



BEYOND BEPS

TJN briefing on the OECD's "BEPS" project on corporate tax avoidance

July 17th, 2013

On Friday 19th July the OECD will publish its long-awaited Action Plan on how to fix the broken international tax system for multinational corporations. An interim report on this project, called “Base Erosion and Profit Shifting ([BEPS](#)),” was published in February with a promise of “holistic and comprehensive” solutions to the problems of taxing multinationals.

We do not, however, expect the OECD to announce any radical new approach on Friday.

What we expect, instead, is a series of piecemeal recommendations for states to apply patches to the increasingly leaky international tax system. The effect would be like trying to plug the holes in a sieve.

The problem, in a nutshell

The OECD plays a co-ordinating role in the international tax system by bringing together national tax officials from rich developed countries, and they have designed international tax rules that many states choose to follow to a greater or lesser degree. But its recommendations are not binding on states. To the extent that the OECD does recommend meaningful changes, all the evidence suggests that these will be a piecemeal patch-up job. They will also face determined opposition from the tax avoidance industry and big business in countries such as the UK, US, Netherlands and Ireland, which have provided special tax breaks and regimes in recent years, in response to such lobbying and pressure by multinationals and their advisers.

Let's now suppose, however, that the OECD *does* succeed in persuading governments to row back on their current strategies and strengthen current tax rules. At best, the OECD can only provide loose coordination of the rules. Its piecemeal strategy outlined so far in the BEPS project would result in governments trying to grab what they can of the various parts of the profit of transnational corporations. Conflicts already abound in the current system, and success on BEPS' terms would lead to intensified international tax conflict. A patch-up job, even if the OECD were to achieve its objectives, cannot deal with the fundamental flaws in the current system.

The Solution

Most tax experts agree that a better approach to taxing multinational corporations requires a fundamental philosophical shift in the underpinnings of the international tax system, away from the current approaches, where multinationals are taxed according to convoluted legal forms devised by their accountants and lawyers, towards a system where they are taxed according to the genuine economic substance of what they do and where they do it.

This alternative is to take a Unitary approach to taxing multinational firms. This involves taking a multinational's total global profits and apportioning them out between the states where it does business according to its genuine economic presence in each country.

Many people, including some experts at the OECD, accept that such a system is desirable. Yet they are refusing, so far, even to investigate it, because they claim that it would be too difficult to obtain global agreement on such a new approach. Another reason, perhaps, is because it would be, as one top U.S. tax expert [put it](#) recently, "too effective" – and the tax shock would therefore be too great for multinationals to accept.

But the naysayers are quite wrong. A unitary system can be introduced gradually, in a series of steps, building on elements in the current system. The first step would be merely a transparency requirement, to help countries see and understand the genuine economic substance of what multinationals do and where they do it. Second, apportionment of the total profits could be done by building on so-called "profit-split" methodologies (explained below), which are already accepted in some circumstances. Thirdly, there should be a procedure for resolving disagreements, which could also be based on existing arrangements, although these also should be more transparent.

Setting out on the road towards a unitary approach is not only far more desirable than merely applying sticking plasters to the current system, but it should also be more politically feasible, if governments really want to ensure an effective system.

All the OECD needs to do now is to crack open the door to serious study of this reform, which is the only effective way that we will be able to tax multinational corporations properly in our globalised world.

We explore this in more detail, below.

The details

Judging by the interim report of February, the OECD will propose measures to deal with the following:

- **'hybrid mismatches'**. Multinationals can exploit differences in national tax rules where each country treats a company or a debt instrument differently, with the result that neither state taxes it effectively. For example, the so-called "Double Irish" gambit where Google forms a subsidiary as a company in Ireland, but Irish law treats it as resident in Bermuda because it is managed from there;
- **'Controlled foreign corporations'** (CFCs). Many countries have rules to try and stop companies from reducing their local tax bill by accumulating lightly taxed foreign profits in tax havens. The rules for addressing these CFCs, however, have been weakened in recent years, due to pressures from multinationals, and enforcement problems.
- **"Harmful tax practices"**. Various countries provide tax breaks such as exempting foreign-source income from tax. This is aimed at attracting nominal activities such as the formation of holding companies. Examples include the holding company regime in the Netherlands, facilitating the famous 'Dutch sandwich'; or the 'Patent Box' regime introduced this year in the UK, which applies a low corporation tax rate to income from the exploitation of patent rights;
- **Limiting the deductibility** from taxable business profits for interest and other payments. For example, multinationals can lend money from a subsidiary located in a tax haven to a subsidiary located in a high-tax country, then charge interest. Those interest payments are earned as tax-free profits in the tax haven, and in the high-tax country they are costs which can be deducted from the tax bill.
- **Transfer pricing rules:** these rules are supposed, in theory, to ensure that cross-border transactions inside multinationals -- such as internal transfers of assets or sales between related entities -- reflect true 'arm's length' prices. The rules are hard to apply effectively, especially for hard-to-value 'intangibles' such as intellectual property (an example would be the algorithm for Google's search engine);
- Avoiding rules defining when a company can be treated as operating a **'permanent establishment'** which determine whether profits can be effectively taxed locally. For example, Amazon has claimed to provide only customer support and order fulfillment through its UK subsidiaries while booking all its sales to Amazon SARL Luxembourg; similarly, Google's London-based company is claimed to do only marketing, and its sales of advertising are booked to its Irish subsidiary;
- the advantages given to **'digital economy'** companies by current tax rules.

