Taxing Multinationals: A New Approach
This paper is based on various reports of the BEPS Monitoring Group (BMG), which are available here. The BMG is a global network of independent researchers on international taxation, sponsored by tax justice organizations, concerned with the effects of tax avoidance by transnational corporations, especially on development. It also draws on the reports of the Independent Commission for the Reform of International Corporate Taxation (ICRICT), available here.

About the Publisher

Public Services International (PSI) is a global trade union federation representing 30 million working women and men who deliver vital public services in 154 countries. PSI champions human rights, advocates for social justice and promotes universal access to quality public services. PSI works with the United Nations system and in partnership with labour, civil society and other organisations.
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The current rules for taxing multinational enterprises (MNEs) are based on principles established nearly one hundred years ago: prior to the internet, the mobile phone, the computing revolution and jet airplanes. Scandals such as Lux leaks and Panama Papers, and the increasingly common reports of corporations like Apple and Google paying very little tax, have exposed the inability of these outdated rules to adequately tax the modern multinational.

They also highlight the key issue of economic globalisation. Given the enormous potential to create global wealth, ordinary people simply do not believe that stagnant economies, rising inequality, declining wages and starved public services are acceptable or inevitable. Fixing the global corporate tax rules is an essential part of an internationalism that would strengthen coordination between states and ensure fairness in the world economy, unlocking a truly competitive dynamic to stimulate sustainable growth.

At the heart of the problem is that the economy has changed dramatically since the international tax principles were established. Underpinning the system is the “arm’s-length principle” - the quaint notion that legal entities controlled by the same multinational will set prices for transactions between themselves as if they were independent market transactions (i.e. at arm’s-length). This legal fiction is the foundation of the current rules, which ignore the economic reality that a multinational operates as a global enterprise, and instead focus on taxing its legal entities in each country on the basis of their own accounts, separate from the others in the corporate group.

This may have been realistic in the 1920s when corporate structures were much simpler and we could police this separate accounting by counting bags of grain on a dock, realistically estimate a market value for them and had some certainty that the best place to grow wheat was in a wheat field.

In contrast the modern multinational exploits intangible inputs such as business services, brands and other intellectual property, and debt financing. Multinationals generate super-profits, or rents, from the synergy of combining activities in many countries, so that the whole is much greater than the sum of its parts.
The value of individual inputs cannot be checked against prices in market transactions between independent entities operating nationally. And unlike the wheat fields, mines or factories of the 1920s multinationals can avoid tax by shifting the ownership of intangible assets and activities such as financial management to tax havens.

The ability of MNEs to create complex corporate structures and manage their internal transfers to their advantage is at the heart of their ability to shift profit into low tax countries. But an MNE is not a collection of independent businesses - it acts as one global company through central coordination of its various activities. MNEs have global brands for consumers and unified consolidated accounts to report profits to investors as a single global company. Yet for tax purposes we continue to uphold the fiction that they are a collection of independent entities operating at arm's-length - and tax each separately.

These rules cannot ensure that MNEs pay a reasonable rate of tax in the countries where their economic activities take place. They create perverse incentives for MNEs to create inefficient complexity in their corporate structures to minimise tax. The asymmetry of information means that the tax office is always at a disadvantage in trying to challenge these arrangements, as the company will always know more about its own business model and sector. The rules also depend on subjective judgement, creating conflict and uncertainty for business.

Critically, digitalised firms are able to take to new extremes the corporate structures that enable tax avoidance under the current principles. Digital platforms such as AirBnB, Amazon and Uber can grow into dominant positions by generating enormous untaxed revenues that accumulate offshore. They are also devastating the brick and mortar economy, undercutting local business owners who pay their taxes, and creating a low-wage economy based on casualisation of work.

The answer is simply to tax each multinational as a single entity – the “unitary principle”. Companies can then structure themselves any way they wish, knowing that they will be taxed on their total global profits by each country according to where they have real activities.
This simple change in paradigm eliminates the ability of companies to shift profits to tax havens. It would benefit everybody except tax avoiders and tax havens. Such rules ensure:

- good corporate tax citizens are not at a competitive disadvantage to those who use the tricks allowed and even encouraged by the current rules;
- local business is no longer put at a competitive disadvantage to foreign companies;
- consumers who pay VAT on everything they buy or workers who pay income tax through PAYE are not left to shoulder higher taxes than necessary;
- public services such as the NHS and schools can be adequately funded.

Our proposed new approach combines principles and pragmatism and will provide results that are fair to both taxpayers and tax authorities, and simplicity and transparency of application.

1. First, a unitary enterprise principle should be adopted, to replace the inappropriate fiction that affiliates of a multinational corporate group are independent of each other.

2. Secondly, the allocation of income and taxes would be based on the fundamental factors that generate profits: labour, capital and sales. This would provide a balance between operational factors (employees, physical assets and users where appropriate) and sales to third-parties (without which profits cannot be realised).

3. Thirdly, tax administrations would pragmatically develop standardised allocation keys and weightings, based on closer analysis of different industries and sectors and commonly-used business models, working cooperatively and in consultation with representative business groups. These keys and weightings would apply as a rebuttable presumption, to allow some flexibility, with a right of appeal to ensure transparency and fairness.

4. Lastly, the allocation keys and methods for their quantification must be objectively measurable and location-specific, using only physical factors reflecting the actual assets, activities, and sales in the countries concerned.

This paper sets out this new approach and argues that the UK can play a leading role in creating a new set of international standards that are fairer, easier to understand, more certain and predictable for business and easier and cheaper to enforce.

WHAT IS NOW REQUIRED IS THE POLITICAL WILL TO FIX THE PROBLEM, AND INTERNATIONAL LEADERSHIP TO ESTABLISH A SYSTEM FIT FOR THE 21ST CENTURY.
INTRODUCTION

There is an unprecedented opportunity over the next 15 months to achieve international consensus on a new approach to taxation of multinational enterprises (MNEs). There is also a real opportunity for the United Kingdom to play a leading role in forging that consensus. This new approach should recalibrate the foundations of international tax rules that were designed almost a century ago but have become increasingly dysfunctional in the last quarter-century. It would help to reduce the tax gap – the gap between the tax that should be paid and what is actually paid – and to ensure a level playing field between multinationals and domestic companies.

We propose that the UK should now take a lead in supporting a new approach based on treating MNEs in line with the economic reality that they operate as unitary enterprises. It would ensure that the taxation of multinational enterprises aligns with where economic activities take place and value is created. This would build on proposals put forward by a number of academics and civil society campaigners, and that have begun to gain increasing support among some governments and international organisations. A political initiative from the UK would help to crystallise an emerging intergovernmental consensus.

