



What Have We Learned About International Taxation and Economic Substance?

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The landscape of international corporate taxation will change significantly as a result of the G20/OECD project on base erosion and profit shifting (BEPS). The contours of this new terrain have become apparent since the publication of the main outputs of the project in October 2015. The BEPS outputs aim to strengthen the system and give better tools to tax authorities – if they have the capacity and will to use them. Overall, however, the proposals are a patch-up of existing rules, making them even more complex and dependent on technical expertise to administer. They do not tackle the more fundamental flaws of the system in a coherent way, but are an important first step on a longer road. It is therefore very important for African countries to inform themselves about the implications of the BEPS proposals, and to form their own views on which aspects may benefit them.

The G20 project itself is continuing, both to supervise and coordinate implementation and to work on some key issues that were

not dealt with in its main phase. In February 2016 an Inclusive Framework was established, allowing any country to join the process as a BEPS Associate. This has turned the OECD Committee on Fiscal Affairs into a global tax body for some purposes, holding its first meeting in this form in Japan in June 2016. Countries that join are expected to implement the minimum BEPS project commitments, but can also be involved in the continuing standard-setting. However, the OECD countries have set the scope of the project, which explicitly excluded any reconsideration of the allocation of taxing rights between residence and source countries. In practice the issue is hard to avoid, especially as many OECD countries have experienced the difficulty of taxing foreign-based internet companies and service providers. Inevitably, the BEPS discussions and negotiations have been dominated by the concerns of the large countries that are home to multinational enterprises (MNEs). It remains to be seen whether increasing the number of

governments involved in the BEPS process to 100 will lead to any rebalancing of the perspective.

The mandate from the G20 leaders for the BEPS project was to reform international tax rules to ensure that MNEs could be taxed 'where economic activities occur and value is created'. However, they also added 'while respecting the sovereignty of each country to design its own rules'. These aims are contradictory. Ensuring that taxation is in line with economic substance requires stronger coordination between states. This inevitably restricts the freedom of states, although it is the only way to restore their effective power to tax MNEs.

This brief begins by outlining the central flaw in the current system for taxing MNEs – its ambivalence between understanding their economic nature as unitary businesses, and taxing their national operations as if they were independent of each other. It then surveys the outcomes of the BEPS project, to show how their strengthening the rules has also sharpened this ambivalence. The third section sketches out the three main alternative approaches that have been proposed for moving to a unitary approach. The concluding section briefly discusses the prospects for the immediate post-BEPS project period, which it is suggested will be essentially a transitional one.

The Ambivalence of International Tax Rules towards MNEs

Since they were first formulated almost a century ago, international tax rules have retained an ambivalence – which is a fundamental flaw. The basic principle, which allocated the right to tax active business income to the source country and passive investment income to the investor's country of residence, was aimed at portfolio investment – then the

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dominant form. It was already understood, however, that foreign direct investment by MNEs posed special problems, since it was hard to determine the appropriate level of profits attributable to the various affiliates (branches or subsidiaries) of a multinational corporate group.

It is well known that this was addressed by a study for the League of Nations, resulting in the voluminous report coordinated by Mitchell B. Carroll.¹ Carroll summarised the issue as follows:

The tax official in each country where there is an establishment has at his immediate disposal only the accounts (if any) of the local establishment, and it is necessary for him to ascertain whether or not they reflect the true profit attributable to that establishment. Obviously, his task is easy if the local establishment is virtually self-contained or is an autonomous unit which is treated as such by the foreign enterprise, or if the foreign enterprise has dealt with each establishment at arm's length as if it were an independent enterprise. This entails, in some cases, allotting to it the capital normally required to carry on its activities, and, in every case, billing to it or

¹ For further details and discussion, see Picciotto, S. (1992) International Business Taxation, Weidenfeld & Nicolson, available at <http://taxjustice.blogspot.be/2013/06/international-business-taxation.html>

making charges at the same rates as it would to an outsider. Unfortunately, however, the local establishment is not so treated by the great majority of enterprises, and the tax inspector finds it necessary to adjust the accounts after securing whatever additional information is available or to make an assessment on an empirical or fractional basis.²

The result was the inclusion in the model tax treaty of the power in Article 9 to adjust the accounts of associated enterprises, to prevent diversion of profits. The Carroll report showed that tax authorities at that time used two main approaches. One was to use empirical methods to compare the profits of associated enterprises of MNEs with those of similar independent firms. The other, used especially when comparable businesses could not be found, was to treat the enterprise as an organic unity, and apportion the total profits on a fractional basis, using an appropriate factor such as turnover. The use of the fractional method was explicitly included for permanent establishments in Article 7 of the model, and this provision remains today in many treaties, especially of developing countries.³

Hence, the tax treaty provisions were ambivalent about how to treat MNEs. On the one hand, they gave tax authorities powers to adjust the accounts of associated enterprises, based on the understanding that they are related parties under unified control. On the other hand, the principle to be applied was that the income should reflect

what might be expected if the entities were independent. Consequently, the system, as it has developed historically, has included both unitary and independent entity elements.

