Profit Shifting

Are We Heading towards a Corporate Tax System Fit for the 21st Century?[1]

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Introduction

A long-standing criticism of the system for taxing multinationals' profit is that it distorts economic activity, affecting investment, financial and location decisions, and economic growth. However, it has been the recent growing realisation that multinationals are able to arrange their affairs to reduce their aggregate tax liabilities by taking advantage of deficiencies in the tax system that has generated a real momentum for reform. The need for reform rose to the top of the political agenda following extensive press coverage of the tax affairs of a few well-known multinational companies, including Starbucks, Google and Amazon. In response, the G20 (G20 2012) called on the OECD to undertake a project on "Base Erosion and Profit Shifting" (BEPS). The OECD published a report in February 2013 (OECD 2013a), an Action Plan in July 2013 (OECD 2013b), and since then has been engaged in developing proposals for reform of the system.

Whilst the BEPS project is still in progress, its general direction of travel is fairly clear. This paper argues that although the BEPS project will probably close some existing loopholes, it will not provide the radical reform that is required to produce a stable system for years to come.

Problems with the existing system

Before turning to the BEPS project, we begin by outlining the most significant problems with the existing system. These stem from two related sources. Firstly, the underlying framework is based on an inadequate compromise in allocating taxing rights between countries; and the system has become more complex and less suited to collecting an appropriate amount of tax as steps have been taken to shore up that compromise. Secondly, the system effectively invites countries to compete with each other in numerous dimensions, which undermines its fragile state. We briefly discuss each of these in turn.

When commercial activity moves beyond a purely domestic setting, many countries can potentially claim jurisdiction to tax the income from it. The international tax system seeks to address this by essentially allocating primary taxing rights between "residence" and "source" countries. Very broadly, the residence country is where a person who has the right to receive the profits of the activity resides, while the source country is where the economic activity takes place. And broadly again, in a "1920s compromise" (Graetz 2001) in the League of Nations, source countries were allocated primary taxing rights to the active income of the business, and residence countries the primary taxing rights to passive income, such as dividends, royalties and interest. Theoretical and practical arguments have been articulated in favour of this allocation, yet they do not stand up to much scrutiny.[3] The allocation is best viewed as an arbitrary compromise, albeit one which has come to be accepted by large parts of the international community.

This system is ill-suited to dealing with modern multinationals operating in a truly global business environment. A modern multinational can have shareholders scattered across the world, a parent company resident in one country, a potentially large number of affiliates undertaking an array of activities, such as research and development, production, marketing and finance that are located in many different countries[4] and consumers that may also be scattered across the world. In such a scenario, there is no clear conceptual basis for identifying where profit is earned; as all of those locations may be considered to have some claim to tax part of the company's profit. Conceptually, the residence/source distinc-

[1] This is an edited and shortened version of a paper by the same authors and the same title, published in *Fiscal Studies*, December 2014.

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[3] See the discussion in Schön (2009).

[4] See OECD (2013a), Chapter 3 on global value chains.

tion does not offer much help. In practice, applying this distinction in the context of intra-group transactions, where affiliated entities in different jurisdictions are assigned the status of "source" or "residence", gives rise to significant problems, not least those relating to transfer pricing. Following the logic of the residence/source and active income/passive income distinctions, specific international tax rules have been introduced that are hard to justify and that are easily manipulated, such as transfer pricing rules dealing with risk and Cost Contribution Agreements. Overall, the system is manipulable, distortive, often incoherent and unprincipled.

A second, important, source of problems is that the system invites countries to compete with one another in ways that destabilise the system itself. Countries compete to attract economic activity and to favour "domestic" companies, which has led to gradual reductions in effective rates of taxation of profit for at least thirty years. For example, the current UK coalition government has been explicit on its strategy in this regard; it came to office in 2010 with the declared "aim … to create the most competitive corporate tax regime in the G20" (Cabinet Office 2010) and it has acted on that aim. Such a goal is not easily reconciled with another goal often explicitly held by governments: ensuring that companies should pay to some country or countries a reasonable amount of tax on their global profits. This tension is particularly evident in the UK, where the goal of having the most competitive corporation tax regime in the G20 is held concomitantly with an active role in pushing forward the OECD's BEPS Action Plan. There may be competition not only with respect to rates, but also with regard to many other aspects of the tax base. For example, several countries have introduced rules – such as the US check-the-box rules and the UK Finance Company Partial Exemption – designed to gain a competitive advantage for domestic companies, but which facilitate the erosion of the tax base of both domestic and foreign jurisdictions.