The approach advocated here is known as a ‘formula apportionment’ approach: it apportions profits of multinationals based on a formula. Crucially, however, while the broad principles of allocation should be decided by a political agreement on principles of fairness, the details of their definition, quantification and application to specific business sectors would be developed pragmatically, on a bottom-up basis, not as one-size-fits-all.
1. The current state of negotiations

In 2012 an attempt was begun by the OECD countries to reform international tax rules, described as the project on base erosion and profit shifting (BEPS). This was a recognition that the international tax system had become dysfunctional due to the increasingly pervasive use of often artificial structures enabling multinational enterprises to create income that was ‘stateless’, i.e. not taxed anywhere (Kleinbard 2011). The BEPS project was extended to involve leading developing countries in the G20, which gave its support in the St Petersburg Declaration of 2013.

The first phase of the BEPS project concluded in 2015 with a package of recommendations that were extensive, but unfortunately only patched up the existing rules and made them even more complex (Andrus and Collier 2017). Since 2016 participation was extended to all countries willing to accept the minimum commitments, under the umbrella of the Inclusive Framework for BEPS (IF-BEPS). This now has 131 members, so it has a numerical majority of developing and emerging countries, although many lack the resources to participate effectively.

The BEPS project entered a new phase in 2018, for several reasons. First, the US international tax reform of December 2017 made it much easier for the US to coordinate with other countries seeking a more comprehensive and effective approach. Secondly, there has been a proliferation of unilateral measures and proposals which have put pressure on countries reluctant to accept change, and made it more urgent to find a coordinated approach. Thirdly, developing countries have begun to make an impact in the IF-BEPS, leading to a greater recognition that a solution must take account of their viewpoints.

Although this work has been done under BEPS project Action 1, Addressing the Tax Challenges of Digitalisation of the Economy, the proposals have much wider application. It was agreed, based on the reports under BEPS Action 1 produced in 2015 and 2018, that:

(i) digitalisation affects the whole economy, and

(ii) it exacerbates existing problems.
This makes it clear that reforms must be both comprehensive and radical. Nevertheless, some countries still seek to restrict the scope of any changes so that they would affect mainly highly digitalised business models. In July 2018 it was agreed to explore new approaches to both the allocation of income and taxable nexus, on a ‘without prejudice’ basis (meaning that many states had objections and accepted no commitments). A discussion document published in February 2019 was debated in a public consultation in March. Following this, a Work Programme was agreed by the IF-BEPS in May, and published in June. ³

This resulted in a proposal for a ‘unified approach’ prepared by the OECD Secretariat, published on 9 October 2019.

Negotiations are currently taking place at an unprecedented pace, in an attempt to reach a solution by 2020.

The next section will outline the flaws in the current system, and limitations of the BEPS project outputs.

Section 3 will outline the consequences of the failing rules.

Section 4 will explain the new approach that we propose.

Section 5 compares it with other approaches to unitary taxation, as well as with the more limited proposal now put forward by the OECD Secretariat, and discusses how it could be implemented and its likely impact on tax revenues and investment.
2. Flaws in the current system

The BEPS project attempted to patch up some of the main defects in international tax rules. However, it has so far failed to achieve the mandate of the G20 leaders to ensure that MNEs could be taxed ‘where economic activities occur, and value is created’. The only effective way to achieve this is to treat MNEs in accordance with the operational and economic reality that a corporate group under common ownership and control conducts itself as a unitary enterprise.

Unfortunately, international tax rules remain contradictory and incoherent. Their main aim is to prevent ‘double taxation’ of MNEs, to which the BEPS project added the prevention of ‘double non-taxation’, i.e. closing the loopholes enabling some income to be untaxed anywhere. Both these objectives necessarily entail consideration of the profits earned and tax paid by the MNE as a whole.

Despite this, international tax rules have become increasingly based on the unrealistic assumption that the various affiliates of MNEs are independent and deal with each other ‘at arm’s length’. The arm’s length principle (ALP) is a fundamental flaw, since it creates a perverse incentive for MNEs to create tax avoidance structures, in particular by forming intermediary entities in low-tax jurisdictions to own assets or provide services to which high levels of income can be attributed, while the corresponding charges reduce the taxable income of the operating affiliates in high-tax countries. This has led to the creation of complex corporate structures, so that the largest MNEs often have hundreds of affiliates.

Many are located in zero- or low-tax jurisdictions and have few if any employees, yet substantial profits can be attributed to them. A typical structure that became publicised as used by Google and other MNEs to generate ‘stateless income’ was the ‘double Irish Dutch-sandwich’ (Kleinbard 2011, see Diagram next page).

Some of the BEPS project recommendations accepted the need to treat MNEs as single enterprises, notably the system established for country-by-country reporting (CbCR). This was a proposal put forward by tax justice campaigners and included in the G20 mandate to the OECD. The CbCRs will for the first time give tax authorities an overview of each MNE, including data on sales, employees, profits, and tax paid and due in each country. However, the system so far applies only to the largest MNEs (over €750m turnover), and the reports will be filed with each MNE’s home country and shared between tax authorities participating in the system.

This makes it harder for less developed countries to get access to the reports and fails to ensure public scrutiny. A better solution would be to require publication, since these data are not commercially confidential. A similar standard for public reporting has been developed by the Global Reporting Initiative, and many MNEs accept that publication of these reports is inevitable. The Labour Party included a commitment to co-operating internationally to introduce full country-by-country reporting in its manifesto at the 2017 UK elections.
CASE STUDY - UGANDA: TAX HAVENs AND PRIVATISATION UNDERMINE DEVELOPMENT

Explanation: The US Parent (P) transfers intellectual property rights (IP) to a company formed in Ireland but controlled from, and treated under Irish law as resident in, Bermuda (IPH). IPH has a cost-contribution contract with P to finance further development of the IP from its income, justifying the original sale of the IP under US transfer pricing rules. Another company (S) both formed and controlled in Ireland receives large income flows from operating the worldwide business (e.g. selling advertising). However, the net profits of S are low, because it pays large royalties for the IP rights. These are channelled through a Netherlands Conduit company (C), so that no withholding taxes are due on these royalty payments in Ireland. C deducts a small handling charge and pays the bulk of the IP royalty income to IPH in Bermuda. Although customers in countries such as the UK deal with another local affiliate company M, it is treated as providing only marketing or other customer support services, the actual sales contracts are concluded with the Irish sales company. M is paid only a fee for the marketing services. Similarly, research done in the UK is treated as under the control of P, which pays the research affiliate (R) a fee.

Diagram: Stripped Risk Structures and the Double Irish-Dutch Sandwich

Explanation: The US Parent (P) transfers intellectual property rights (IP) to a company formed in Ireland but controlled from, and treated under Irish law as resident in, Bermuda (IPH). IPH has a cost-contribution contract with P to finance further development of the IP from its income, justifying the original sale of the IP under US transfer pricing rules. Another company (S) both formed and controlled in Ireland receives large income flows from operating the worldwide business (e.g. selling advertising). However, the net profits of S are low, because it pays large royalties for the IP rights. These are channelled through a Netherlands Conduit company (C), so that no withholding taxes are due on these royalty payments in Ireland. C deducts a small handling charge and pays the bulk of the IP royalty income to IPH in Bermuda. Although customers in countries such as the UK deal with another local affiliate company M, it is treated as providing only marketing or other customer support services, the actual sales contracts are concluded with the Irish sales company. M is paid only a fee for the marketing services. Similarly, research done in the UK is treated as under the control of P, which pays the research affiliate (R) a fee.
However, the BEPS project did not directly tackle the central issue of principles for the allocation of income of MNEs so that they could be taxed ‘where economic activities occur, and value is created’, as mandated by the G20. Regrettably, the BEPS Action Plan continued to adhere to the arm’s length principle in the work on transfer pricing. Consequently, it resulted only in extensive revision and expansion of the OECD Transfer Pricing Guidelines (TPGs), which has made them even more complex, obscure, subjective and difficult to apply.