This provided a perverse incentive, which MNEs have increasingly exploited to minimise their taxes. Since the 1930s, and increasingly from the 1950s, they began to form intermediary entities to hold assets and shift profits through conduits to base companies, creating the tax haven and offshore secrecy system.⁴ Today, most MNEs typically consist of often hundreds of affiliates, forming complex corporate groups. The shift to the knowledge economy and digitalisation has further facilitated the restructuring of MNE operations around global value chains, which can be tax-driven. This enables the fragmentation of different functions (research, design, assembly, marketing, distribution) as well as management and back office activities. The independent entity principle enables MNEs to attribute only routine levels of profit to entities in high-tax countries, while channelling large revenues for payments for intangibles, finance and fees to low-taxed affiliates. Countries now compete to offer tax advantages to attract the location of entities that perform such high value-adding functions.

The measures adopted by tax authorities to counteract these strategies have continued to remain ambivalent. Some provisions override the fiction of separate entity, such as rules allowing taxation of the undistributed income of a controlled

² Carroll, M. (1933: 12 para 6) *Taxation of Foreign and National Enterprises*. Volume 4: *Methods of Allocating Taxable Income*, Geneva: League of Nations, available at <http://setis.library.usyd.edu.au/pubotbin/toccer-new?id=cartaxa.sgml&tag=law&images=acdp/gifs&data=/usr/ot&part=0>

³ Avi-Yonah, R. and Pougá Tnhaga, Z. (2015) *Unitary Taxation and International Tax Rules*, ICTD Working Paper 26, available at <http://r4d.dfid.gov.uk/pdf/outputs/taxation/ICTD-WP26.pdf>

⁴ The US first referred the problem to the OECD soon after the establishment of the Committee on Fiscal Affairs, which in 1962 set up Working Party 21 on Tax Avoidance Through the Improper Use or Abuse of Tax Conventions, consisting of Denmark and the US. Although its work was secret at the time, the records have recently become easily available through the Tax Treaties History project: <http://www.taxtreatieshistory.org/>. Its investigations focused on the question of 'how a country may prevent taxpayers domiciled within its borders from artificially avoiding tax by placing their sources of income outside the borders of the country'; see *Preliminary Report on the Improper Use or Abuse of Tax Treaties*, Fiscal Committee Working Party 21, 9 January 1963, FC/WP21 (63) 1 (Paris, OECD). In 1964, Stanley Surrey, Assistant Secretary of the US Treasury for Tax Policy from 1961-69, again wrote to the OECD proposing work to agree guidelines on transfer pricing, but this was not done at that time.

foreign corporation (CFC) as part of the tax base of its parent, first introduced by the US in 1962. Others, particularly the rules on transfer pricing, have increasingly emphasised the independent entity principle. When the US introduced its more detailed Transfer Pricing Regulations in 1968, they focused on the pricing of inter-affiliate transactions, and gave priority to the Comparable Uncontrolled Price (CUP) method. This approach failed as suitable comparables could not be found, for the very good reason that MNEs benefit from the advantages of scale and scope, and the synergy resulting from their integrated operations. The introduction by the US of the comparable profit method led to a conflict at the OECD. This was eventually resolved by the inclusion of two new methods in the OECD's 1995 *Transfer Pricing Guidelines* (TPGs), the transactional net margin method (TNMM) and profit split.⁵ They have been labelled transactional profit methods, in an effort to maintain the fiction of independent entity.

The mandate for the BEPS project implied that MNEs should be treated in accordance with the business reality that they operate as single firms. Although the final BEPS project proposals did not accept this explicitly, in some respects they did move in that direction. However, on the crucial question of criteria for allocating profits, the proposals remained unclear and complex. Hence, although they open up a new road for the international tax system, the direction of travel is uncertain.

The BEPS Project Outcomes

In some respects the BEPS project reports do move towards treating MNEs as unitary firms. The requirement for country-by-country reporting

for the largest MNEs, together with standardised templates for a master file and local file for transfer pricing documentation, will for the first time make it possible for all tax authorities to have a clear view of the firm as a whole, and the relationship of its various parts.

