.

On this basis, a definition of intangible assets that are to be recognized for TP-purposes ought to include three typical characteristics: *ownership*, *control*, and *transferability*.

Although business attributes or notions such as goodwill, going concern, synergies, location savings etc. may affect the valuation of a taxable transaction, ie. the value of the

transfer of an intangible asset, such attributes or notions are not themselves assets which can be owned, controlled or transferred separately. Consequently, they should not be included in the definition.

It should be noted that such a definition of intangible assets does not include just those assets which can be registered or otherwise protected through a similar procedure (such as trademarks, patents, etc.) It also covers intangible assets where these characteristics can be manifested and upheld in a contractual arrangement between two parties (dependent or independent).

Goodwill, going concern, synergies, location savings etc., are not intangible assets themselves and should not be recognized for TP-purposes on a stand-alone basis. Instead they are elements connected to the valuation (and comparability) of such assets and may accordingly affect the transfer price of an intangible asset.

Thus, unless it is possible to identify the transfer of a tangible or intangible asset (either by way of a realization of such an asset or the right to use such an asset, purchase and sale), goodwill and similar value elements cannot by themselves trigger a taxable event.

Ownership issues are another important aspect. The owner should typically receive the economic benefits of the intangible assets as well as assume the risks related to the assets in question.

Legal ownership in terms of the contractual arrangement between the parties, including the allocation of rights and obligations, appears to be a sound starting point for the ownership analysis.

Administrations should be very careful when deciding to forgo and disregard what the taxpayer has clearly set out to accomplish. The legal ownership should be respected unless the economic substance and the conduct of the parties clearly deviate from the contractual arrangement. In line with chapter IX of the TPG, such actions from administrations should be allowed in exceptional cases only.

Reasonable efforts to centralize IP-rights must not be disregarded by administrations without there being substantial and significant factors to indicate that such efforts would in fact be incompatible with how business is actually performed.

Nevertheless, in cases where the intention of the parties cannot be determined and/or when the conduct of the parties clearly deviates from such an arrangement and the arm's length principle, the objective should be to determine what would be a reasonable allocation between independent parties given the facts and circumstances of the case.

The notion of control, as further developed in chapter IX, appears to have merits also for the purpose of allocating ownership of intellectual assets (intangible property). However, caution should be exercised when adopting the concept of control in this context since there may not always be a close proximity between control and an arm's length allocation of such ownership.

By way of example, outsourcing of R&D activities between independent parties is sometimes done because the principal does not have the resources or competence to perform these functions. This party might therefore not have the ability to control and/or manage the process in any detail but only in a high level management sense.

"There must not be any opportunities for some countries to claim that the changes of rules are made to disadvantage them"

The meaning of control is therefore crucial. Any requirement in this context ought to be in the form of high level strategic and economic management and decision making, such as the right to "hire and fire", participation in and ultimate authority over budgets, key strategic decisions etc.

The fact that the contractor/service provider is using its particular competence to decide how to reach the objectives outlined, should not influence the allocation of IP-ownership.

The notion of funding (ie. which of the parties has funded the IP-development) equally seems to be a useful guide in determining ownership. It is indeed reasonable to assume that among independent parties the one that has funded the R&D-activities, whether the actual development work has been conducted by this party or not, will have a rightful claim to the benefits (and risks) related to the IP- so created.

Conclusions

It is positive that the OECD has decided to get involved and request comments/guidance from business at an early stage in the project. For this cooperation to be fruitful, it is equally important that the OECD process is transparent and that an economic analysis is presented at the same time as proposed tax changes are presented. There must not be any opportunities for some countries to claim that the changes of rules are made to disadvantage them.

The ideal situation would of course be designing guidelines that have a chance of gaining acceptance not only within the OECD but also in developing countries outside the OECD. Too many divergent views on these issues could, rather than leading to further guidance end up in increased complexity and ambiguity. We must not forget that the purpose of transfer pricing projects must be to eliminate (or at least mitigate) international double taxation in a timely manner.

Governments have a responsibility to ensure that tax rules applied do not act as a hindrance to a free flow of investment and trade. Furthermore, and in conclusion, the OECD governments have as an economic policy objective the development of high value businesses based on intellectual property. It would seem very strange if the OECD Intangible project resulted in a tax framework that does not support this economic policy and continued free movement of capital, goods and services. ■

Transfer pricing and the arm's length principle

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Some estimates suggest that 30 percent or more of world trade occurs between affiliates of the same global MNE group. In today's globalised economy, it is typical that production of components for an MNE's products will occur in one country and final assembly of products in another country.

Sales and marketing functions may well take place in local markets, far removed from the place of production, and with rapidly increasing frequency can take place over the internet from remote locations.

Group management activities may be decentralised or occur in matrixed organisations with participating managers located in numerous jurisdictions around the globe.

"... companies and tax administrations have a lively interest in transfer pricing determinations related to all types of cross-border transactions"

Research and development activities leading to the creation of valuable intangibles may similarly be geographically dispersed. Service transactions where the service provider and the beneficiary of the service are geographically separated are also common.

Where transactions in goods and services move between associated enterprises across country borders it is necessary for companies to establish transfer prices with respect to those transactions. The prices set determine in large measure the way an MNE group's income will be allocated among the various members of the MNE group and among the taxing jurisdictions that host their operations.

Accordingly, companies and tax administrations have a lively interest in transfer pricing determinations related to all types of cross-border transactions. Moreover, the growth of international commerce has led more and more countries to have an active interest in transfer pricing as developing economies have become important participants in the international flow of goods and services and have accordingly found it necessary to protect their local tax bases with well enforced transfer pricing rules.

The OECD Transfer Pricing Guidelines establish principles for establishing intercompany transfer prices. They are based on the arm's length principle, ie. the notion that the best guide to how associated enterprises should price transactions and allocate income can be found in arm's length dealings between unrelated parties. This arm's length principle forms the basis for transfer pricing legislation and enforcement in virtually all countries.

Questions often arise, however, regarding the effectiveness and practicality of transfer pricing rules based on the arm's length principle. Some critics have argued that the existing rules are too easily manipulated by MNE groups intent on shifting income into lower-tax jurisdictions for financial advantages.

Those critics point to some highly publicised instances where transfer pricing outcomes and the underlying economics of MNE group operations seem not to be aligned and seem designed to isolate more income in low-tax jurisdictions than the economic activity in those jurisdictions can justify.

Developing countries sometimes express concern that the existing rules are too complex for tax administrations with limited resources to apply, or that their application requires access to data on comparable unrelated transactions that simply does not exist in their jurisdictions. Others argue that the increasing importance of internet based commerce, and in particular the growing importance of intangibles in driving corporate profitability, require new approaches for allocating the corporate tax pie among countries.

These varying criticisms of existing rules based on the arm's length standard have created increased pressures for countries to adopt inconsistent approaches and to seek more arbitrary and superficially simpler rules that, it may be argued, will protect the local tax base more effectively and at lower cost.