It should be noted that most tax avoidance does not concern the mispricing of actual transfers of physical goods between affiliates of an MNE, but transactions involving debt finance, intellectual property and risk. Such transactions between members of the same corporate group are essentially fictitious, as finance, research and development and risk management are all highly centralised within MNEs. Functions relating to these activities can easily be relocated to a convenient jurisdiction, and designing structures to do this is the bedrock of international tax avoidance.

The TPGs require an individual analysis of the facts and circumstances of the MNE to determine the functions performed, assets used, and risks assumed by each of its affiliates, and then to attribute to each of them profits in line with those of comparable independent entities. To apply this ‘functional analysis’, tax authorities need staff with a range of skills, who not only are familiar with the legal and economic techniques needed to interpret and apply the TPGs, but also understand the taxpayer’s business model and industry segment well enough to analyse the documented transfer pricing model, choice of method and selection of comparables.

The approach creates a burden for taxpayers, who must ensure that their transfer pricing policies are properly justified and documented. However, large MNEs can assemble teams of transfer pricing specialists to design structures aimed at tax minimisation, and to produce the necessary documentation. This has created a boom for professional advice, so that transfer pricing has become a principal area of international tax practice, growing ever larger as more countries adopted transfer pricing regulations.

The need to conduct a functional analysis creates a severe information asymmetry, since a company will always know more about its own business and its sector than any outsider, especially tax authorities who have little background in the industry of the MNE and no detailed knowledge of the taxpayer’s operations. Matching the resources available to MNEs is impossible for tax authorities even from developed countries, which are often under-resourced.

For example, in 2014 the US IRS hired a specialist consultant at a cost of $2m to assist its audit team in the examination of the transfer pricing arrangements of Microsoft (Gupta 2014). In the UK, HMRC expanded its transfer pricing specialists from 65 to 81 between 2012 and 2016 (PAC 2016), while in 2018 it reported that 365 full-time-equivalent staff were involved in dealing with ‘international tax risk’ including both transfer pricing and the diverted profits tax, working with ‘other expert industry and tax specialists’ (HMRC 2018). Developing countries of course face an even greater challenge. A high priority should therefore be to devise rules for allocation of income that are simple, clear and easy to administer.
3. Consequences of the failing rules

The failures of the BEPS project resulted in a growth of unilateral measures by states. In particular, in 2016 India introduced an ‘equalisation levy’ on payments to non-residents for digital advertising; this was followed by proposals for similar measures by other states, and in 2018 the European Commission published proposals for both short-term and long-term solutions (EU Commission 2018). The UK introduced a ‘diverted profits tax’ (DPT) in 2015, which was extended in 2016. In 2018 it published proposals for a digital services tax, to be introduced by 2020 unless significant progress is made towards a multilateral approach, and France introduced a similar tax in 2019.

However, these short-term measures are crude palliatives, as they target only a narrow range of business models, apply to gross payments rather than actual profits, and are directly passed on to customers. They also may be challenged as discriminatory against foreign suppliers of services, e.g. under the WTO’s General Agreement on Trade in Services (GATS). The US administration has denounced the French tax as discriminatory, and opened an investigation under s. 301 of its Trade Act, which could lead to retaliatory tariffs.9

The UK government’s policies have been contradictory and incoherent. Far from leading efforts to find a constructive multilateral approach, its actions have been unhelpful and obstructionist. It has introduced unilateral measures, both targeting some foreign companies, particularly the DPT, and giving tax handouts to others, such as the patent box. Yet it has continued to support the arm’s length principle, even though this has clearly been seen to be ineffective, especially against some of the largest MNEs.

For example, Amazon derives its revenues from cloud computing, video streaming, sales of kindles and e-books and own-goods sales, as well as its ‘marketplace’ for third-parties. As was revealed in August 2018, Amazon’s UK subsidiaries in 2017 paid under £5m in tax, although according to its US filings it had some £8.6b in UK sales.10 This is because the UK subsidiaries are treated as providing contractual services to the group, and the sales revenues are attributed to its Luxembourg entity. Although Amazon in 2015 agreed to treat its UK retail sales as booked in the UK by accepting that the Luxembourg company has a UK taxable presence (a ‘permanent establishment’), this entity is also likely to be treated as providing sales support services and hence pay little UK tax. (Since it is a branch, its accounts are not published.) In short, the current rules allow Amazon to attribute its various activities and functions to separate entities and attribute income to them in ways that minimise how much tax it has to pay overall.

This clearly indicates the fundamental flaws of the arm’s length principle, which requires each affiliate of a multinational corporation (MNC) to be treated as if it were independent. This ignores the integrated nature of MNCs, which produces additional profits due to synergy, as the whole is much greater than the sum of its parts. This is clearly shown by Amazon, whose website provides access to a wide range of content and services, which reinforce each other. The company itself clearly recognizes this, since the top executives of its UK affiliates were rewarded with shares in the parent company, which allowed them to participate in its global success.
These payouts are deductible from Amazon’s income, and further reduced the tax payable in the UK: in 2017 for Amazon UK Services the deduction was £17.5m on profits of £72m, and for Web Services a whopping £12m on profits of only £5m, several multiples of the tax collected by HMRC.

Similarly, Google has a UK affiliate with many hundreds of employees engaged in ‘marketing’ of advertising, but sales are attributed to its affiliate in Ireland, resident in Bermuda. Google also has UK affiliates with staff engaged in software engineering, including the artificial intelligence pioneer DeepMind, which it bought in 2014 for £400m. A 6-year investigation of Google by HMRC involved between 10 and 30 specialists at any one time, eventually resulting in a settlement for payment of an additional £130m covering a 10-year period (PAC 2016, paras. 4-6). Even after the DPT came into effect, in 2017 Google announced a pre-tax profit in the UK of only £148m, paying £36.4m in tax on revenues of around £1 billion (Kentish 2017).

These large internet-based companies are far from alone in exploiting these techniques. For example, since its creation in 1997 the beverages giant Diageo, despite being headquartered in London, centred its brand ownership and financial functions in the Netherlands, and downgraded its production entities such as distilleries in Scotland to being ‘contract manufacturers’. Despite the blatant avoidance of hundreds of millions in tax, HMRC accepted the structure (Brooks 2013, ch.5). This type of structure has facilitated the acquisition of other brand-based UK businesses by MNEs, such as Walkers Crisps by Pepsico, and Cadburys by Mondelez. The OECD has now accepted that the BEPS project recommendations so far have not dealt with these so-called ‘stripped-risk’ structures.