The adoption of an apportionment approach was easier for costs, since MNEs themselves would like a guarantee that they can be deducted somewhere. However, the adoption of a simplified method for pooling and allocating central service costs within a corporate group has been limited to low value-adding services,⁶ because many tax authorities rightly consider that such deductions can be used to reduce the source country tax base. An important departure from the independent entity principle came in the proposals on limitation of interest deductions. The initial draft suggested a limit based on apportioning the group's consolidated net costs of interest paid to third parties by the MNE as a whole, in proportion to each affiliate's earnings before interest, tax, depreciation and amortisation (EBITDA). This was explicitly presented as not-an-arm's-length rule.⁷ However, the final report recommended a fixed cap of between 10 and 30 per cent of EBITDA, although combined with a group ratio rule, at the taxpayer's option. This is clearly ineffective, since data submitted by business groups themselves showed that over half of non-financial MNEs had net consolidated interest expense below 10 per cent of EBITDA, and around 80 per cent had a ratio below 30 per cent.⁸ The recommended fixed cap will clearly allow most MNEs to continue to deduct excessive interest. Nevertheless, a fixed

⁵ Durst, M. and Culbertson, R. (2003) 'Clearing Away the Sand; Retrospective Methods and Prospective Documentation in Transfer Pricing Today', *NYU Tax Law Review* 57: 37-136.

⁶ Through revisions to chapter VII of the TPGs in the BEPS Report on Actions 8-10.

⁷ Discussion draft on Action 4, December 2014, paras. 21-24.

⁸ See the survey done by PwC for the Business and Industry Advisory Group of the OECD: Comments received on Public Discussion Draft BEPS Action 4: Interest Deductions and Other Financial Payments, Part 1, p.136, available at <http://www.oecd.org/tax/public-comments-action-4-interest-deductions-other-financial-payments.htm>

cap is an improvement on thin capitalisation rules – these are still widely used in developing countries, but are largely ineffective.

The greatest reluctance to abandon the independent entity principle is seen when it comes to the allocation of profits. The report on BEPS Actions 8-10 has resulted in a substantial rewriting of the OECD's TPGs – these are important because they are applied in practice in countries around the world, and not only by OECD members. Indeed, most African countries have in recent years introduced transfer pricing rules that are either explicitly or implicitly based on the OECD's TPGs. In Kenya this was precipitated by a court decision in the *Unilever* case (2003), in which Judge Alnashir Visram rejected transfer price adjustments made by the Kenya Revenue Authority, even though they were based on the comparable uncontrolled price method, on the grounds that the taxpayer was entitled to rely on any method in the OECD Guidelines, although the Kenyan legislation at that time made no reference to them.⁹ Consequently, Kenya enacted Transfer Pricing Regulations in 2006 adopting the OECD's five methods, although they also allow for the Commissioner to specify a different method. In some countries the OECD TPGs are given statutory status to be used as guidance for tax treaty interpretation, although along with the *UN Manual on Transfer Pricing*.¹⁰ Others have simply enacted rules specifying the OECD methods – for example, Madagascar in 2014.¹¹ It remains to be seen whether, and if so how, African countries introduce the changes to the TPGs agreed in the BEPS project. The OECD Council has agreed these changes, so they are

regarded as applicable in OECD countries, and a version incorporating the changes is likely to be issued in 2016.

Despite the revisions, the TPGs still stress that the starting point should be the various entities in the MNE group and the transactions between them. There is nevertheless a significant reorientation of the rules, with a new emphasis on accurately delineating the true nature of these transactions, based on an analysis of the facts and circumstances of each business. This 'requires a broad-based understanding of the industry sector in which the MNE group operates ... including its business strategies, markets, products, its supply chain, and the key functions performed, material assets used, and important risks assumed'.¹²

The difficulties posed by this procedure should be readily apparent. Tax authorities must carry out individual audits of firms, analysing the firm's group structure and business model, which requires specialist knowledge of each type of business. The F-A-R (functions-assets-risk) analysis in the revised TPGs is now elaborated in greater detail, especially as regards the functions relating to intangibles and to risks. A key intention is to ensure that an affiliate that is used simply as a cash box, either for owning and receiving income from intangibles, or for group financing, should receive only a risk-free return.