The OECD strongly believes that in today's rapidly globalising economy it is more important than ever that countries around the world follow a consistent standard in determining transfer prices. The proliferation of different rules and principles will give rise to the taxation of income in more than one jurisdiction. This double taxation has the potential of distorting investment decisions and inhibiting

the free flow of goods across borders, to the detriment of all.

Just as importantly, the proliferation of different approaches to transfer pricing issues can easily lead to double non-taxation, ie. situations where corporate income can be sheltered entirely from tax in the interstices between different individual country rules. Moreover, the OECD continues to be of the view that the arm's length principle provides the most sound and effective underpinning for a consistent global approach to transfer pricing.

This commitment to a single set of guiding transfer pricing standards based on the arm's length principle does not mean, however, that the current rules work perfectly or that they cannot be improved. Rather, there is a strong need to improve the current system in at least three ways:

(i) rules on the most difficult transfer pricing issues need to be continually updated and clarified so that countries and taxpayers are clear as to the guiding principles;

(ii) ways need to be found to simplify existing transfer pricing practices in order to limit the administrative burdens on tax administrations and taxpayers alike and to find ways to address the most straight-forward transfer pricing issues in a less labour intensive fashion; and

(iii) transfer pricing dispute resolution mechanisms need to be continuously improved so that taxpayers and tax administrations alike can achieve certain outcomes that relieve double taxation in reasonable amounts of time and at reasonable cost.

The transfer pricing work programme at the OECD is focused on these objectives. Pursuing the objective of developing clearer rules for the most difficult transfer pricing issues, the OECD recently published a discussion draft on transfer pricing aspects of intangibles.

The discussion draft addresses the definition of intangibles, the manner in which intangible related returns are allocated among members of an MNE group, and the manner in which arm's length prices can be established for transactions in both goods and services where intangibles are used by one or both parties to the transaction, and for transactions involving transfers of intangibles and interests in intangibles.

The discussion draft seeks to make clear that taxpayers may not use transactions in intangibles to separate income from the functions, assets and risks that give rise to that income under the arm's length transfer pricing principle.

At the same time, the OECD has embarked on a substantial project aimed at simplifying transfer pricing rules and administration. The first element of this project resulted in the recent publication of a discussion draft of revised guidance on transfer pricing safe harbours. That discussion draft emphasises that safe harbours can be used in many instances by countries to resolve lower-risk cases and to limit administrative burdens. It also provides country competent authorities with tools that can be used to develop bilateral safe harbours in appropriate circumstances.

It is believed that these tools will have particular application in some developing countries and may provide an avenue for developing countries to find transfer pricing solutions in common cases in a way that can simultaneously protect their tax bases and limit their administrative burdens.

Future work on the simplification project will focus on transfer pricing documentation, charges for routine head and regional office costs, and APA processes. In particular, the documentation work will seek to find ways to more effectively provide tax administrations with the information they need to assess transfer pricing risk at the beginning of an audit, while limiting the proliferation of document production rules that create heavy compliance burdens for taxpayers.

"Success in these endeavours will require the active involvement of all interested parties, including OECD member countries, emerging and developing economies that are not currently OECD members, taxpayers, development organisations and other interested parties"

OECD work on dispute resolution is discussed in greater detail in another article in this issue.

In adopting this three pronged approach to transfer pricing issues, the OECD believes that some of the shortcomings of current practice can be addressed and transfer pricing rules and administration can become more streamlined and effective. Success in these endeavours will require the active involvement of all interested parties, including OECD member countries, emerging and developing economies that are not currently OECD members, taxpayers, development organisations and other interested parties.

OECD processes are designed to be open to all affected parties and many non-OECD countries are taking an active role in the elaboration of the rules on simplification measures and intangibles. In March of this year, 90 countries and organizations met in the first meeting of the OECD Global Forum on Transfer Pricing to improve transfer pricing skills and discuss how the OECD work programme on transfer pricing can most appropriately be taken forward.

Business and other interested persons have been asked to comment on the recently released discussion drafts by 14 September 2012 and to participate in a public consultation on these topics in November. This sort of open dialogue around challenging transfer pricing issues will continue to be the hallmark of OECD work in this area. ■

Transfer pricing update

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The OECD has recently published two discussion drafts on transfer pricing that are open for public comment.

The first is an interim draft of a proposed revision of the provisions of Chapter VI of the OECD Transfer Pricing Guidelines ("Guidelines"); together with a proposed revision of the Annex to Chapter VI. There are also examples illustrating the application of the provisions of the revised text of Chapter VI. The discussion draft has been released following consultations with representatives of the business community and requests for regular updates on the deliberations of Working Party 6 ("WP6").

The Discussion Draft is not a complete draft of all of the provisions ultimately expected to form part of the final output. In particular, the Working Party still intends to address the following additional topics:

(i) any necessary modifications to Chapter VIII of the Guidelines relating to cost contribution arrangements that may arise as a result of the modifications to Chapter VI;

(ii) the transfer pricing consequences of various items treated in the discussion draft as comparability factors rather than intangibles, including market specific advantages, location-based advantages, corporate synergies and workforce issues; and

(iii) any additional conforming changes to Chapters I – III and Chapter VII of the Guidelines required as a result of the changes to Chapter VI. Discussion drafts of additional proposed changes will be released for comment at a future date.

The Second discussion draft relates to the revision of the Safe Harbours section of the Guidelines.

"To assist with the discussion, the OECD updated the survey... and invited more countries to participate"

This project started with a survey of the transfer pricing simplification measures in existence in OECD and non-OECD countries and led WP6 to review the current guidance on safe harbours in Chapter IV of the Guidelines. The current guidance in the Guidelines has a somewhat negative tone regarding transfer pricing safe harbours which does not accurately reflect the practice of OECD member countries, a number of which have adopted transfer pricing safe harbour provisions. Also, the current guidance is largely silent with regard to the possibility of a bilateral agreement establishing a safe harbour, even though some countries have favourable experience with such bilateral agreements.

The discussion draft therefore includes proposed revisions of the section on safe harbours in the Guidelines and also associated sample memoranda of understanding for competent authorities to establish bilateral safe harbours.

To assist with the discussion, the OECD updated the survey referred to above and invited more countries to participate. Eight additional countries responded to the invitation and a total of 41 OECD and non-OECD countries provided detailed responses concerning measures currently existing in their domestic law to simplify the application of their transfer pricing rules. This revised survey presents updated analysis of existing transfer pricing simplification measures as of 1 January 2012.