The OECD will aim to develop detailed proposals covering these issues over probably two years.

An Action Plan, or an Inaction Plan?

The OECD's report will merely produce a set of recommendations, which will not be binding on states. It will require actions by states which will in many cases mean sharp reversals of their policies of recent years, when rules have generally been relaxed in order to attract investment. So the OECD recommendations will face fierce political headwinds from the start.

For example, the US eviscerated its rules against CFCs by allowing 'check-the-box' and 'pass-through' arrangements, which have so far proved politically impossible to reverse. The UK largely abandoned its anti-CFC regime in 2012, moving towards a 'territorial' system (and thus encouraging large-scale tax avoidance.)

We have campaigned against these policies, and we certainly hope that the OECD can persuade these governments to abandon them, and indeed to reinforce their rules against CFCs.

Similarly, we hope that Ireland will tighten up its corporate residence rules, and that the Netherlands will end its holding company regime. We also think that tax authorities should take a much stronger line on the artificial distinctions made between marketing or customer support and sales, which allow misattribution of profits from sales.

Capping deductibility of interest, royalties and other payments, which can reduce or even eliminate the taxable profits of operating companies, would also be a positive step. This is often especially damaging to developing countries, as shown by the examples of [SAB-Miller](#) and [Associated British Foods](#), highlighted by reports from ActionAid.

These measures would have to be carefully coordinated, both among themselves and between countries.¹

It remains to be seen whether the OECD and national tax authorities will succeed in persuading governments to adopt such tough measures, which will of course be opposed by the big business lobbies. The UK's Confederation of British Industry (CBI) is already [preparing a report](#) which apparently will urge that the UK should prioritise 'maintaining and improving UK tax competitiveness' – a word that has long been a recipe for the indulgence of corporate tax avoidance.

Some multinationals, and perhaps some governments and even some OECD experts, are hoping that as these detailed reforms are pursued, the impetus for change will dissipate. Perhaps, they hope, growth will return, fiscal pressures will abate, and the tax justice movement will run out of steam. Perhaps the complexity of the measures needed will make it harder for campaigners to track progress, or to maintain the interest of press and public in the issues. Let us hope not.

A recipe for conflict?

Taking a more optimistic view, however, governments around the world will take vigorous actions to implement the OECD's proposals.

But this would pose its own problems. The OECD's piecemeal strategy would result in governments trying to grab what they can of the various parts of the profit of transnational corporations. The OECD can only provide at best loose coordination of the rules. Already there are significant divergences in interpretation and enforcement of provisions such as the OECD's Transfer Pricing Guidelines. Some OECD countries disapprove of measures adopted by Brazil, for example, and India is in open conflict especially with the US authorities.² Stronger rules would exacerbate and multiply such conflicts.

¹ For example, limiting royalty deductions would need to be linked to revision of transfer pricing rules concerning intangibles, and limited interest deductions to anti-CFC measures.

² The OECD Transfer Pricing Guidelines have recently been adopted also by emerging and developing countries, which are now strengthening their scrutiny of transfer pricing. However, the Guidelines allow

The OECD is also likely to recommend strengthening the 'mutual agreement procedure' for dealing with such disagreements. The preference of business and OECD officials is to provide for arbitration as a fall-back to resolve such conflicts. We consider that these procedures must become fully transparent and with publication of outcomes. There must be no secret deals when hundreds of millions of tax revenue dollars may be at stake. Publication would also improve the system, by establishing a record of the principles applied, to guide other taxpayers.

However, our view at TJN is that this piecemeal patchwork approach is a recipe for intensified tax conflict and ultimate failure. The fundamental defect of current international tax rules is that they treat TNCs as if they were separate entities in each country, dealing with each other at 'arm's length'. But this is a fiction: they are unitary bodies under common ownership and control, and they should be treated as such.