The aim of functional analysis is to try to identify the specific functions performed by different affiliates. In practice this is difficult or impossible when it comes to knowledge-based intangibles or risk, both of which are spread through the firm as a whole. Although this flows from the basic

⁹ *Unilever Kenya Limited v. Commissioner of Income Tax* Income Tax Appeal 753 of 2003 (Kenya High Court).

¹⁰ e.g. the Nigerian Income Tax (Transfer Pricing) Regulations No. 1 of 2012, and the Tanzanian Income Tax (Transfer Pricing) Regulations of 2014.

¹¹ Decision 04/2014 Application des dispositions spécifiques sur les prix de transfert. For an analysis and critique, see Tovony Ranandramanalina, *Les Prix de Transferts dans les pays en Développement: Le cas de Madagascar*, paper delivered at the African Tax Research Network conference, Cape Town, December 2015.

¹² New para. 1.34 in chapter 1 section D of the TPGs.

theory of the firm, it is also borne out in practice. As a submission by BASF, the German-based chemicals firm, explained:

Quality management and controls relating to the risks, functions and assets employed are to a wide extent part of corporate procedures which are generally valid group-wide and are fully integrated in the business processes. The research and development process is managed by electronic systems which track the allocation of projects to specific research centres, the adherence to budgets, the sign-off processes and the registration of IP rights. “Control” is therefore to a large extent built in to group-wide guidelines and operating systems, and can therefore be performed anywhere as such systems enable a decentralised, collaborative organisation.¹³

Indeed, MNEs pride themselves on being both global and local, able to benefit from their coordination of activities worldwide, while their central management teams may be relatively small.

The revised TPGs place significant emphasis on control functions. In relation to intangibles they identify the especially important functions as design and control, direction of and establishing priority, and management and control (revised TPGs para. 6.56). Similarly, for identifying the location of risk the key test is the ‘capability and authority to control’ (para. 1.67).

This control test for the location of key functions clearly favours countries of residence. It is likely that countries where the corporate headquarters, chief financial officer, or main research centre are located will assert that the control over functions such as finance and research is exercised there, even if the firm operates in a decentralised way. Hence, an MNE could employ large numbers of people in research and development activities in

affiliates around the world that could be treated as having only routine research functions, to which relatively low profits would be attributable.¹⁴ At the same time, the aim to end tax avoidance by attribution of profits to cash box affiliates may have limited success. A company could relocate a few senior people to carry out control functions in a country that offers low effective tax rates for such activities. Indeed, countries are already competing to attract research hubs by offering low tax rates on structures such as the ‘patent box’.

The attempt by some developing country members of the G20 to strengthen the claims of source countries achieved limited success, in the inclusion of some revisions to refer to location advantages, and assembled workforce (revised TPGs Chapter 1, sections D.6 and D.7), but these provisions are worded very cautiously. The result is that MNEs can continue to treat their affiliates in developing countries, such as those in Africa, as adding little value even if they have substantial activities – on the grounds that they do not control the key functions of managing risk or intangibles. Under the OECD approach to transfer pricing they can continue to allow only routine levels of profit to these affiliates, based on the cost plus or TNMM methods.

Alternative Approaches

Several alternative approaches are available that involve treating transnational corporate groups as unitary firms. Indeed, as already discussed above, the existing rules already include unitary elements. Hence, some of these approaches could be compatible with current rules.

Residence-based Worldwide Taxation (RBWT)

Residence-based worldwide taxation would apply home country tax directly on a current

¹³ In its submission to the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, September 2013, <http://www.oecd.org/ctp/transfer-pricing/basf-intangibles.pdf>.

¹⁴ BASF in its evidence cited in the previous footnote stated that it has ‘numerous research hubs, located primarily in Germany, USA, China and India’.

basis on the consolidated worldwide profits of a corporate group, but with a full credit for foreign taxes paid.¹⁵ This would in effect treat all foreign affiliates on a full-inclusion basis as Controlled Foreign Corporations (CFCs). RBWT gives the residual right to tax to the firm's home country, but the initial right to the source country. Hence, it can be seen as strengthening source country taxation by removing the incentive for the MNE to shift profits, since any reduction of source taxation would lead to an equivalent increase of tax in the home country. For the same reason, it also removes the temptation for the source country to offer tax advantages to attract inward investment.

Such provisions could, from a legal perspective, be formulated and implemented unilaterally, without the need for agreement between states, and probably also without alterations to tax treaty rules. Indeed, strengthening of CFC rules was Action 3 in the BEPS project, but the final proposals were very weak. In practice its unilateral adoption is difficult, especially for a country with a high corporate tax rate, due to the risk of relocation or inversion of the group headquarters. This could be counteracted legally, through appropriate residence rules. However, as many have argued, corporate residence is increasingly hard to define. Place of incorporation is obviously ineffective, and place of central management may also be prone to avoidance, since it involves identifying where key central management decisions are taken.