The survey focused specifically on simplification measures countries have adopted as part of their transfer pricing regimes. These include not only safe harbours but also measures such as less stringent documentation requirements, alleviated penalties, streamlined procedures, etc. The document contains both an analysis of the key findings from the survey and a compilation of the country responses. Some of the two key findings are;

- More than 80% of the respondent countries have transfer pricing simplification measures in place,
- Almost 75% of available simplification measures are directed to small and medium sized enterprises ("SMEs"), small transactions and low value added intra-group services,
- Out of 33 respondent countries which have simplification measures, 10 countries have safe harbours, ie. a simplified transfer pricing method, safe harbour arm's length range/rate, safe harbour interest rate, and an additional 6 also have exemption from transfer pricing rules/adjustment,

In addition to the two discussion drafts, there is also a request for comments on certain timing issues related to transfer pricing relating to the work of WP6 on intangibles and other

projects. Modifications to the Guidelines on these issues have been discussed by WP6 delegates but are not agreed by all countries. However, they raise certain difficult issues on which comment by the business community is specifically requested by OECD.

The paragraphs under consideration highlight the fact that OECD member countries follow two different approaches in applying the arm's length principle. The existence of these different approaches raises a number of issues and comments on the practical problems caused by the existence of these two different approaches are welcomed.

Comments on the two discussion drafts and the timing issues are requested by 14 September 2012 and following receipt of comments there should be a public consultation in November. ■

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The impact of the FTT on financial stability

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The European Commission has revealed its preferred method for taxing the financial services industry in October 2011. To the surprise of many, the measure came in the form of a financial transaction tax (FTT) despite concerns that the proposal will lead to a massive relocation of activities and increase the cost of capital. Although the FTT may raise sizeable tax revenues, which is a key concern in the on-going sovereign debt crisis, it fails to address (and may even worsen) the key factors that contributed to the global financial crisis of 2007/9.

Traditionally, the key aim of a financial transaction tax has been to discourage speculative trading. In the words of James Tobin, the measure's godfather, the taxes are to *"throw sand in the wheels of international finance"*, aiming to impose transaction costs for short-term trading, prevent excessive volatility and thereby mitigate the incidences of bubbles. But the current focus appears to be elsewhere.

In the present context of a sovereign debt tragedy, the transaction tax has also been highly popular due to its revenue potential. According to the Commission's own arithmetic, the proposed tax can raise anywhere between €25 billion to €45 billion per year.

The FTT did not appear to be the top choice among the list of tax policy alternatives. In its earlier communications, the Commission appeared to prefer focus appeared to be more on the Financial Activity Tax (FAT), which would tax 'supra-normal' profits and remuneration. The application of a third alternative, the Financial Stability Contribution (FSC) and its variants, which would tax un-insured liabilities (excluding equity), has been left for the member states.

The Commission's initial preference of FAT was mostly in line with the guidance provided by the IMF's reports on taxing financial services published in 2010. Having considered the three tax alternatives, the reports argued that the FTT would fail to address the 'core sources of financial instability', avoidable, and can be easily passed-on to consumers.[1] The documents provided ample evidence, highlighting the Swedish and UK experience from the 1990s that suggested that transaction taxes tend to lower market liquidity - and not always the bad kind - increasing short-term volatility.

"The Commission's initial preference of FAT was mostly in line with the guidance provided by the IMF's reports on taxing financial services published in 2010"

So, why did the Commission shift its focus? The reason appears to be political. Over the past few years, the measure has gained support in some member states, such as France and Germany. The concept of a transaction tax is simple and strikes a sense of equity, given that most of the household transactions are subject to a tax while financial transactions tend to be untaxed. To top it off, there is a sense that the moment is ripe for the 'financial sector to make a contribution back to society'. In short, given the resistance to any form

taxation from the industry, the Commission appears to have gone for the alternative with the most immediate political support.

Instead of relying solely on political or revenue-raising rationalizations, the discussion should also consider the impact of taxes on financial stability. Whichever alternative is chosen, it should not weaken financial stability and ensure that taxpayers would *"never again be asked to foot the bill"* for the banks' mistakes.[2] For those matters, three lessons learnt from the financial crisis of 2007/9 appear applicable.

First, the crisis highlighted the risks from 'too-big-to-fail' or 'too-systemic-to-fail' institutions. Such institutions benefit from an indirect guarantee of a bail-out, which gives their shareholders an incentive to direct the managers to take on more risks. To a large extent, this particular form of moral hazard emanates from the facts that (i) the public authorities have the ability (ie. fiscal space) and the motive (ie. domestic interest) to engage in a bail out; and (ii) no credible resolution mechanism exists to prevent messy bankruptcy procedures. To the extent possible, the proposed policy should contribute to a solution and not aggravate the existing conditions.

Second, and in a related sense, there are incentives for financial institutions - especially for investment banks - to become over-leveraged, especially through the use of debt with short maturities. These activities introduce systemic externalities through increased inter-connectivity as well as counter-party and propagation risks.[3] Indeed, as the history of financial crises have amply demonstrated, speculation only becomes a problem when it is done with borrowed money, resulting in layers of promises that eventually become untenable as a whole.

"... although the FTT has received political support in some member states, it is unlikely to materialize as an EU-wide measure"

Many reasons are put forward to explain the increased use of debt by financial institutions in recent years, including lax monetary policies, tax preference for debt financing, limited growth potential of traditional forms of funding, and incentives to match the volatility in asset valuations using short-term debt. To the extent possible, taxes should correct - and certainly not worsen - the incentives to take on more leverage.

Third, the crisis has confirmed the belief that tougher regulations do not automatically enhance stability when regulatory arbitrage is a viable option. Relocation to less regulated jurisdictions or the 'disappearance' of certain transactions through repackaging may simply hide problems beneath the carpet.

It should not be forgotten that having the risks of global banks stored in off-balance sheet vehicles in offshore jurisdictions - tidily tucked away from home-state regulators' reach - did not stop the financial crisis to propagate globally. In short, whatever form of tax instrument is introduced, it must be relatively hard to avoid.

How does the FTT fare on these three fronts? Not so well. To the extent that it can be used to contribute to a credible resolution mechanism, any tax can be used to tackle the moral hazard risks from big and systemic banks. However, in all likelihood, the FTT will only be used as a revenue-raising tool for individual member states, which is partly behind its political acceptance.[4] The FTT could ideally play some role in mitigating systemic risks by targeting derivatives transactions, which give rise to such interdependencies. Despite this indirect impact, however, the FTT misses out completely on addressing the growth of leverage.

A globally uncoordinated FTT is also likely to aggravate tax avoidance and relocations. As many observers have noted, trading operations are highly mobile, especially for the larger institutions. For those institutions, the list of 'safe harbours' will be long, given the fact that many G-20 countries, including the US and Canada - not to mention some EU member states, such as the UK - reject the idea of adopting an FTT. In driving a substantial proportion of the transactions away, the tax is also likely to hamper the monitoring and enforcement capacities of the home supervisors.

In contrast, the other alternatives originally on the table appear more appropriate in responding to these challenges. On avoidance grounds, although the FAT liabilities can be mitigated by the existing profit shifting arrangements, anti-transfer-pricing rules that are in place in many OECD members reduce the prevalence of such artificial transfers. FAT could correct the incentives for increased risk-taking by limiting excessive earnings. In this manner, the tax could serve as a substitute for the value-added tax (VAT), which is not applicable to financial services due to inherent difficulties in charging taxes to margin-based intermediation services.