This fundamental tension is at the heart of whether the existing international tax system can be reformed to provide a reasonable and stable system for taxing the profits of multinational companies in the 21st century. The issue is one of incentive compatibility. If countries acting in their own interests believe that they have an incentive to undermine the international consensus, then that international consensus cannot provide a stable long-run system. There is ample evidence that countries have been acting in precisely that manner.

What is the OECD BEPS project trying to achieve?

The OECD BEPS project focuses on the need to change the existing legal system. A first question is whether the reform being considered is as radical as the brief analysis in the previous section suggests it needs to be. A starting point is provided by the OECD's articulation of the central problem it is addressing: "double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it" (OECD 2013b, 13).

In the first document produced by the OECD in this process (OECD 2013a) it intimated a willingness to take a bold approach: "it is also important to revisit some of the fundamentals of the existing standards. Indeed, incremental approaches may help curb the current trends, but will not respond to several of the challenges governments face" (OECD 2013b, 8). The second document produced (OECD 2013b) also spoke of "a bold move by policy makers [being] necessary to prevent worsening problems" (OECD 2013b, 10). However, it made it clear that there was a limit as to how bold and fundamental the proposed reform would be. This document explained that its proposed actions "are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income" (OECD 2013b, 11).

The reforms proposed by the OECD are both less and more radical than the statements cited above make it out to be. It is less than a "fundamental" and "bold" reform because the Action Plan seeks to bring change within the existing international tax framework. The OECD is not setting out to change the framework itself. It is not even questioning the desirability or logic of a regime centred on the residence/source and active/passive income dichotomies in the 21st century. Indeed, it only mentions one alternative to the current framework, formulary apportionment, and gives it very short shrift.

On the other hand, it is more radical than might at first appear because whilst purporting not to be changing the current allocation of taxing rights, the changes proposed do depart from it to some extent. This is done by adding a qualification to the current allocation rules where abuse is perceived. Specifically, a number of the actions focus on 'economic activity', relevant substance' or 'value creation'. Indeed, the general principle guiding the reform proposals of the OECD is explained in

these terms "this Action Principle should provide countries with domestic and international instruments that will better align rights to tax with economic activity" (OECD 2013b, 11). We discuss this general principle first, and then consider problems of competition.

A principle based on the location of economic activity: some issues

The use of a new notion of economic activity raises at least six problems, which are discussed in turn.

First, the desired outcome of better "align[ing] rights to tax with economic activity" constitutes a departure from the current regime. Put simply, the international tax system does not currently allocate taxing rights to countries according to where "economic activity" takes place. When passive income is paid across borders it will be taxed in the recipient's country of residence solely by virtue of the recipient's residence in that country. No economic activity in the country of residence is required. This change thus overlays a new and completely different principle onto the existing structure. As the new principle points in a different direction the inevitable conclusion is that the OECD is proposing a shift in the taxation of certain forms of passive income from a residence basis to a "place of economic activity" basis. Whether this is a sensible policy is open to discussion. However, the OECD does not attempt a proper analysis of such a change.

Secondly, as the basic structure is being kept in place and the principle overlaid on top of it, the post-BEPS international tax regime will be even less coherent. In some situations taxing rights will be aligned with "economic activity", but in others it will not. Consider the following example. P, a company resident in State A, funds S1, a wholly-owned operating company resident in State B through debt. Under the current international tax regime interest paid by S1 to P is primarily taxed in State A. Generally, interest payments are deductible from S1's taxable profits, meaning that to the extent that they are covered by the interest payments, profits generated by S1 are taxed by State A and not State B, where the economic activity might be deemed to have taken place.

Action 4 addresses base erosion via interest deductions and other financial payments, although how this might be done is still under discussion. The Action Plan does, however, shed some light on the perceived problem created by inbound financing of this nature:

"From an inbound perspective, the concern regarding interest expense deduction is primarily with lending from a related entity that benefits from a low-tax regime, to create excessive interest deductions for the issuer without a corresponding interest income inclusion by the holder" (OECD 2013b, 16).