Instead of trying to reform the arm’s length principle, the UK has targeted selected MNEs with the DPT. This threat has resulted in a settlement with Diageo for £190m (Stupples 2018). Another giant MNE targeted by the DPT has been Glencore, which built a global mining empire based on commodity trading using tax avoidance structures centred on Switzerland. Transfer pricing rules based on the arm’s length principle have been ineffective against these techniques, but in February 2019 Glencore revealed that it had been hit with a demand from HMRC for $680m under the DPT (Hume 2019), though this will be contested. The DPT is a very blunt weapon, used as a threat by HMRC, creating uncertainty for business. Under this approach the amount of tax paid by these large MNEs is largely subjective, and a matter for negotiation. A better approach is clearly needed based on clear and transparent rules.

The proposed digital services tax would not resolve these problems. It is a narrowly targeted solution, aimed only at digitalised business models that rely on ‘user participation’. It is also impractical and hard to administer. For example, the line between active and passive users is hard to draw and varies between different business models, yet it would need to be applied in some cases to the revenues from a single platform, as some platforms fulfil several functions. The government’s intention seems to be to try to forestall wider proposals that it fears would affect the services sector more generally.
International tax rules were formulated nearly a century ago, and the challenge we now face is therefore also an opportunity: to settle principles fit for the next century. The discussions and negotiations of the past few years, outlined in the previous part, clearly show that we need more than temporary and partial responses to immediate problems. At the same time any realistic prospect for progress will also require pragmatism.

We suggest that what is now required is a combination of:

1. general principles on the aims to be achieved, and
2. a pragmatic approach to develop convergence on detailed methods.

The aim should be to devise a system which would be fair and easy to understand and apply, minimise complexity to reduce the burdens on tax administrations, increase certainty and predictability for business, and avoid costly and time-consuming disputes.

The next sections in this part will outline the principles that we argue should be adopted, and then discuss some of the detailed issues that will need to be examined more closely and collaboratively to ensure their effective implementation.
4.1. THE UNITARY ENTERPRISE PRINCIPLE

A key first step is to state clearly that effective reforms must be based on a holistic approach to MNEs, treating them as unitary firms.

We therefore propose adoption of:

- the unitary enterprise principle: corporate groups under common ownership and control should be treated as unitary enterprises in applying international tax rules.

Explicit adoption of this principle would help to create greater coherence in the international tax system, which at present is bedevilled by inconsistent and contradictory rules.

This would remove the incentive under the current rules for MNEs to create complex structures aiming to minimise tax by fragmenting their functions and assigning key activities such as management of risk, finance, and R&D to low-taxed entities. Attempting to treat affiliates as if they were independent is an inappropriate and insecure foundation for assessing and allocating MNE profits.

MNEs report a single set of consolidated group accounts to their shareholders, and tax authorities should also start from their consolidated global profits. The issue is how those profits should be allocated among the countries where they have business activities. Attempting to attribute an appropriate level of profit to each affiliate in isolation is the wrong starting-point.

Ending the independent entity presumption would go a long way to deal with the taxable presence problem, since in practice large MNEs, even if they are highly digitalised, do have affiliates in jurisdictions where they have a substantial market presence. An online marketplace with a large customer base (e.g., Amazon) will have order fulfilment and delivery capability in countries where it has a significant customer base. Even social media platforms and search engines (e.g., Facebook, Google), which generally monetise their user base through targeted advertising, will often have local offices or send personnel to deal with their advertising customers. However, a long-run solution would require revision of tax treaty rules to extend the definition of a PE, along the lines of the current proposals for a significant economic presence put forward by India and the European Commission, and under consideration in the BEPS project.

Both assessment and collection of tax should treat MNEs as unitary firms. Some countries are already applying this principle to enforce the short-term measures they have adopted due to the limitations of the BEPS reforms so far. For example, the UK’s DPT has been extended to apply to profits shifted out of the UK even if this is due to arrangements between entities neither of which are resident in the UK. Since it is difficult to collect tax directly from non-resident entities, the UK has based enforcement on the principle of ‘joint and several liability’, so that any member of a corporate group can be responsible for tax due from any other member. This concept is also part of the current UK proposal for a digital services tax.
4.2 PRINCIPLES FOR ALLOCATION OF INCOME

The goal that MNEs should be taxed ‘where activities occur, and value is created’ clearly intends that tax rights should be aligned with the real economic activity taking place in the country concerned.

However, the concept of ‘value’ creates difficulties, because

• (i) it is subject to various interpretations,
• (ii) it is hard to quantify and
• (iii) ‘value-creation’ is not easily attributable to activities taking place in a specific location.

An overriding need is to devise allocation methods that are clear, simple and easy to apply, and hence reduce compliance costs and increase business certainty and predictability. This now seems widely accepted, and the recently published 2019 OECD Secretariat paper at various points refers to the use of ‘formula-based solutions’ (para. 15), ‘formula-based calculations’ (para. 45) and ‘a simplified approach … through the application of fixed percentages’ (para. 54).

The February 2019 OECD discussion paper rightly pointed to the need to make ‘policy trade-offs between the search for precision – e.g. through the use of detailed and factual determinations – and the need for certainty and predictability e.g. through the use of simplified methods’ (para. 70).

An apportionment approach could build on existing accepted methods, in particular the profit split method, as recognised in the February discussion paper (e.g. paras. 24, 47, 56). However, it is neither necessary nor appropriate to use the ‘residual’ profit split method, on which the OECD Secretariat’s proposal is based (see section 5.2 below).

This entails a two-step process, with attribution of a ‘routine’ profit using existing methods, and apportionment only of the ‘residual’ profits. This would retain most of the disadvantages of the current approach. It would be far better to apply the profit split method based on a contribution analysis, which is recognised in the TPGs.

Provided that suitable allocation keys are chosen, they can adequately reflect the relative contributions of the various entities, without the need for a subjective judgement as to whether an entity performs only ‘routine’ functions.
A BASIC PRINCIPLE FOR ALLOCATION SHOULD BE THAT:

- apportionment factors must be objectively measurable and location-specific, reflecting the actual performance of the activity in the country concerned.

A long-lasting solution should establish principles at a general level that are valid for all business models. These can be supplemented by a pragmatic approach to develop more concrete definitions, quantifications and weightings for common business models.

At the general level it can be said that profits are generated by the following combination of factors:

1. labour – the firm’s employees,
2. capital – the firm’s assets, and
3. sales – essential to the realisation of profit.

Allocation of income and tax using these factors would provide a balance between factors of production (people and capital) and consumption (sales). In other words, the apportionment would use evidence about a multinational’s labour, capital, and sales base in a country such as the United Kingdom in order to derive the tax owed. Such a balance is fairer, and more legitimate than for example using a single factor such as sales, which has sometimes been advocated (e.g. Avi-Yonah and Clausing 2019).