In many respects, an FSC would make a more fundamental contribution, effectively putting a price on systemic externalities arising from reliance on short-term funding, which constitutes the most volatile portion of banks' balance sheets.[5] Taxes on (uninsured) liabilities are much harder to avoid provided that the tax basis is sufficiently broad, covering any activity that will arise from the use of offshore entities to offload taxable debt.

The tax could also go a long way to address one of the age-old problems in finance, namely the tax disincentive for raising capital since interest payments are tax-deductible while dividend payments are subject to taxation. Lastly, the FSC systems that are in place (or being considered) in many countries are often designed to contribute to the maintenance of credible resolution schemes, addressing one of the key sources of moral hazard risks.

To sum up, although the FTT has received political support in some member states, it is unlikely to materialize as an EU-wide measure. The proposal will be at best implemented in a subset of member states under the so-called 'enhanced cooperation' rules. This will throw the proposal's ultimate impact further into question, ensuring more flexibility in

relocating and avoidance and diminishing the revenue expectations.

The ultimate aim in taxing financial services should not be to implement what is politically feasible now but to use the instruments to address (and certainly not aggravate) some of the inherent weaknesses in the global financial system. In any case, the FTT should not undermine the chances of more meaningful tax options in the future. ■

1. For more details on IMF's work on financial sector taxation, see Claessens, S, M Keen and C Pazarbasioglu (2010), "Financial Sector Taxation", IMF's Report to the G-20 and Background Material, International Monetary Fund (IMF), Washington DC
2. The quote comes from the US President Barack Obama, in signing the Dodd-Frank Wall Street Reform and Consumer Protection Act, in July 2010.
3. For evidence on over-leveraging in European and US investment banking, see Ayadi, R, E Arbak and WP de Groen (2011), Business Models in European Banking: A pre- and post-crisis screening, Centre for European Policy Studies (CEPS), Brussels.
4. The political support for the FTT mostly rests on its revenue-raising potential, implying that the receipts will most likely to be diverted to a general budget or to EU's own sources (see European Commission's proposal for the Multiannual Financial Framework for 2014-2020, SEC (2011) 876 final, p 29-30). Therefore, unless the bank resolutions are properly addressed, the tax measures can actually contribute to increased fiscal space (either at the member-state level or at the Community-level) and increase likelihood of future bail-outs, thus aggravating the moral hazard risks.
5. Many variants of the FSC exist. Among these, see Perotti, E and J Suarez (2009), "Liquidity Risk Charges as a Macroprudential Tool", CEPR Policy Insight, No. 40, Centre for Economic Policy Research (CEPR), November; Bianchi, J and EG Mendoza (2010), "Overborrowing, Financial Crises and 'Macro-prudential' Taxes", NBER Working Paper, No. 16091, National Bureau of Economic Research (NBER), Cambridge, MA; Acharya, VV, LH Pedersen, T Philippon and M Richardson (2010), "A Tax on Systemic Risk", Working Paper, NYU Stern School of Business, New York, NY.

Spain: the challenge to set an effective tax policy

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Spain faces significant economic and social challenges as a result of the crisis. The latest events seem to indicate that the GDP evolution will soon form a "W" (although it is still lacking the final upward trend), with a forecasted contraction of 0.7% for year 2012. The deleveraging of the economy, particularly of the private sector, coupled with the difficulties for refinancing existing foreign debt in the currently unstable international financial markets have vanished hopes of a fast return to growth.

In addition, unemployment is reaching long forgotten figures (24.7% estimated for 2012) which will be difficult to revert (Spain traditionally required growth rates well over 2% to reduce unemployment). Naturally, the combination of lower economic activity, reduced public revenues, and higher public spending to provide welfare assistance to those in need, resulted in public deficit soaring to 11% of GDP in 2010 and 8.9% in 2011, and are increasing the otherwise reasonable public debt levels (68.5% of GDP).

On the other hand, the burst of the real estate bubble, which hit its peak in 2007, has caused a very sharp decline - and this is an understatement - in the number of new homes constructed or acquired. In addition, the increasing difficulties for indebted home owners, land developers and construction companies to pay their mortgages has sent waves of concern to the banking sector which, until two years ago, – unlike its US or European peers – had coped relatively well with the early crisis years due to their low exposure to toxic financial products.

In this context, since it took office in late December 2011, Mr Rajoy's government has had to act with determination and take many hard and unpopular measures. The government's initiatives focus on three lines of action:

Firstly, a thorough and long awaited reform of the labour market in order to introduce flexibility, reduce labour unitary costs and, ultimately, gain competitiveness;

Secondly, a crucial reform of the banking sector, which is still under way, aimed at ensuring solvency of the systemic financial institutions, consolidating the sector in order to improve efficiency (especially among savings banks - cajas) and, most importantly these days, dismissing fears of the real estate exposure and implicit losses affecting banks beyond a point where, given the limited ability to finance through public funding, EU or international help would need to be sought - as has finally happened.

Lastly, there is a strong urge to sharply reduce public deficit and bring it to the target levels agreed within the EU (5.4% in 2012 and 3% in 2013, although it looks like the European Commission might accept to postpone the 3% requirement until 2014). This last objective (which in 2012 alone roughly implies a €35 billion adjustment) is obviously a bitter pill - we shall see whether or not the prescription causes an overdose that might harm the patient - that demands drastic cuts in public spending as well as trying to raise public revenues through the tax

system despite the weak economic pulse. This last point about boosting public revenues has been the *leit motiv* of tax measures taken in Spain during the last year and will be the focus of this article.

Back in 2007, the Spanish tax system (excluding regional or local taxes managed by the autonomous regions or the municipalities) collected an all-time record of €200.7 billion. By 2009, that figure had plummeted to €144 billion. (roughly the same, in nominal amounts, as in 2004). In 2011, total revenues reached €161.7 billion. It is particularly relevant to notice that by far, the strongest drop in tax revenues is from corporate income tax. Indeed, while personal income tax and VAT revenues have decreased by 9.6% and 8.8%, respectively, from 2007 to 2011, revenues from corporate income tax have plummeted a staggering 63%.

"So, what's next? I am afraid that there are more tax increases down the road"

There is fear that the recession might bring tax collection figures down again (figures of the first quarter of 2012 are not encouraging), at a time when most efforts are on reducing public deficit. So, what is the government doing about it?

The previous government had already taken some action. In August last year, the first package of measures (the *"summer package"*) was implemented. The measures are transitory until fiscal year 2013. They essentially focus on raising corporate income tax revenues and re-established wealth tax, which had been abolished in 2008. Payments on account of corporate income tax (not final tax rates) were raised significantly for companies with a turnover higher than €20 million, thus anticipating the collection of tax and providing free financing to the Treasury. Also, the ability to use tax loss carried forward credits was limited to 50% or 75% for companies with a turnover exceeding €60 million or €20 million, respectively, and the carry-forward period was extended to 18 years.