This explanation suggests that the options for change the OECD might consider could include making S1's ability to deduct interest paid in State B dependant on whether State A taxes the interest and at what rate.[5] Taxing rights would be aligned with economic activities if State A has no or low taxation but not otherwise. This might address the problem of profit shifting through the use of debt, but it does not appear to be principled and also introduces further incoherence into the system. As discussed below, competitive pressures might also undermine this change altogether.

Action 3 of the BEPS Action Plan concerns the strengthening of Controlled Foreign Company (CFC) rules. Their operation, in conjunction with the limitations on interest deduction rules, raises further questions. Let us suppose now that P has another subsidiary S2, resident in State H, a tax haven, and that P funds S2 through equity, which, in turn, funds S1 through debt. Let us assume also that State A, where P is resident, has robust CFC rules in place. Action 4 implies that the deduction in State B for the interest paid by S1 to S2 ought to be addressed given that State H is a low tax regime. This could be done, perhaps, by allowing State B to limit the interest deductions available to S1. However, the CFC rules of State A might make the interest received by S2 taxable in the hands of P in State A, so that the rules resulting from Action 4 addressing the interest paid by S2 to S1 would not be required. Note however, that if this were the case, and by "economic activity" the OECD here means more than funding through debt or equity, the taxing rights would again not be aligned with "economic activity". State A would have taxing rights despite the fact that no economic activity takes place there, other than P owning shares in S2.

For these reasons the post-BEPS international tax system is likely to be more incoherent, with taxing rights being aligned with economic activity in some cases, but not in others. There does not appear to be any principle

[5] Note that the primary response recommended under Action 2 to deal with hybrid mismatch arrangements which produce deduction/no inclusion outcomes is to deny the deduction in the payer's jurisdiction. If the payer's jurisdiction does not adopt such a rule, the defensive response recommended is for the income to be included as ordinary income in the payee's jurisdiction. See OECD (2014b, 36).

for distinguishing between the two; at best, reliance will be placed on vague and arbitrary tests such as "artificial" and "excessive".

Thirdly, if applied too narrowly an "economic activity" test might wrongly identify instances of low or no taxation. Consider the following example. P is a parent company resident in State A, a high tax jurisdiction operating an IP Box regime which taxes royalty income at five percent. S is a wholly-owned subsidiary of P, resident in State B, a high tax jurisdiction. S develops intellectual property which it sells to P for a fair price; and S pays tax in State B on the transfer. P grants a licence over the intellectual property to T, an independent company resident in State C, another high tax jurisdiction. T pays royalties to P which it can deduct from its taxable profits; P pays tax on the royalties at the low tax rate of five percent.[6]

As a result of this arrangement, royalties that might otherwise have been taxed at a high rate in State B, where the IP was developed, are taxed at a low rate in State A. Focusing narrowly on the royalty payments. one could reach the conclusion that there is low taxation as a result of taxable income (in State A) having been segregated from economic activity (in State B). However, if the transfer of the intangible to P were priced correctly, with State B collecting appropriate tax on that transfer, single taxation on the intangible would have already taken place.[7] This is not therefore a case in which there is "no or low taxation … associated with practices that artificially segregate taxable income from the activities that generate it" (OECD 2013b, 10). But to identify this, one cannot focus only on the royalty payment and ignore the tax paid on the transfer of the intangible. By contrast, the OECD's approach does not appear to consider any tax paid in B in the transfer of the IP (OECD 2014c, 33); indeed, the example given above appears to fall foul of the regime proposed by the OECD in relation to Action Plan 5 dealing with harmful tax practices.

Fourthly, the focus on economic activity suggests a misdiagnosis of the problem in some situations. In the last example given above, if P paid S less than the fair price for the intangible, there would not have been single taxation of the intangible and the concern over low or no taxation would be warranted. However, this problem is not due to a lack of economic activity in State A. The problem here stems from the inability to price inter-company transfers such as that between P and S. If this is the real cause of the problem it should be addressed directly.[8] If it is not possible to remedy that situation, then the soundness of a system which relies on the correct pricing of such transfers should be questioned. If the real problem here is that the system itself is unsound then a stable, long-run solution cannot rely on keeping the system, but amending one part to correct for the failure of another part.