In selecting allocation factors, it is important to bear in mind their effects not only on tax revenue but also on investment decisions by MNEs (the ‘dynamic effects’, see de Mooij et al 2019, p.26). The tax policies of countries aim not just at raising revenues but also at encouraging investment, especially to create jobs. Countries with large workforces may be tempted to favour the labour factor in order to maximise tax revenues, but this would act as a disincentive to inward investment and job-creation. The sales factor encourages investment especially in production for export, and hence it acts as a brake on the competition to attract investment by reducing tax rates or other incentives. Thus, if countries take into account both tax and investment considerations, there could be agreement on this balanced mix of allocation factors. What is needed is a principled approach looking to the long-term implications, not narrow and short-term calculations by governments or companies of the possible distributional effects.

Overall, there should be gains for all countries, except for the most egregious tax havens, from both ending tax avoidance and reducing compliance costs. Most MNEs should also win by being allowed cross-border deduction of losses, which would be automatic if profits were apportioned.

The implementation of this new approach could take place pragmatically and by international agreement, by developing more detailed methodologies for the definition, quantification and weighting of the allocation factors. Standardised, concrete allocation keys and
Weightings could be developed for common business models within significant industries/sectors. These standardised keys and weightings would be applied unless a taxpayer could prove that alternative keys and weightings or some other allocation or inter-company pricing approach is more appropriate. Special consideration needs to be given for important and distinctive business sectors, notably extractive industries and financial services and banking (see de Mooij et al 2019, p.8).

However, the detailed methodologies should adhere to the general principles, especially that the allocation factors should be physical, easily quantifiable and location-specific. Thus, the capital factor should include only physical assets, and not intangibles such as intellectual property rights (IPRs). The mere ownership of IPRs can be located anywhere; if the rights themselves were to be linked to a geographical location, it should be in the country where they are given protection, which grants the monopoly rights that produce the super-profits or rents. IPRs also result from the extensive investments in R&D made by MNEs, which can be recognised through the production factors: people and physical assets.

In fact, the OECD TPGs, especially after the revisions made in the BEPS project, make it clear that no significant value should be attached to the mere ownership of intangibles. What is important is the ‘practical capacity’ of affiliates in each jurisdiction, reflected by the performance of ‘significant people functions’ involved in the activities of development, enhancement, maintenance, protection or exploitation of the intangible (the DEMPE functions, see TPGs 2017 para.6.54).

Hence, the value contributed by intangibles should be reflected in the remuneration costs of the employees engaged in the DEMPE functions. In the case of marketing intangibles, which have been suggested as a profit allocation factor by the US and in the OECD discussion paper, a combination of employee contributions to DEM-PE functions and sales should be a fair way to reflect the various contributions to their value.

Similarly, user contributions are argued by the first proposal outlined in the OECD discussion paper to be important for many digitalised business models. As the paper points out (para.59), user contributions in some respects resemble marketing intangibles, so their value could be regarded as reflected in sales. However, it is also pointed out that users are not always located in the same jurisdiction as sales, and that perhaps an active user base should itself be considered as creating value. Where users contribute content, their input may be regarded as unremunerated labour, although as the discussion paper points out users obtain access to the platform in exchange for contributing content. It can also be argued that a user base is more appropriately considered to be an asset.

Thus, some businesses such as social media platforms aim in their early years to create a large user base rather than generate quick profits, which equates to investing in assets that could produce future income. This expansion is reflected in an increase in the company’s share price, which benefits its shareholders (including those employees who are rewarded by equity participations), suggesting that a user base is essentially an asset.

Similarly, an acquisition of an unquoted company would typically take account of a user base in the valuation. Unlike intellectual property rights, users are location-specific, so they may be treated as assets located in the country where they are based. In our suggested pragmatic approach, a methodology could be developed to define and quantify the value of a user base, and to include this for appropriate business models, we suggest as part of the asset factor.
5. Charting the way forward

5.1. THE NEW PHASE OF THE BEPS PROJECT

Overall, the BEPS project outputs in 2015 produced only a patch-up of existing rules. There were several interrelated reasons for the limited progress:

- i) the negotiations had to reach consensus among some 44 states (OECD members plus the other G20 states), within a very short timescale of 30 months;

- (ii) the initial BEPS Action Plan was largely a compilation of pre-existing ideas and initiatives and included assurances that the arm’s-length principle would not be reconsidered as well as proposals that could ‘go beyond’ it;

- (iii) participation by the USA was key because the US system had become misaligned, with a very high nominal tax rate coupled with very low effective rates on non-US income; but US negotiators could not accept any proposals that would require primary legislation, since they represented a Democrat administration while the Congress had a Republican majority;

- (iv) other OECD countries also adopted positions defending their own existing approaches.

The failures were most evident in relation to Action 1 of the BEPS project, which was the main issue that had led to its initiation, the digital economy. The Action 1 report of 2015 produced only an analysis of the problem, and the OECD requested a further five years to come up with solutions. The reasons for the failure were evident from the analysis in the report, which clearly explained that:

(i) digitalisation is part of wider changes affecting the whole economy, and

(ii) these changes have exacerbated the problems caused by existing tax rules.

Hence, it was accepted that addressing the tax challenges of digitalisation requires a comprehensive reform of the existing rules. The continuing political pressures resulting from public dissatisfaction with these failures resulted in the current efforts, outlined in Section 1 above, sometimes described as BEPS 2.0.
The UK bears particular responsibility for the failure of the BEPS process. The UK’s published negotiating position explicitly stated that it would defend measures it considered important to attracting investment such as the ‘patent box’ and the revised rules on controlled foreign corporations (UK 2014 para. 1.14), both introduced in 2012 to attract MNEs, and both subsequently found harmful.\textsuperscript{12}

Indeed, while the project was still under way, the UK unilaterally introduced the diverted profits tax (DPT), a move suggesting that the government did not expect the BEPS project to produce measures that could stem the losses from international tax avoidance.

The UK now has an opportunity to redeem its previous negativity by helping to formulate a genuinely international solution based on the unitary approach we have outlined. A step towards this has been taken by the G24 group of developing countries, which have outlined a proposal for ‘fractional apportionment’ (G24 2019). The government of India has also issued a discussion draft for changes to its domestic rules moving in this direction (India 2019). The European Commission’s proposal for a long-term solution (EU Commission 2018) takes a similar approach. An initiative by the UK could make a significant contribution to a broad alignment around an effective and comprehensive reform.
5.2 DESIGNING A UNITARY APPROACH

Several methods have been put forward that also adopt a unitary approach to MNE taxation (Picciotto 2017). Three main methods were evaluated by the Independent Commission for the Reform of International Corporate Taxation (ICRICT): a destination-based cash-flow tax (DBCFT), residence-based worldwide taxation (RBWT), and unitary taxation with formulary apportionment. It concluded that the third option was clearly the best (ICRICT 2018), and we agree with this evaluation.