Some opt for a test of shareholder residency combined with a rebuttable presumption for place of incorporation, arguing that this information should be increasingly available 'in a post-FATCA world'.¹⁶

A shift towards RBWT would also be facilitated if a more coordinated approach could be developed, despite the failure to do so in the BEPS project. Adoption of RBWT by both the US and the EU could make the approach effective – although there should be some coordination, which would be hard to achieve. The BRICS countries are now also the home of large MNEs, and could be potential adopters of RBWT. However, in the present climate there seems little appetite for such coordination. The draft Anti-Tax-Avoidance Directive published by the European Commission in January 2016 included common CFC rules, but aimed only at defined types of passive income, and confined to entities in non-European countries with very low tax rates (a threshold of 40 per cent of the home country rate). This has subsequently been further weakened, and a highly attenuated CFC rule was included in the Directive that was adopted in June 2016.

Destination-based Cash Flow Tax (DBCFT)

A Destination-Based Cash Flow Tax has been advocated, especially by some economists.¹⁷ A pure DBCFT is not a tax on profits, but akin to a value added tax (VAT), except that

¹⁵ This has been advocated by a number of US-based commentators, see especially Kleinbard, E. (2011) 'The Lessons of Stateless Income', *Tax Law Review*, available at <http://ssrn.com/paper=1791783>; Kadet, J. (2013) 'Worldwide Tax Reform: Reversing The Race to the Bottom', *Tax Notes International* 69: 1133-6; Fleming Jr., J., Peroni, R. and Shay, S. (2014) 'Formulary Apportionment in the U.S. International Income Tax System: Putting Lipstick on a Pig', *Michigan JI. Intl Law* 36: 1-57; Avi-Yonah, R. (2016) 'Hanging Together: A Multilateral Approach to Taxing Multinationals' in T. Pogge and K. Mehta (eds.), *Global Tax Fairness*, Oxford University Press.

¹⁶ Fleming et al. (op. cit: 22). This refers to the Foreign Account Tax Compliance Act 2010, which required reporting of non-resident recipients of interest payments. The BEPS Action 3 report on CFC rules discusses how to define a CFC, suggesting a combination of legal and economic control tests, but does not address the question of how to define the ultimate parent.

¹⁷ Auerbach, A. and Devereux, M. (2013) *Consumption and Cash-Flow Taxes in an International Setting*, NBER Working Paper No. 19579, <http://www.nber.org/papers/w19579>. It has also been proposed by the Republican majority in the House Ways and Means Committee of the US Congress: see *A Better Way. Blueprint for Tax Reform* (2016), available at <https://waysandmeans.house.gov/taxreform/>

full and immediate deduction is allowed both of labour costs and other cash expenses including investments. Applied on a destination basis it could therefore be regarded as trade distorting, and hence conflict with world trade rules. Nevertheless, from the perspective of international tax rules,¹⁸ this approach has the merit that it is in effect a unitary approach, since internal transfers within a corporate group are ignored, and the tax base is both defined and apportioned in terms of sales to third parties. Allocating the corporate tax base according to the location of final consumers may have economic attractions. Notably, corporations could make investment and employment decisions without being affected by the varying tax rates of the jurisdictions where the investments would be made or workers are employed. On the other hand, it raises concerns about the distributional effects on tax revenue for countries with relatively small consumer markets (discussed further below).

It also raises considerable practical problems. First, it requires identification of the location of customers, which is difficult in the era of electronic commerce. However, some solutions are being developed to enable the effective collection of VAT on cross-border sales in the country of residence of the consumer, by both the EU and the OECD. The report on BEPS Action 1 suggested the possibility of enforcement through intermediaries such as banks. This would require foreign firms to register, and maintain identifiable accounts, payments into which would be taxed. This mechanism could be used either for a sales transaction tax, or for a withholding tax on sales credited against a corporate income tax liability. A stronger

objection is that a high proportion of exports consist of sales of intermediate goods to businesses, and not finished products to final consumers. This could encourage the location of assembly industries, and purchasers of capital goods (such as aircraft leasing companies), in countries with low corporate income tax rates.¹⁹

Another major problem is that, since it apportions income based entirely on sales, the DBCFT brings into sharp relief the problem that taxing rights could be allocated to countries where a company has little or no physical presence. To deal with this a clearing house system has been proposed, modelled on the one-stop-shop being trialled in the EU to enable VAT to move to a destination basis. However, this would entail considerable cooperation among states, in effect a joint system of collection and enforcement of corporate taxes, with a netting out procedure, including an element for the costs of collection.²⁰ In view of the experience to date of attempting to reach agreement between states, this seems to be an extremely ambitious undertaking.