Fifthly, the proposed solutions are likely to be undermined by tax planning and to create real economic distortions. While it is unclear what "substantial activity" will be required for preferential regimes, one can safely predict that as long as the cost of satisfying this test is less than the resulting tax saving, multinationals will satisfy it by moving real activity to low tax jurisdictions. This will undermine the OECD's solution and, more importantly, it will also create a real economic distortion where there was none.

Sixthly, from a conceptual perspective, a system that seeks to align taxing rights over income with the "economic activity" that created it is questionable because it is not at all clear where such economic activity actually takes place. Thus far, we have side-stepped the issue by assuming that the OECD means an activity which goes beyond simply holding a debt or equity instrument or an intangible. However, these concepts are elusive and thus constitute a critical weakness in the OECD's project. Numerous factors contribute to the creation of income, including finance, research and development, head office functions, manufacturing, marketing and sales. In the context of a multinational, these factors might be spread over a number of countries thus making it impossible to pinpoint where the relevant "economic activities" which created the income took place.

Problems of interaction with tax competition

Even if all the problems with the approach proposed by the OECD were solved, however, there remains the problem that the system will be undermined by national governments competing with each other. To illustrate this, let us return to the last example given above where P, resident in State A, acquires intellectual property from its wholly owned subsidiary, S, resident in State B.

[6] The tax base would be net of any allowances relating to the purchase of the intellectual property; but unless the full purchase price was immediately deductible, then P would face a positive tax liability in present value terms.

[7] From an economic perspective there is no difference between S licensing the intangible to T in return for a royalty and S selling the intangible to P which then licenses it to T in return for a royalty. A neutral tax system should treat both in the same way.

[8] At the time of writing the OECD's work on transfer pricing has not been finalised. The OECD is considering the introduction of special measures to address hard to value intangibles. Whether such measures will be adopted and how successful they will be, is, of course, not known. See OECD (2014d).

T, resident in State C acquires a licence over the IP and pays a royalty to P in return. The perceived problem here arises because State A taxes the royalty income at a low rate.

It might be argued that the relevant economic activity took place in State B where the intangible was created. However, State B might decide not to tax that income or to tax it at a very low rate, because taxing the income would raise the effective tax rate on R&D in State B, thereby deterring real economic activity from taking place there. Alternatively, it might be argued that the relevant economic activity took place in State C, where the operating company's activities took place. However, State C might also decide not to tax that income or tax it at a low rate because taxing the income would raise the effective tax rate in State C, thereby deterring real economic activity from taking place there. There is no evidence that under the existing system either State B or State C would wish to tax the income associated with the royalty payment to State A. On the contrary, many examples of various forms of tax competition suggest that neither State B nor State C would wish to do so since if they did, they would worsen their competitive position with respect to other countries.

If one of the three states agreed to tax the income (above a certain rate) for the foreseeable future, there would be nevertheless a concern that this could not be the basis of a stable tax system. This is because there would always be an underlying incentive for a future government in these states to gain a competitive advantage by switching to not taxing the income (or cutting the tax rate).

Even if it were successful on its own terms, the BEPS project would not contain the power of existing competitive forces. The outcomes resulting from the project are expected to take different forms. Some changes will be enshrined in legally binding international treaties. This should limit, although probably not eliminate, states' ability to compete in the areas covered. However, these treaties will be limited in scope. In other areas, the expected outcome is a recommendation for domestic legislation. Here the hope is that states adopt legislation effectively limiting their ability to compete in these areas. Whether steps will or can be taken against states that refuse to meaningfully follow these recommendations is unclear. Furthermore, if their interests so dictate, future governments might not feel constrained from changing their domestic law and recommencing competition in these areas. Other factors, such as tax rates, are outside the scope of the BEPS project altogether, and thus competition on these factors will continue unhindered. Finally, whilst the BEPS project includes a broad group of countries, it is not truly global. Again, it is unclear whether steps can be taken to encourage countries that are not part of the BEPS process to adopt the recommendations resulting from the project.

Conclusion

Even if the actions proposed by the OECD are successfully implemented, the international tax regime will still not be fit for purpose. The regime will consist of a confused, complex mass of arcane, arbitrary and sometimes illogical rules, competition will still drive rates down and reliefs up, location of real economic activity will remain distorted, and cross-country arbitrage opportunities are likely to persist. More radical reform is required if we are to have a stable system for the taxation of multinational companies for the longer term.

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