The DBCFT was hotly debated in the US in 2017 (Shaviro 2018). It would allocate an MNE’s income (and therefore tax) according to where it has sales to final customers. Allocation by sales does have some advantages. First, customers are relatively immobile -- but so are physical assets, and labour forces. However, a sales-based allocation would reduce the temptation for governments to offer tax incentives for investments they think will create jobs. A major disadvantage is that the DBCFT would be regarded as an export subsidy and hence contrary to international trade rules, and it would have highly disruptive effects on currency exchange rates. Mainly for these reasons, the proposal was abandoned in the US.

RBWT would extend current rules on controlled foreign corporations by treating the income of all an MNE’s foreign affiliates as taxable by the home jurisdiction of the ultimate parent, subject to a credit for foreign taxes paid. This would act as a disincentive for host countries to offer incentives to foreign-owned companies, but its effectiveness would depend on the home country’s tax policies. MNEs could create pressure on these by threatening to relocate, which is relatively easy. However, this approach is an element of the global anti-base-erosion tax which is currently being formulated in the OECD work programme on BEPS.

The formula apportionment approach is now gaining momentum in international discussions. This is reflected in the proposals put forward by India and the G24 developing countries, for fractional apportionment (G24 2019). They argue that the fairest way to allocate profits is by balancing factors reflecting both supply (assets, employees, users) and demand (sales). This proposal was put forward in relation to attribution of income to the new concept of significant economic presence, and India is also proposing to adopt the method unilaterally. However, it would be preferable if the approach were adopted as a more general one, and applied to global consolidated profits.

The current negotiations are attempting to find a compromise, by focusing on a hybrid approach, based on residual profit allocation (RPA). This entails distinguishing between the MNE’s ‘routine’ profits, which would continue to be attributed using current transfer pricing rules, and the ‘residual’ profits that would be apportioned by a factor, usually related to sales. The determination of the residual profits can be done in two ways: top-down, by starting from the global consolidated profits of the MNE, or bottom-up, by first attributing the ‘routine’ profits to individual affiliates (using existing transfer pricing rules) and treating the remainder as the residual (Devereux et al. 2019, p.4).

Hence, this combines formulary apportionment of the residual while retaining the current arm’s length principle to attribute the routine profits (IMF 2019, p.36).
Most proposals so far have assumed a bottom-up approach, but the OECD secretariat has formulated a blueprint for a top-down method, published on 9th October 2019. This has the merit that it would take a unitary approach to MNEs, starting from global profits, and therefore the OECD will undertake technical work on how to adjust consolidated financial accounts to something more suitable for tax purposes.

However, the hybrid approach has major drawbacks, as already alluded to. Firstly, there is no rationale for separating ‘residual’ from ‘routine’ profits, and the attempt to do so rests on a fundamental flaw. Large MNEs generate extraordinary profits that are in effect rents, resulting from the synergy due to the combination of their activities and market presence in many countries. It is not appropriate to distinguish between routine and residual profits, especially based on financial account information on categories of expenses. It seems that the method for determining residual profits would be a primarily political decision, based on imperfect or even speculative estimates of outcomes. This does not provide a basis for a solution that can be seen as fair and accepted as legitimate, or provide a sustainable foundation for MNE taxation.

Secondly, the approach would entail attempting to apply two inconsistent approaches: the identification and allocation of the ‘residual’ profits of a group as a whole, while attributing ‘routine’ profits to its various affiliates treated as if they were independent entities, using existing transfer pricing rules. These rules are based on the arm’s length principle, which is conceptually unsound and in practice highly complex and difficult to apply, especially for developing countries.

The proposals now put forward by the OECD secretariat for consultation are based on this hybrid approach, so they also embody these basic flaws. In addition, they have some further major limitations.

First, they propose a ‘new taxing right’, which will be overlaid on existing rules. The new right would apply only to businesses within its scope, so leaving the existing unsatisfactory rules to apply to all others. This scope will be significantly reduced by limiting it to ‘consumer-facing’ businesses, and also to only the largest TNCs. Hence, it will not apply to a large number of MNEs, for which the existing rules on allocation of income would be unchanged. Indeed, for MNEs which have different types of customers, the new right would apply only to those parts of their business which are consumer-oriented, requiring segmentation of their accounts. This would apply for example to Amazon, which has a highly profitable cloud-computing business, as well as the more familiar consumer-delivery services, which have much lower margins.

Hence, tax authorities would be left trying to apply the existing unsuitable transfer pricing rules for large parts of their economy, in parallel to the new taxing right. The resulting system would be both complex and incoherent. Developing countries in particular have stressed the need for the new rules to ensure that the system can be simpler and capable of efficient administration. Adding a new layer to the existing rules clearly does not achieve this aim.

Secondly, introduction of the new right will require changes to tax treaty rules. Many countries will undoubtedly resist changes to their treaties. This would create big loopholes in the tax treaty network, making the new right largely ineffective, and would in any case take
years to implement. It seems clear that this highly unsatisfactory compromise is due to a deadlock between governments that see the need for radical change, and those doggedly defending the current broken system.

The proposal does not offer a convincing route past this deadlock, as countries are likely to prefer their own unilateral measures to the uncertain possibility of introducing a flawed alternative.

What is now needed is a firm declaration that the aim should be taxation of MNEs as single firms, and a statement of the broad principles for allocation, based on a balance of supply-side and demand-side factors, as outlined in section 4. While many international tax researchers and practitioners accept that formula apportionment would be an optimal solution, they point to the difficulty of reaching agreement on the formula to be applied. This assumes that there would be a single formula, to be decided top-down. Our approach is different, as it combines principles and pragmatism. There are two strong reasons why we think political agreement could be reached on this.

Firstly, an allocation which balances these factors is more likely to be acceptable as fair and workable in the long run. A broad principle needs to be able to stand the test of time. Formulation of the principles can be followed by more detailed work on how to define, measure and quantify the factors used for apportionment, and their appropriate weighting. This can be done pragmatically, on a bottom-up basis, by tax authorities working cooperatively, and in conjunction with industry associations.

Secondly, in evaluating the allocation keys, countries need to take account of the likely effects not only on the allocation of tax revenues but also on investment. Countries with large labour forces such as China might gain tax revenues from a formula with a high weighting for workers, especially if based on headcount rather than payroll costs. However, this would create an incentive for MNEs to invest in improving labour productivity elsewhere.

A pragmatic approach is important because of some significant differences between industry sectors. For example, in financial services the capital structures are distinctive (and highly regulated), and the measurement of revenues would also need to be adapted. The extractive industries are also distinctive, as it is generally accepted that the bulk of profits of raw materials should be attributed to the countries of extraction, as they constitute rents. These are also highly capital-intensive industries. As already mentioned above, in many digitalised models the contributions of users are considered to be valuable, and methods need to be agreed to quantify and weight them.