A new approach is needed, to replace fiction with economic reality.

A better way forward: a road map towards unitary tax

It is obvious that TNCs should be taxed on the principle that they are unitary firms.

Unitary taxation involves taking a multinational's total global profits and apportioning them out between the states where it does business according to its genuine economic presence there – based on a formula that using factors such as sales, assets and workforce / payroll. Each state can then tax its portion of the global profits at its own rate.³

Crucially, a shift towards a unitary approach can and should be adopted gradually, building on existing provisions.

A workable Unitary Tax (UT) system should have three components:

1. combined reporting,
2. apportioning profits to the different jurisdictions, and
3. a resolution procedure.

These three are explained below. Each can be introduced to some extent immediately, and could be refined gradually. What is more, all three approaches can be implemented by building on existing provisions already adopted by the OECD.

Indeed, versions of unitary taxation with profit apportionment are already quite widely used: notably in federal systems such as the United States (where a majority of states

five different methods, and leave wide scope for interpretation, which results in significant disputes and conflicts. For example, Brazil uses legislated fixed margins, while China prefers profit-split, but with special consideration for 'location factors'. India now has 3000 cases pending before tax appeals tribunals, and a frosty relationship with the US IRS, which has suspended bilateral mutual agreements. The transfer pricing regime is now generally regarded as failing: it may provide a nice source of income for tax advisers, but hardly ensures certainty for business. Attempting to reduce administrative and compliance costs, the OECD now advocates 'safe harbours' and Advance Pricing Agreements (APAs), which are essentially palliatives.

³ Note that this approach does not seek to *attribute* profit, since it assumes that the profits of an integrated firm result from its overall synergies, and economies of scale and scope. It *allocates* profits according to the measurable physical presence of the firm in each country.

use it) as well as Canada and Switzerland. Europe is currently taking its own steps towards such a system.⁴

1. Combined reporting

The first component, combined reporting, is essentially just a transparency requirement. Any company with a business presence in more than one country should be required to submit a **Combined and Country by Country Report** to each tax authority. This should include (i) consolidated worldwide accounts for the firm as a whole, ignoring all internal transfers; (ii) details of all the entities forming the corporate group, and their relationships; and (iii) data on its physical assets and employees (by physical location), sales (by destination), and actual taxes paid, in each country.

No change is needed to international rules for this: indeed, states are already recommended to obtain such data by both the United Nations and the OECD.⁵ At present, few states have such a requirement, so tax officials starting from separate affiliate tax returns find it hard to see the big picture – and this is especially difficult for those in poorer countries. (A combined and Country by Country Report, or CaCbCR would effectively be an enhancement and expansion of current schemes for [country-by-country reporting](#), which has already been adopted by some countries, and is under consideration by the EU.) Formalisation of this requirement should be facilitated by drawing up an agreed template for such a CaCbCR. In the meantime, national authorities could use a version of financial accounts, such as earnings before interest, tax and depreciation (EBITDA), which is widely relied on by corporate analysts.

2. Apportioning profits

Next, states can use the CaCbCR to decide on how a TNC's global profits are apportioned out to the different jurisdictions where it does business. This can build on existing practice, in particular the so-called “profit-split” method⁶ already accepted by the OECD Transfer Pricing Guidelines, which aggregates the profits of related entities then apportions them according to so-called “allocation keys.” **This is a narrower, transaction-level version of apportioning profits by formula.**

This approach, as currently used, aggregates profits only at the level of bilateral transacting entities - whereas in reality TNCs use more complex cross-linkages among multiple affiliates. It would not be such a great stretch to extend this practice from the

⁴ Unitary taxation has long been used for state taxes in federal systems with unified markets, such as Canada, Switzerland and the USA. California, for example, developed it to stop Hollywood film studios siphoning profits out by using distribution affiliates in Nevada. Today, all 47 US states which have a corporate income tax use formula apportionment, although following a campaign by non-US MNEs in the 1980s it has been limited to their US business (‘water’s edge’). The EU also now has a fully worked out proposal for a Common Consolidated Corporate Tax Base ([CCCTB](#)), developed by the Commission in consultation over several years with business representatives and specialists. It was approved, with some amendments, by the European Parliament [in April 2012](#), and since then has been under consideration by the Council of Ministers. The proposal could certainly be improved, but if adopted it would go a long way towards dealing with many of the avoidance devices, e.g. the use of entities in Ireland and the Netherlands as conduits for low-taxed income flows. It is not surprising that such member states have opposed the proposal, but it is regrettable that successive UK governments have been sceptical or hostile