Only a few days after forming his government, Rajoy decided to put forward a new package of measures - the *"winter package"* - that are in stark contrast with the basic tax principles that he has always defended. Indeed, the mounting pressure to comply with public deficit commitments together with the realisation that the 2011 deficit would be off target by 2.5% (an estimated 8.5% at the time, vs. 6%) forced the implementation of some unpopular measures.

The most significant one was an increase in personal income tax rates for 2012 and 2013 by imposing a *"complementary tax"*. Depending on the region, total maximum marginal rates were set to range from 52% to 56% where income exceeds €300,000. However, high rates (47%) already apply with respect to income over a threshold of just €53,400; quite a change when one thinks that just two years earlier, maximum marginal rates were generally 43%. Moreover, withholding taxes on financial income or gains were raised from 19% to 21% and the final tax liability may reach 27% if they exceed €24,000.

Other measures, such a slight increase in non-resident income tax and a more substantial property tax burden, were included in the package. But, indirect taxes - in particular VAT - remained practically untouched. The government's stance was that VAT should not be raised (it had already gone up two years ago from 16% to 18%) because of the impact it would have in consumption and domestic demand at a time when they are particularly weak; furthermore, the point was made that raising VAT is regressive, since it hurts the most those in need given that they must use substantially all of their income for consumption.

While these are by no means secondary issues, raising income taxes significantly drains not only consumption but also savings; indeed, at a time of deleveraging, one wonders whether reducing by way of higher income taxes the ability of families to repay existing debt is the wiser thing to do and what impact it could have in banks and in making the deleveraging process last longer.

But events kept unfolding... By March, the government realised that despite the first measures introduced, further action would be required if public deficit targets were to be met. Consequently, yet another tax package - the *"spring package"* - was implemented on 30 March. Again, tax measures were all revenue driven.

First of all, significant changes were introduced in corporate income tax legislation in order to restrict tax credits and deductions. The most relevant ones are the elimination of tax depreciation freedom, which allowed taxpayers to depreciate certain new investments in full and had been introduced without further requirements a year before as a means of fostering corporate investment, and the restrictions for the deductibility of financial expenses. The latter are clearly inspired in the German rules and establish that net financing expenses in excess of 30% of adjusted EBITDA in a given year will not be deductible for companies belonging to a Group (although they may be carried forward for future years).

While it is true that in an over-indebted private corporate sector this measure may have an impact in corporate income tax revenues, it looks awkward that, in a crisis context the lower the EBITDA, the lower the tax deduction and the higher the tax liability; especially, if one thinks that since the lender receiving interest is paying taxes on it, there is bound to be a blatant double taxation.

A third measure worth noting is the establishment of a special 8% tax to be applied in lieu of corporate income tax at the choice of the taxpayer in fiscal year 2012 on dividends or gains deriving from foreign subsidiaries that do not comply with the requirements to benefit from the otherwise applicable exemption upon repatriation. In other words, an incentive is established for Spanish parent companies to repatriate profits from other jurisdictions at a cost of 8% which are currently *"locked"*, because repatriation to Spain would trigger a 30% tax burden.

There is a myriad of other measures but, clearly, the star of the spring package in terms of social impact is the special

programme for voluntary disclosure of undeclared assets, which the media insist on calling the *"tax amnesty"*. It is, no doubt, unfair for compliant taxpayers to offer an advantageous way out to those who evaded taxes.

However, it is also an exercise of pragmatism in times of dire circumstances for the country to seek mechanisms to bring hidden money out into the open, start circulating and generating new flows of tax revenues in the future. I think the government was brave to put the programme on the table, since it was conscious about the political cost it would entail, and that, while it is certainly arguable how good the deal should be for tax evaders (and this one is, perhaps, too good), overall it is positive for the country. So, what's the deal?

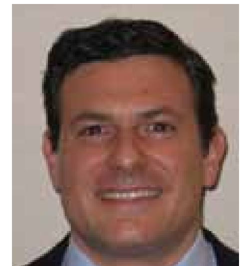
The deal consists of a payment equal to 10% of the acquisition value of assets or amounts of money concealed or held offshore, subject to those assets or money having connections with undisclosed income. The payment results in that income becoming declared for income tax purposes; no penalties, surcharges or delay interest will be imposed. The window of opportunity to use this mechanism closes on 30 November.

Not surprisingly, following a carrot and stick policy, the voluntary disclosure programme is coupled with a bill of law on measures to combat tax fraud that was sent for discussion to the Parliament. Amongst the many relevant measures contemplated in the coming legislation two stand out: first, a new obligation is established for any Spanish resident individual or entity to report to the tax authorities each and every asset or right that they hold outside Spain. Failure to do so will result in specific penalties and, in addition, the statute of limitation will not elapse with regard to income or gains deriving from those assets.

Secondly, the statute of limitations for criminal tax offences will be extended from five to ten years where the taxes evaded exceed €600,000 per tax and per year or complex structures are used. Penalties on tax offences will be raised up to six years' imprisonment. Therefore, the government is sending a strong signal to tax evaders: either they take advantage of this opportunity or they face a much more worrisome future if caught. Compliant taxpayers will undoubtedly agree at least with this second proposition.

So, what's next? I am afraid that there are more tax increases down the road. The government, very much forced by the European Commission's latest recommendations, has recently suggested that a VAT increase is just around the corner (probably in 2013). The figures seem to indicate that it will have no choice but to pull one of the few effective levers that remain available to raise revenues. Having said that, obvious as it may seem, there is no better lever than expanding the tax base, which means increasing the number of compliant taxpayers and making reforms to make money circulate and the economy grow. That is the challenge, that is what they are up to. ■

Tax avoidance in Europe



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What is tax avoidance?

The Oxford English dictionary defines tax avoidance as follows *"the arrangement of one's financial affairs to minimize tax liability within the law"*. From this definition a key feature is the legality of the manner in which the tax liability is reduced. Meanwhile tax evasion is referred to as *"the illegal non-payment or underpayment of tax"*. A clear difference emerges between the two concepts, one being a legitimate part of financial planning, the other being illegal.

In recent times the government has become keen to differentiate between legitimate financial planning, to which they have no interest in pursuing and abusive arrangements contrived with the sole purpose of reducing tax liability. Where should the line be drawn between legitimate financial planning and these *"abusive arrangements"*?

Many people legitimately reduce their tax bill by making simple changes to their personal tax affairs, for example a self-employed person in the UK may pay income tax, at a rate of 40 – 50 per cent if a high earner, could set up a company and start paying corporation tax at a rate of 20 per cent and therefore reduce his or her tax liability. Another example involves group of companies such as Google who bills UK companies from Ireland in order to take advantage of the low Irish corporation taxes. Are these examples of legitimate tax planning or abusive arrangements?