Unitary Taxation with Formulary Apportionment (UTWFA)

Unitary taxation with formulary apportionment is probably the most radical alternative. This has long been advocated by a variety of independent commentators. It would have the enormous advantage of providing a comprehensive approach, not only replacing the complex and subjective transfer pricing and source-of-income rules, but also dispensing with the need for most of the other elaborate anti-avoidance rules, such as anti-hybrid provisions and limitations on deductions. It is not a panacea, however, nor could it be introduced in the short term. Research

¹⁸ Cui, W. (2015: 21-3) *Destination-Based Cash-Flow Taxation: A Critical Appraisal*, available at <http://dx.doi.org/10.2139/ssrn.2614780>

¹⁹ Grubert, H. (2015, 53-58) 'Destination-Based Income Taxes: A Mismatch Made in Heaven?' *Tax Law Review* 69: 43-72, who also compares different versions of the DBCFT with formulary apportionment.

²⁰ Devereux, M. and de la Feria, R. (2014: 21) *Designing and Implementing a Destination-Based Corporate Tax* OUCBT Working Paper 14/07.

is needed on its main elements, especially the definition of the consolidated tax base, and the implications of the choice of factors for the apportionment formula. Some work has recently been published resulting from research supported by ICTD, which particularly aimed to investigate the implications of this approach for developing countries.²¹ There is no space here to evaluate UTWFA in any detail.²² However, a few comments can be made in response to some of the objections that have been made to this approach.

It is often argued that it would be impossible to reach political agreement on the apportionment formula, and that without such agreement there would be an unacceptable level of double taxation. A related argument is that unitary taxation would not end tax competition between states, or tax planning by companies, but shift them onto new ground. However, these overlook the point that, in choosing a suitable formula, states would need to take into account not only the tax revenue it would produce, but also the likely effect on their ability to attract foreign direct investment, which are interacting factors. Since firms would have an incentive to shift labour-intensive activities away from countries that emphasise labour in the apportionment factors, states would need to balance the effects of the formula on tax revenue with those on investment.²³ The incentive effects on both national tax policies and corporate strategies could therefore be mutually supportive, and potentially benign.

Unlike the situation under current international tax rules, these decisions would concern real and not paper activities. This has important implications. It means that this revenue-investment trade-off would create a basis for convergence or agreement between states in the choice of apportionment factors, and that this choice is not a zero-sum game. States with a labour-intensive economy would not necessarily choose a high labour weighting in the apportionment formula, for fear of driving away investment, and discouraging investment to improve productivity. Hence, even in the absence of agreement on the apportionment formula, double taxation is unlikely to result.²⁴

There is perhaps a bigger danger of double non-taxation, unless states can learn from experience – notably in the US, where states have shifted towards a sales weighting, aiming to encourage investment for production and hence increase employment in the state. However, this has ceased to have a significant effect over a longer period, as competitor states adopt similar policies.²⁵ It should also be borne in mind that the DBCFT would allocate the entire tax base to the country of destination of sales. A sales-only formula could still be a concern for developing countries, where much inward investment involves production or extraction for export without significant local sales. However, they are also significant importers of goods, and especially services, from MNEs, often with little or no local value added, so that such activities contribute little or nothing to the tax base under

²¹ Available at <http://www.ictd.ac/index.php/unitary-taxation-of-transnational-corporations-with-special-reference-to-developing-countries>

²² A more detailed presentation is in Picciotto, S. (2016) *Taxing Multinationals as Unitary Firms*, ICTD Working Paper 53.

²³ This point seems to have been overlooked in the otherwise insightful analysis by the IMF policy paper, which states: 'Countries have an incentive under FA to attract whatever factors are given high weight in the formula' (IMF (2014: 41) *Spillovers in International Corporate Taxation*, Washington DC: IMF.

²⁴ See Durst, M. (2015) *The Tax Policy Outlook for Developing Countries: Reflections on International Formulary Apportionment*, ICTD Working Paper 32, who also points out that UTWFA would provide MNEs with a high degree of predictability for planning investments.