⁵ The UN Practical Manual on Transfer Pricing, and the OECD’s Draft Handbook on Transfer Pricing Risk Assessment of 2013 (para. 98)

⁶ Where the aggregate profits from a series of transactions between related parties are split between jurisdictions based on “allocation keys” reflecting the genuine economic activity in different jurisdictions.

level of transacting entities to the combined whole. Indeed, there is already considerable experience in some sectors in applying formulaic profit apportionment, especially in the finance sector, e.g. where a trading book is transferred between offices in different time-zones over 24 hours. Formula apportionment of such profits has been done for 20 years through Advance Price Agreement (APAs) with banks.⁷ If firms such as Apple, Amazon, Google and Starbucks really do want to pay a fair level of taxes wherever they do business, they too could enter into APAs and agree an appropriate apportionment.

The experience of using profit split and APAs could be combined with proper research to determine appropriate apportionment formulae⁸. Some degree of divergence of formulae is likely, but this is acceptable.

Some argue that states would simply aim to weight the factor which produces the biggest 'tax grab' for themselves – and that therefore it will be impossible for there ever to be full global agreement on a formula: and so, they argue, the whole approach is politically impossible.

But this is quite wrong, for several reasons.

First, full convergence is not necessary. Differing formulae could certainly lead to some overlaps between different countries' tax systems – but as explained above this already happens under the current system, and the problem is likely to be less under unitary taxation.

Second, states won't just go for the biggest possible tax grab – because they need also to consider the effects that this would have on inward investment. This is likely to lead to a more balanced approach towards designing a formula, and to encourage convergence. A balance between production and consumption factors seems best⁹. In the US, the trend among states using unitary taxation has been for convergence (towards emphasising the sales factor.)

Some also argue that firms could still reorganise themselves to minimise their taxes.

This is true but it would happen to a dramatically lesser degree, and in a very different way. It is far harder for a firm to relocate physical assets, workers and sales to other

⁷ APAs provide agreement binding for a period of years (e.g. five) on the method to be used for pricing transactions or allocating profits. The APAs with banks covering 24-hour global trading have been based on profit split, using mainly the remuneration of the traders in each locality.

⁸ The most balanced approach seems to be a 3-factor formula:

(i) physical assets: not intangibles (which are elusive to define and value, and can easily be relocated);

(ii) employees: US states use employee payroll costs not headcount, but internationally account should be taken of wage differences; the Common Consolidated Corporate Tax Base (CCCTB) proposed for the EU would use a 50:50 weighting of payroll and headcount, which seems appropriate; and

(iii) sales (by location of customers).

⁹ This could be locked in by adopting a 2-stage apportionment: an initial allocation to each country by production factors, then apportionment of the residual by sales. Special formulae may be needed for specific sectors. However, it should be remembered that tax on business profits is only one instrument. For extractive industries in particular it must be supplemented by rent taxation, using royalties and/or a rent resource tax.

countries than it is for them to shift artificial profits under the current system. And if they chose to divest some operations to truly independent third parties, they would lose the profits of synergy and scale. It is hard to imagine a company like Apple being willing to transfer to a truly independent wholesaler in a low-tax country a significant slice of its profits. Relocation of real activities may well occur, but this is very different from the artificial shifting of profits to largely paper affiliates that happens under current rules.

States would remain free to choose their own marginal tax rates. So countries could compete to attract genuine investment rather than formation of paper entities aimed at subverting the taxes of other countries. UT would therefore eliminate harmful tax competition, while allowing countries to make genuine choices between attracting investment in production and generating revenues from corporate taxation. Such a system would of course not be perfect, but aligning tax rules more closely to the economic reality of integrated firms operating in liberalized world markets would make it simpler and more effective.

3. Procedures for resolving disagreements and conflicts

The **third** important element of reform would involve a procedure for resolving disagreements and conflicts between states. Such a system already exists in the OECD's Mutual Agreement Procedure (MAP) but it could be improved, as explained above, and extended to include negotiation of APAs.

Currently, the MAP is very secretive, and decisions often involving hundreds of millions or even billions of dollars are not published. The secrecy of both MAP processes and APAs greatly increases the power of frequent actors in these processes, i.e. the international tax and accounting firms – to the great detriment of the system as a whole.

Publication of both would be a great step towards a system which could both provide and more importantly be seen to deliver a fair international allocation of tax.

Future Prospects

Developing this approach requires serious study. We don't expect the OECD now to advocate a wholesale push towards unitary taxation, – but we hope that it at least leaves the door open for others, including other international organizations, to develop such an alternative approach.

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