Both examples appear to be legitimate tax planning yet have the sole purpose of reducing tax liabilities. It is a genuine strategic business decision to move a company headquarters to a location, where it could be taxed more efficiently

and hence, result in a reduced tax bill for the group. One might even go so far as to say that a company advised by professionals to transfer its headquarters to a tax efficient host, by not doing so could potentially be accused of *"not acting in the best interests of the company"*. It is legitimate to make use of the legal remedies available within the law to reduce the tax liability.

The EU Treaty poses an additional dynamic. In an EU context why isn't tax just another cost standing in the way of a single borderless market? Just as a company can legitimately be set up in a member state which charges lower costs on the formation of a company (eg. Inspire Art) why can't the promoters of a company chose to put its business in the member state with the lower effective tax burden and do so for that reason alone?

"Where should the line be drawn between legitimate financial planning and these *"abusive arrangements"*?"

The UK position

With the spending cuts the government has recently announced and an austere future for Britain on the horizon, tax avoidance has become a key area, which the government is keen to tackle. The government wants to ensure that the UK projects an image of an attractive place to do business and has affirmed a commitment to improving predictability and stability through a new tax policy, with an emphasis on clear policy objectives, transparency and consultation. The government estimates that the tax gap in the UK is around £40 billion, of which more than a sixth is due to tax evasion, and a further one sixth is estimated to be due to tax avoidance.

HM Treasury has published in March 2011 a paper named *"Tackling tax avoidance"*. The British government has invested heavily in tackling tax evasion by putting forward over £900 million in funding to HMRC, which has estimated that it will bring in around £7 billion per year in additional revenue by 2014-2015. HMRC have made clear that their focus is particularly on large business cases and on wealthy individuals, where the immediate tax at risk is greater.

HMRC's new anti-avoidance strategy will focus in three core areas:

- preventing avoidance at the outset where possible;
- detecting it early where it persists;
- countering it effectively through challenge by HMRC.

GAAR

With the aim of addressing tax avoidance, Graham Aaronson QC was in charge a committee responsible for producing a report on General Anti-Avoidance Rule (GAAR) (*"GAAR Study"* dated 11 November 2011). The aim of such a rule is to deter and counter tax avoidance but at the same time retain a tax system that is attractive to business and minimises costs for businesses and HMRC.

In his findings it was reported that a moderate rule would be beneficial for the UK tax system. A rule that does not apply to responsible tax planning but instead is targeted directly at abusive arrangements. The report states that a GAAR should initially be applied to direct taxes such as income tax, capital gains tax, corporation tax, petroleum revenue tax and to national insurance contributions. However, Graham Aaronson QC goes on to warn against the introduction of a broad-spectrum general anti-avoidance rule. The Government is in consultation with a view to introducing legislation in the Finance Bill 2013.

HMRC closing tax avoidance schemes

The Finance Act 2004 has introduced the disclosure rules which have now been extended and apply to direct tax, SDLT, VAT, pension contributions and national insurance contributions. The idea behind the disclosure rules is to provide HMRC with the necessary information so that HMRC can assess potential tax avoidance schemes and introduce legislation where appropriate and which could have retrospective effect.

For example, the media has reported that Barclays voluntarily disclosed to the revenue 'abusive' tax schemes, which were blocked with retrospective effect by the Treasury. The scheme used by Barclays allowed the bank's commercial profits, from a buyback of its own debt, to be used to avoid corporation tax payments. A further scheme involved Authorised Investment Funds and intended to give non-taxable income a repayment of tax credits from HMRC for tax that has never been paid. Barclays contends the scheme is legal and in compliance with the tax code.

A further example where HMRC has attempted to take control of the situation is with the closure of the Channel Island VAT loophole whereby mail order companies could send low value items to the UK without payment of VAT and then be re-imported to the UK (a circularity similar to that of many others tax avoidance schemes).

Thin capitalisation legislation

The UK has introduced the thin capitalisation legislation, to counter tax avoidance by groups of companies through the parent company financing a subsidiary by means of loans rather than equity, with interest payments on loans being deductible for the purposes of calculating taxable profits. The effect of the thin capitalisation legislation was to treat any interest paid on a loan, which exceeded what would be paid on an arm's length transaction as distribution of profits.

The thin capitalisation legislation was recently challenged in the case *Test Claimants in the Thin Cap Group Litigation* where the Court of Appeal in February 2011 stated that the application of the arm's length test did not automatically breach art 43 of the EC Treaty (Freedom of Establishment) provided that: the taxpayer was given an opportunity to present his case to the tax authorities to show that the transaction was on an arm's length terms; that the taxpayer could challenge the decision before national courts and that the effect of the legislation was limited to those aspects of the advantage conferred by the taxpayer company that do not satisfy that test. This is one of many cases where the

lawfulness of the UK tax regime has been challenged in light of European Union law.

The other side of the coin

Whilst the British Government has invested over £900 million with HMRC to tackle tax avoidance, HMRC recently settled a dispute with Vodafone in 2010 in a deal that was reported by the media to have cost the taxpayers billions of pounds.

When Vodafone took over Mannesman in 2000, through a Luxembourg subsidiary, Vodafone became the biggest telecommunications company in the world and began making profits through Luxembourg's tax haven. HMRC said that the controlled foreign companies legislation meant that Vodafone's profits in Luxembourg should be taxed.

After a legal dispute with Vodafone, a settlement was eventually agreed whereby Vodafone was to pay £800 million with a further £450 million over the next five years. This was reported as £1 billion less than what Vodafone had originally set aside to resolve any tax issue.

What is the rest of Europe doing?

Tax-Evasion.org reports that tax evasion in Europe has a value of approximately €860 billion a year and tax avoidance of around €150 billion a year. Within Europe, Italy is considered one of the countries making the biggest loss as a result of tax evasion, with Estonia making a larger loss when the tax lost is expressed as a proportion of the government spending (more than 28% of its spending is lost to tax evasion).

Looking more closely at individual European countries, in France there is no requirement to disclose avoidance schemes in advance to the company's tax returns. Tax avoidance schemes could be challenged under abuse of law provisions provided the scheme is fictitious or intends to benefit from a tax advantage that is contrary to the intentions of parliament and is exclusively tax driven. If the tax has to be reassessed under the abuse of law procedure an 80% penalty applies. The penalty is reduced to 40% if the taxpayer is not the initiator of the scheme or its main beneficiary. Moreover, French law also provides for regulations limiting transfer pricing.

In Luxembourg, the tax authorities can challenge sham transactions under the so-called abuse of law doctrine in the field of direct taxes, but not to capital duty and transfer taxes. It remains unclear whether VAT is covered.

Spain appears to be taking an active approach to tackling tax avoidance, however, there is no general anti-avoidance rule nor is there a necessity to disclose avoidance schemes in advance of the company's tax returns.

The new Spanish law from 2006 on tax avoidance sets up new regulations regarding transactions between related parties and new scenarios under which companies incorporated in overseas 'tax haven jurisdictions' could be deemed as a tax resident in Spain.