Pragmatism is also important in recognising that no system can be perfect. Tax rules should be designed to establish a clear and predictable basis for enterprises to take decisions based on business considerations. The current rules based on the arm's length principle encourages the creation of artificial structures to attribute substantial income to entities with few employees and bare ownership of formal legal rights to intangibles. Under our proposed system business decisions might still be influenced by tax considerations. However, the allocation of income would depend on the location of real and quantifiable factors which have a clear and fixed location: workers, physical assets, users and customers. There would still be problems of definition and interpretation of the rules, and attempts to avoid or evade them. Some firms may switch to using contractors instead of employees, as already occurs, but this can be dealt with by properly designed rules. The valuation of assets poses some difficult problems, but least-bad solutions can be found.
It is clearly important to cooperate with other countries and move forward together as far as possible. The current negotiations provide an unprecedented opportunity for broad agreement on a new approach along the lines we have proposed. Similar concepts have been put forward by India and the G24 developing countries, as well as the European Commission. The UK could make a powerful intervention by tabling a clear and well-designed proposal.

Nevertheless, it would be naïve to expect a rapid global consensus. Ways should and can be found for countries to take a lead individually and in a concerted manner. Each country can consider its own position, while designing and adopting measures that lead towards and contribute to the multilateral approach we have outlined. This would be far more constructive than the unilateral measures adopted so far by the UK, which are one-sided, and fail to pave the way towards an international approach.

India has already taken such an initiative. It has amended its domestic legislation to create a new taxable threshold suitable for digitalised MNEs, and tabled further proposals for new rules for allocation of profits based on fractional apportionment. These are carefully designed to be compatible with its tax treaty provisions. The US international tax reforms of 2017 were also designed to align more closely to a cohesive international approach. While reducing the corporate tax rate to 21%, they included anti-avoidance measures aiming to ensure equality between MNEs and domestic firms. Indeed, the concept behind the new US anti-base-erosion tax (the GILTI) has been used in a proposal originating with Germany and France and now being pursued through the OECD, for a global minimum tax on MNEs.

One criticism of a unitary approach is that it would fall foul of current double taxation treaties. However the unitary enterprise principle could be applied in ways that could be regarded as compatible with existing tax treaty rules. The basic rule in article 9 of tax treaties allows adjustment of the accounts of affiliates of an MNE to ensure that their profits are in line with those of independent enterprises. This does not, as is sometimes supposed, require that each affiliate should be assessed in isolation. On the contrary, the rule was always aimed at ensuring a fair and reasonable allocation of the worldwide income of the MNE as a whole.

Indeed, there is increasing evidence that the arm’s length principle, as interpreted in the TPGs, fails to attribute profits to MNE affiliates similar to those of independent enterprises. A recently published paper (Bilicka 2019) based on analysis of data from HMRC of actual corporate tax returns 2000-2014 found that the ratio of taxable profits to total assets reported by foreign MNE subsidiaries was half that of comparable domestic independent companies. This is a significantly greater difference than shown by previous studies, which have used data from published financial accounts. Thus, it is fully justified - even necessary - to remove any requirement in domestic tax rules to attribute income separately to MNE affiliates and only by adjusting the prices of transactions between them.

Furthermore, many existing rules rest on
a unitary approach, such as those on controlled foreign corporations (CFCs), the group ratio principle for interest deductibility and, in particular, the system for country-by-country reporting now being applied globally. In the longer run the treaty text should be revised by agreement to state the unitary principle more clearly. In the meantime, however, it is important to set the system on a new path of reforms, and introduce measures that can be considered as compatible with existing treaty obligations, even if they would require changes to non-binding international soft law, and to national law.

It would be compatible with existing tax treaty rules to introduce a rebuttable presumption that allocation of income of corporate groups under common ownership and control should be done by an apportionment methodology. This could build on the ‘profit-split method’ already accepted in the existing TPGs (Kadet et al 2018). Indeed, this approach has been put forward by the European Commission in 2018 in its proposed reforms of EU corporate tax rules for the digital economy (EU Commission 2018, article 5 para. 6). Furthermore, ‘fractional apportionment’ is still permitted for attribution of profits to PEs under article 7(4) in the vast majority of actual tax treaties. This could provide many countries with a ready-made legal basis to use a fractional apportionment method, as has been pointed out in the OECD 2019 discussion paper (para. 52), and the Indian Government discussion document.

Nevertheless, the adoption of formula apportionment as the primary method would require a radical overhaul of the current TPGs. However, this could take place relatively easily, as the TPGs have the status only of international ‘soft law’, as guidance for the interpretation of the treaty texts. Although they are only ‘guidelines’ they have become increasingly complex and convoluted, resulting in a text that is biblical in size and style. What is needed is a fresh start on a clean slate.

An initiative by the UK should begin by overhauling its domestic legislation, to remodel it on unitary taxation principles. This should be done in parallel with the international discussions and negotiations for reform of the international rules. Showing a determination to take active steps would encourage others to adopt similar and converging measures. This would be far more constructive than designing beggar-thy-neighbour tax breaks to try to attract MNEs.
Adoption of the approach we propose would have multiple benefits. Firstly, it would increase corporate tax revenues in all states except tax havens.\textsuperscript{14}

The extent of this increase depends on the factors used for apportionment, but all relevant countries would benefit from a formula that balances production factors (especially employment) and consumption (sales). It is not possible to provide any more than broad estimates, because of the limitations of data sources, and the difficulty of determining the dynamic effects due to the impact on MNEs’ future decisions especially on investment location. However, a recent study for the IMF estimates the overall increase in global tax revenues as between 3\% and 14\%.\textsuperscript{15}

It also shows that all countries would benefit, apart from those it describes as ‘investment hubs’, i.e. tax havens. Another recent study, although based on only one data source, broadly confirms these estimates, based on a formula balancing sales and employment.\textsuperscript{16}

This study suggests an increase of 13.8\% in tax paid to the UK if a 2-factor formula (labour and sales) were used, based on data from US multinationals with over $750m turnover.\textsuperscript{17} This would mean about $3.96bn (roughly £3bn) extra tax from these large US MNEs alone. Since US MNEs account for some 22\% of the UK’s total stock of foreign direct investment, an extrapolation of the additional revenue from all MNEs of around $18bn (£14bn) could be obtained. More conservatively, assuming only that the UK operations of all non-US multinationals are about the same size as those of US multinationals, the projected additional revenues would be around £6bn, an increase of around 10\% in total UK corporate tax revenues. By comparison, the IMF study using a 3-factor formula and applied to a broader dataset of US multinationals finds an increase of UK corporate tax paid of 30.2\% (de Mooij et al 2019, p.33), around twice the size. These studies use different methodologies and data sources, and can only provide broad estimates, but our suggestion of £6 billion seems realistic. Revenues could be even higher under a Labour Government, given the Labour Party’s proposal to increase corporation tax. All of these revenue estimates make no allowance for behavioural response.\textsuperscript{18}
Even countries which today are to some extent tax havens would lose only in the short-run, as the new approach would encourage investment in activities that are genuinely local, and rebalance their tax base towards factors reflecting such activities.