²⁵ Clausing, K. (2014) *Lessons for International Tax Reform from the US State Experience under Formulary Apportionment*, ICTD Research Report 2.

current rules. Thus, the net effect of a sales basis for apportionment for them would depend on the balance of exports to imports by MNEs, taking account also of whether MNEs responsible for imports have a taxable presence in the country. These countries should apply the destination basis also to sales of services, provided the services supplier has a significant business presence. Developing countries have been disadvantaged by the shift towards a service economy, due to the difficulty of taxing profits of foreign suppliers of services under current tax rules, even though such a claim to tax can be justified by the importance for services of close relations with clients. On the other hand, they would be justified in applying a source basis for sales of minerals and hydrocarbons, since these are anyway heavily taxed at and after processing in the countries of consumption.

The UTWFA approach would allow for a balanced formula. Principle and experience suggest that it should balance production as well as consumption factors. Some have argued that UTWFA would result in stronger competition to reduce the tax rate, but this would be reduced by inclusion of a sales factor, since firms need to seek out customers regardless of the tax rate in the state of consumption.

Finally, these approaches could be evaluated from the perspective of distributive justice, both between firms and companies. In this connection, Schoueri has recently suggested that 'discussions concerning transfer pricing have moved from fair taxation of a taxpayer within a given community, i.e. the ability-to-pay principle, to the allocation of tax revenues among states'.²⁶ In this light, he asserts that formulary apportionment contravenes the ability-to-pay principle, because 'no attention is paid to the

effective income of a given taxpayer compared to other taxpayers within the same community'. On the contrary, the focus of all unitary taxation approaches is very much on the actual income, and hence ability to pay, of each MNE. It is precisely the insistence on the application of inappropriate comparables under the arm's length principle that has allowed MNEs to achieve effective tax rates far below those of purely national firms, despite their greater ability to pay due to generally higher profitability.

The issue of inter-state equity is more difficult, and goes to the heart of the question of how value is created. It can be suggested that value ultimately derives from labour; on the other hand, production is valueless unless profits can be realised through sales (as Alfred Marshall said, supply and demand are like scissor blades, both are needed for cutting). Some would suggest that capital is also essential, although others would respond that it derives from previous labour through accumulation. Capital could presumably be represented by the inclusion of assets in the formula, but from a practical perspective the valuation of assets is highly imprecise. Overall, it can be argued that distributive justice could be achieved by a formula that balances sales and labour. The key remaining issue would be whether the labour factor would be measured by headcount or payroll (costs of remuneration). A good case can be made for payroll, which can be said to reflect the value created by different types of work, but this would clearly disadvantage poorer countries. A compromise could be effected by weighting the labour factor equally between headcount and payroll.²⁷

The central point is that UTWFA directly addresses the issue of criteria for apportioning the tax base, rather than leaving it to be dealt with ad hoc.

²⁶ Schoueri, L. (2015: 691) 'Arm's Length: Beyond the Guidelines of the OECD', *Bulletin for International Taxation* 69: 690-716.

²⁷ This was the solution of the European Parliament when it approved the proposal for a Common Consolidated Tax Base in 2012: *Report of the Committee on Economic and Monetary Affairs on the proposal for a Council directive on a Common Consolidated Corporate Tax Base (CCCTB)*, A7-0080/201, 28/3/2012. Payroll should also be measured by purchasing power parity to take account of national differences in living costs.

The Current Period of Transition

Regrettably, the BEPS project failed to establish a clear and cogent approach to the central issue of how to allocate the income of MNEs according to their activities and the value added in each country. This was evident in the final reports of October 2015, which left key issues for further work to be done. It was seen most clearly in the report on Action 1, which recognised that digitalisation of the economy means that MNEs have come ‘closer to the economist’s conception of a single firm operating in a co-ordinated fashion to maximise opportunities in a global economy’ (para. 232). Furthermore, it showed that digitalisation undermines the concepts of residence and source on which traditional international tax rules are based (para. 273). It identified some far-reaching possible reforms to deal with these challenges, including a ‘substantial rewrite of the rules for attribution of profits’ (para. 286). However, this will require continuing work over a further five years. At the same time, work is taking place on the profit split method, which may move towards apportionment methodologies, based on value chain analysis.

In the meantime, states are taking steps to protect their tax base. The UK has enacted a Diverted Profits Tax, which aims to dissuade MNEs from using some of the more egregious tax avoidance structures. Australia is already following suit, and similar proposals are being considered in other countries, such as Germany. Developing countries also can and should design suitable strategies to protect source taxation,

such as withholding taxes on interest and fees for services. However, these are blunt measures, as they apply on a gross basis rather than on net profit, and are more easily passed on to consumers.