In February 2012 Greece has signed the Convention on Mutual Administrative Assistance in Tax Matters. The Convention facilitates international co-operation for a better operation of national tax laws, while respecting the fundamental rights of taxpayers. The Convention provides for all possible forms of administrative co-operation between states in the assessment and collection of taxes, in particular focus to combating evasion and tax avoidance. Thirty-four countries are signatories to the Convention so far.

Sweden currently has a general anti-avoidance rule. The Swedish tax authorities and the courts in Sweden apply a "substance over form" approach in establishing whether or not there was tax avoidance. The transactions are analysed in order to establish their 'real economic meaning'.

Italy, with the purpose of combating tax avoidance, is planning to adopt enquiries into bank accounts using a new computer system named 'Serpico' and to cut off cash transactions at a maximum of €969.

A tax evasion treaty has been signed between Germany and Switzerland, which according to the German's Finance Ministry could help Germany raise €8.3 billion in revenues next year.

> **"European countries appear to be taking serious measures to tackle tax avoidance and tax evasion, highlighted as a priority given the current economic climate and the estimated sums of money involved"**

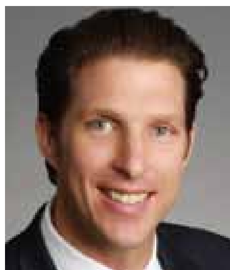
Final remarks

European countries appear to be taking serious measures to tackle tax avoidance and tax evasion, highlighted as a priority given the current economic climate and the estimated sums of money involved. Whilst tax evasion is illegal, tax avoidance remains a form of legitimate financial planning.

In their essence, legitimate financial planning and tax avoidance are mechanisms of how to be financially efficient acting within the law consistently with the essential feature of the single market - competitiveness without the restriction of borders.

Just as businesses are encouraged to take advantage of the lowest costs structures, tax savings too are a legitimate target. It could be said that the differences between legitimate financial planning and tax avoidance, seem more a question of semantics.

The real player appears to be the amount of money involved for the parties. This does not mean that legislation shouldn't be amended where there is a loophole so that that loophole could not continue being exploited by artificial means. Such legislation however should not be introduced retrospectively unless there are transitional arrangements compatible with European law. ■



The dangers of the new functional risk analysis

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Within the ever-evolving standards and judicial doctrines applied by the courts to assess the validity of tax-advantaged transactions, there has been an increasing trend to supplement, or even abandon, a traditional risk analysis in favour of an analysis that examines not only whether a risk exists, but also the probability that such risk will manifest itself. This new analysis can lead to the application of entirely subjective standards, thus creating additional uncertainty for taxpayers in structuring and defending tax-advantaged transactions.

Though death and taxes may be certainties of life, the amount of tax each taxpayer owes has been gaining uncertainty for many decades. This is due in large part to taxpayers having to comply both with technical statutory provisions in the Internal Revenue Code and interpretations of these in Treasury Regulations as well as the many judicial doctrines - substance over form, step transaction, sham transaction, and economic substance - that the Internal Revenue Service can use to scrutinize or recast a transaction.

These judicial doctrines can be traced back to the early 1900s. However, not until after the Supreme Court's landmark decision in *Frank Lyon Co. v. United States* did the IRS begin to progressively challenge transactions with these judicial doctrines because it believed the transaction at issue failed to comply with the spirit of the technical rules.

"Over the last several years, the new Functional Risk Analysis has been gaining significant momentum in the IRS's litigating positions"

In *Frank Lyon*, the Supreme Court held that *"[w]here as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached,* ***the Government should honour the allocation of rights and duties effectuated by the parties.****"* *Frank Lyon Co. v. United States*, 435 US 561, 583-84 (1978) (emphasis added).

Since *Frank Lyon*, courts have scrutinized tax-advantaged transactions with differing frequency to determine whether a transaction creates substantive rights, obligations, and economic benefits that are not solely driven by or resulting from the tax consequences.

Legal Risk Analysis

Regardless of which judicial doctrine the IRS uses to scrutinize a transaction, the inquiry into whether a tax-advantaged transaction will be respected for Federal income tax purposes necessarily commenced with an examination of the transaction documents or other legal blueprint for the arrangement. The allocation of rights, obligations, and risks by the documents - as opposed to the labels attached to the documents - were used to determine a transaction's true substance. We call this approach the 'Legal Risk Analysis' because the governing legal documents were responsible for defining and allocating the parties' risks.

The Legal Risk Analysis was limited to examining the allocation of risks without regard to the *probability* that they will be invoked. A determination that a party possesses legally enforceable rights, assumes obligations, and faces risk would support a finding that a transaction has substance. The Legal Risk Analysis lent itself to examining what happens in a 'worst-case' scenario, eg, how do the documents work in the event of disaster, or default by one party to a transaction, and who is entitled to what? The presence of risk was central to this analysis and very little consideration was ever given to how *likely* the worst-case scenario is to occur.

The new Functional Risk Analysis

Recently the IRS and the courts have been evaluating risk based on the 'real world' probability of an event occurring.

Not only must the transaction documents allocate a risk, but the likelihood of the event occurring must not be too remote in order for a transaction to withstand judicial scrutiny. We refer to this as the 'Functional Risk Analysis,' which disregards what could happen in a worst case scenario if that event is unlikely from a subjective point of view to occur. In this analysis, the substance of a transaction is assessed based on the 'best case,' 'most likely,' or 'expected' outcome. Risks that are less likely to occur, even though any such event may result in catastrophic consequences, are disregarded.

The Functional Risk Analysis opens the floodgates to questions over exactly what probability standards are to be applied in analyzing a transaction, which can vary from **remote**, to **possible**, to **reasonable expectation**, to **most likely**, to **probable**, to **certain**. By departing from the worst-case scenario inquiry posed by the Legal Risk Analysis, the choice of the correct probability standard becomes very unclear and extremely subjective.

Legal Risk Analysis vs. Functional Risk Analysis

Over the last several years, the new Functional Risk Analysis has been gaining significant momentum in the IRS's litigating positions. The IRS has used this analysis to disregard the tax consequences of transactions that it perceives are abusive, such as Son of Boss transactions.

For example, in *Stobie Creek Invs, LLC v. United States*, the court adopted the IRS's position that the transactions at issue was done solely for tax reasons because the probability that the taxpayer would earn a profit was low, even though the amount of profit would have been very large. *Stobie Creek Invs, LLC v. United States*, 608 F.3d 1366, 1378 (Fed. Cir. 2010) (evaluating substance of transaction based in part on the 'structure of the investment,' which eliminated any 'reasonable possibility' of nontax profit).

This success has resulted in the IRS wielding the Functional Risk Analysis to attack everyday business decisions such as a company's capital structure and intercompany transactions. The rest of this discussion focuses on a how a court recently applied the Functional Risk Analysis and then concludes with an example of this impact on transfer pricing and considerations for taxpayers going forward.

Pritired 1 LLC v. United States

On September 30, 2011, the United States District Court for the Southern District of Iowa ruled in favour of the government in *Pritired 1, LLC, Principal Life Ins. Co., Tax Matters Partner v. United States*, 2011 US Dist. LEXIS 116366, (SD Iowa 2011), a so-called foreign tax credit generator case ("*Pritired*"). The transaction details are complex, but the simplified structure involved the use of a tax partnership ("SAS") to co-invest with a foreign investor, with the US investor receiving the benefit of crediting the foreign taxes paid on the combined investments.

The partnership contribution was structured as an equity investment, with the taxpayer receiving hybrid securities called perpetual certificates ("PCs") along with "B Shares." In its decision, the court held for the IRS on three separate and independent grounds: (1) the court recast the partnership equity investment as a loan; (2) the court found that the transaction lacked economic substance and a business purpose beyond the foreign tax credits; and (3) the court found that the transaction violated the partnership 'anti-abuse' regulation.

Pritired has extremely unfavourable facts and circumstances specific to that case and was strategically selected by the IRS for this exact reason. As the saying goes, bad facts make bad law and, in examining the facts at issue, the court in *Pritired* utilized a Functional Risk Analysis that applied several different risk standards when analyzing the substance of the PCs and B shares. Specifically, this article focuses on the court's debt-versus-equity analysis in which it disregarded objective and historic standards in favour of subjective risk standards based on probabilities that ranged from 'could not have foreseen,' to 'realistic scenario,' to 'reasonable expectation,' to 'have almost no risk.'

"This success has resulted in the IRS wielding the Functional Risk Analysis to attack everyday business decisions such as a company's capital structure and intercompany transactions"

In its debt-versus-equity analysis, the court first articulated 'black letter' law using Legal Risk Analysis: *"**A debtor may not miss a required interest payment without suffering consequences, such as default**. If a debtor fails to make a required payment on a debt, the holder of that debt has **legal recourse** against the debtor. A receiver of equity capital, on the other hand, may decide not to pay dividends without suffering any similar contractual limitations. **Equity holders generally cannot legally force the liquidation** of an issuing entity based on a failure to pay."* Id. at *80-*81 (emphasis added).

But then the court disregarded the Legal Risk Analysis in the next breath by looking at surrounding circumstances to determine that, based on the analysis of the IRS's expert, the PCs had *"ongoing payment attributes more similar to debt."* Specifically, the court found that the *"SAS had no contractual requirement to make ongoing payments on the PCs... the transaction **was designed in a manner to ensure that payments would be made, based on [the IRS's expert's] analysis**."* Id. at *81 (emphasis added).

Similarly, with regard to whether the returns were more debt or equity-like, the court first stated the traditional Legal Risk Analysis by examining the trade off between risk and return for equity and debt. But then, once again, the court went on to disregard that analysis based on surrounding circumstances: *"Although the B Shares **appeared to have a more equity-like return, the actual return had debt-like features**. For example, the B Shares had a right to 1% of the SAS income, which was **potentially uncapped**. But the strict investment guidelines on the SAS bond portfolio **effectively capped the return** the B Shares could receive..."* Id. at *79 (emphasis added).

The court also discussed the Legal Risk Analysis of the duration of the transaction, specifically noting that a change in voting rights could allow a liquidation of the transaction by a simple majority vote of shares. But the court again relied on surrounding circumstances to disregard that Legal Risk Analysis: *"[t]he Court finds that the provisions for change in voting rights reveals that the parties* ***planned and expected*** *the duration of the... transaction to be five years. The internal approvals by [the parties involved]* ***all suggested that the [foreign parties] would unwind the transaction by the end of 2005****. The change in voting rights... also* ***provided a measure for [Principal Life] to force the transaction to unwind****."* Id. at *31 (emphasis added).

The Functional Risk Analysis going forward

As shown in *Pritired*, the Functional Risk Analysis is quickly becoming a favourite government argument. Often this analysis is the result of a cursory view of a transaction's structure and so-called 'business realities,' which leads directly to consideration of facts and circumstances outside the four corners of the governing deal documents.

"When looking at the global picture one needs to take into account the positive impact that the use of the receipts can generate"

These arguments have superficial appeal because the arguments are presented in an easily distilled form and, accordingly, a court does not have to understand complex transactions and allocations of risk if it simply accepts an expert's testimony that only the 'most likely' scenario need be considered.

Thus, the IRS can put forward simple arguments based on expert testimony that cuts through the intricacies of otherwise complex transactions. By focusing on the 'most likely' outcomes rather than worst-case scenarios, the IRS can argue that a taxpayer should not be allowed to create tax benefits by advancing an artificial and unrealistic analysis. This puts the taxpayer on the defensive right from the start.

As stated previously, this analysis has far-reaching effects and may capture everyday transactions, such as typical transfer pricing allocations. In transfer pricing, the traditional risk analysis is made in accordance with Treas. Reg. §1.482-1(d)(3)(iii), which provides that the allocations of risk specified or implied by the taxpayer's contractual terms will generally be respected if it is consistent with the economic substance of the transaction.

None of the factors for assessing risk for transfer pricing purposes look to the probability of the legal risks becoming real events, which is entirely consistent with the Legal Risk Analysis. However, consider the not-so-abstract example of what happens if the IRS applies a Functional Risk Analysis in its determination of the proper pricing of an intercompany arrangement. By moving away from the allocation of risks in the legal documents, the IRS might instead focus on whether this risk has ever occurred.

For example, legal documentation may allocate product liability risk or manufacturing risk to one affiliate, but if there has never been a product recall the IRS could attack the transaction because this risk may not be considered probable (in light of historic events). Thus, the IRS could disregard or ignore any risk allocated in transfer pricing documentation if the taxpayer does not have a 'real life' example of when such risk actually happened.

Not only is such an analysis flatly inconsistent with the Treasury Regulations, it could become nearly impossible under this standard for a taxpayer to find a comparable that has the same real-world risk experiences. In the sway of the Functional Risk Analysis, the transfer pricing regulations cannot be administered.

In the end, any analysis focusing on probabilities can be distorted or limited by the imagination of the person conducting the analysis. For example, if someone cannot imagine that a major financial crisis could occur, they will not think there is any risk in a transaction backed by a bank guarantee or AAA securities.

The layman does not often appreciate or comprehend the real risks allocated by the transaction documents. As the risk analysis becomes more focused on probabilities or business realities outside of the transaction documents, courts and the IRS will continue to turn to experts to explain those risks.

It is always hard to predict the winner in an after-the-fact battle of experts and taxpayers need to understand that the IRS experts may not be addressing the same legal risk analysis that the taxpayer may be putting forward. In fact, you may be talking past one another. Therefore, taxpayers should expect that experts will become involved earlier in the audit process and should be prepared to defend against the ever-increasing use of the Functional Risk Analysis. ■

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