For the allocation of profits, developing countries need above all a method that is clear, simple and easy to administer. A comparison can be made between the contrasting approaches and experiences of India and Brazil. India adopted transfer pricing rules based on the OECD guidelines in 2001, leading to a total of transfer pricing adjustments estimated at about \$16 billion in seven rounds of transfer pricing audits, and close to \$9 billion in 2007-2008 alone. Not surprisingly there was an explosion of conflicts, and Indian transfer pricing litigation has been estimated to account for 70 per cent of the global total, resulting in an estimated backlog of 3,000 cases before the tribunals in 2012,²⁸ and around double that number today.²⁹ This is clearly a dysfunctional approach, which benefits only tax practitioners. In sharp contrast, Brazil’s system of legislatively fixed transfer pricing margins results in very few disputes, removing the need for expert staff applying subjective judgements, and the scope for corruption. Setting profit margins by broad industry sector is a very broad-brush approach, and the OECD considers the method incompatible with the arm’s length principle.³⁰

Developing countries clearly need a more effective and sustainable approach. With these aims in mind, Michael Durst has put forward a proposal for a modified version of the Transactional Net Margin Method (TNMM).³¹ Durst’s Modified Net Margin Method would

²⁸ Supekar, D. and Dhadphale, A. (2012) ‘Indian Tax Tribunal Establishes Special Benches for Transfer Pricing Cases’, *Worldwide Tax Daily*, 16 October 2012.

²⁹ Personal communication from a senior tax appeal judge.

³⁰ Schoueri (*Arm’s Length*, note 25 above) explains its merits and suggests how it could be modified to be compatible with the OECD model, as a ‘rebuttable fixed margin method’.

³¹ Durst, M. (2016) *Developing Country Revenue Mobilisation: A Proposal to Modify the ‘Transactional Net Margin’ Transfer Pricing Method*, ICTD Working Paper 44.

avoid the need for a detailed audit based on functional analysis and attempting to identify comparable independent firms, by simply establishing a benchmark for the local affiliate's profitability. This would require the local affiliate to earn a profit margin in proportion to that of the corporate group as a whole. The benchmark he suggests is 25 per cent of the group's rate of earnings before tax. This is based on experience of attempting to apply the existing TNMM to a wide range of distributors, manufacturers and service providers, and the fraction is chosen to arrive at a profit allocation that could be acceptable to both the revenue authority and the taxpayer. It would generally prevent the very low requirements of income that under current practice tend to be ascribed to risk-stripped subsidiaries in the course of BEPS planning. The suggested method would require a minimum

level of income, consistent with group-wide profitability, even after all payments to related parties. This would limit base erosion through the use of related-party loans, as well as other deductions such as fees and royalties. Such a provision could be applied as a safe harbour, although to be effective it should not be optional for taxpayers.

Amid all these contending approaches, a clearer lead is needed on the direction of travel. In the absence of a more coherent approach, MNEs will be subjected to increasingly conflicting claims to tax. If these burdens come to outweigh the tax savings from BEPS strategies, MNE senior managers might begin to throw their weight behind effective reform proposals. Expanding participation in the BEPS project to all interested states may help to create a basis for a more balanced and global perspective.

Credits

This ICTD Summary Brief was written by **Sol Picciotto**. Sol Picciotto has taught at the universities of Dar es Salaam (1964–68), Warwick (1968–1992) and Lancaster (1992–2007), where he is now emeritus professor. He is the author of *International Business Taxation* (1992) and *Regulating Global Corporate Capitalism* (2011), several co-authored books, and numerous articles on international economic and business law and regulation, as well as state theory. He is coordinator of the BEPS Monitoring Group and a Senior Fellow of the ICTD with which he has conducted research on international tax.

This is based on the pre-print version of an article published in the *Bulletin for International Taxation* (2016), vol. 70 no. 12. The final copy-edited and formatted version of that article can be accessed here: https://www.ibfd.org/IBFD-Products/Journal-Articles/Bulletin-for-International-Taxation/collections/bit/html/bit_2016_12_int_1.html.

The ICTD is funded with UK aid from the UK Government and by the Norwegian Government; however, the views expressed herein do not necessarily reflect the UK and Norwegian Governments' official policies. Readers are encouraged to quote and reproduce material from the series. In return, ICTD requests due acknowledgment and quotes to be referenced as above.

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