Secondly, the new approach would create greater competitive equality between MNEs and domestic firms. For example, bookshops could compete more equally with Amazon, taxi drivers with Uber, and small hotels with the large chains and with Airbnb. There is considerable and growing evidence that the dysfunctional nature of current rules has created a great disparity in the tax paid by large MNEs and small and medium domestic enterprises. The study mentioned in section 5.3 above, using actual HMRC tax return data, estimates that the effective tax rate on foreign MNE subsidiaries was half that of comparable domestic independent companies.

Much of this is apparently due to the large number of MNE affiliates declaring zero taxable profits in the UK (although their accounting reports tell a different story).¹⁹

Thirdly, the improvement in revenues could be achieved much more efficiently than under the current system. The arm’s length principle entails enormous administrative resources, since it essentially requires a detailed individual audit of all MNEs, while failing to ensure fair taxation. The unilateral measures introduced so far to staunch these losses have recouped some revenue, but greater amounts have been disbursed in corporate tax giveaways, and these ad hoc stop-gap measures have required considerable additional staff resources.²⁰

HMRC can ill afford to devote large resources of skilled staff to administering defective rules while it is being continually pressurised into trying to do more with less staff.

Fourthly, most MNEs would themselves benefit from the new approach, since it would provide greater predictability and certainty. It would also greatly reduce their compliance costs, although this would mean significant reductions in the legions of international tax and transfer pricing advisers they employ, mostly in the Big Four and other specialist consultancy firms. Furthermore, MNEs would gain substantially from being able to consolidate losses.²¹

Above all, taxing MNEs on the basis of rules which are clearer, fairer and more transparent would greatly improve the morale of all taxpayers, and ensure a much healthier climate for investment and jobs.
At the heart of the problem are rules written nearly a hundred years ago, no longer suitable for the modern economy and based on a fiction that related companies will trade with each other as if they were independent entities. The result is unnecessary complexity, uncertainty and unfair outcomes that benefit only tax avoiders and tax havens - undermining the ability of states in the world community to tackle crippling social problems, and creating economic inefficiency.

Recent attempts to fix the system deal with the symptoms and not the causes. The attempts to tackle these fundamental problems by ignoring the flaws at the heart of the system and instead further papering over them with patch-up remedies are making the system more complex and ineffective.

The failure to develop more fundamental reforms is politically unsustainable, and public pressure has been building for some time. Individual countries, starved of tax revenue, and under increasing political pressure, are now adding even more layers of inconsistent complexity on an already failing system. The digital economy is magnifying the contradictions and laying bare the failures for all to see. Continued failure to address the fundamental design flaws are increasingly resulting in poorly designed ad hoc measures that add to international diplomatic tensions at a time when international co-operation is desperately needed.

This paper outlines the way forward. It identifies the key flaws in the current system – flaws which are shockingly simple to spot.

A shift to a new model suitable for the twenty first century requires agreement on the correct principles, and then an inclusive process to refine the detail. This paper outlines those principles and sets out that process.
Our proposed new approach combines principles and pragmatism and will provide results that are fair to both taxpayers and tax authorities, and simplicity and transparency of application.

- First, a unitary enterprise principle should be adopted, to replace the inappropriate fiction that affiliates of a multinational corporate group are independent of each other.

- Secondly, the allocation of income and taxes would be based on the fundamental factors that generate profits: labour, capital and sales. This would provide a balance between operational factors (employees, physical assets and users where appropriate) and sales to third-parties (without which profits cannot be realised).

- Thirdly, tax administrations would pragmatically develop standardised allocation keys and weightings, based on closer analysis of different industries and sectors and commonly-used business models, working cooperatively and in consultation with representative business groups. These keys and weightings would apply as a rebuttable presumption, to allow some flexibility, with a right of appeal to ensure transparency and fairness.

- Lastly, the allocation keys and methods for their quantification must be objectively measurable and location-specific, using only physical factors reflecting the actual assets, activities, and sales in the countries concerned.

WHAT IS NOW REQUIRED IS THE POLITICAL WILL.

Countries have already begun implementing unilateral measures. Some are advocating a rethinking of the underlying principles. What is now sorely needed is international political leadership from a large developed-economy country committed to international co-operation to lead a process away from the current quagmire.

The UK is uniquely placed to lead the process and in doing so ensure the funding required to rebuild its quality public services, tackle inequality and rebuild its reputation as a nation committed to creating the global conditions necessary for economically sustainable growth.
THE FOLLOWING INFOGRAPHICS ARE DESIGNED TO GIVE A SIMPLE OVERVIEW OF HOW NEW GLOBAL TAX RULES, INCLUDING UNITARY TAXATION, WOULD BENEFIT BOTH PRODUCING AND CONSUMING NATIONS, COMPARED WITH THE CURRENT GLOBAL TAX REGIME.

For reasons of simplicity this example uses transfer mispricing (the manipulation of prices paid for goods and services between related parties) as the means of shifting profits to tax havens. In the modern economy the methods more likely to be used involve placing intangibles in the tax haven such as intellectual property, debt finance or risk. The company would then charge itself for these services to shift the profits to the tax haven.
Scenario 1: Old Economy, Old Tax Rules

Simplified operations of Widget Global Corporation

The Widget Global Corporation makes widgets via a subsidiary Company in Country A then sells them to a subsidiary Company in Country B. Company B then sells the widgets on to consumers in Country B. Profits are declared and taxed in the country they are made. Hunky-dory.

Country A
Tax Rate - 30%

Widget Company A Production
500 Workers
Major Factory

Total costs: $100 m
Widget Sales: $110m
---------------------
Total Profit: $10m

TAX PAID
$3m

Widgets sold for $110m

Country B
Tax Rate - 20%

Widget Company B Sales
100 workers
50 shops

Buys Widgets: $110 m
Other costs: $20m
Widget Sales: $150m
---------------------
Total Profit: $20m

TAX PAID
$4m

$7m after-tax profit used for:
- Local investment
- Local jobs
- Local wages

Tax paid Country A = $3 million
Tax paid Country B = $4 million
---------------------
Global Tax Paid = $7 million

$16m after-tax profit used for:
- Local investment
- Local jobs
- Local wages
Scenario 2: New Economy, Old Tax Rules

Simplified operations of Widget Global Corporation

The Widget Corporation opens a new Shell Company in a tax haven and shifts all its profits offshore, massively reducing tax revenue for Countries A and B.

Country A
Corporate Tax: 30%

- Total costs: $100 m
- Widget Sales: $100m
- Total Profit: $0m

TAX PAID $0m

$0m after-tax profit:
- Lower investment
- Fewer jobs
- Lower wages

Country B
Corporate Tax: 20%

- Buys Widgets from A: $100m
- Sells widgets to B: $130m
- Total Profit: $30m

OST PAID $0.6m

$30m offshore profit:
- Increased inequality
- Increased corporate wealth
- Increased luxury yachts

TAX PAID $0m

$0m after-tax profit:
- Lower investment
- Fewer jobs
- Lower wages

Offshore Country
Corporate Tax: 2%

- Widget Shell Company
  - 3 staff, 1 Post Box
  - Widgets sold for $130m
  - TAX PAID $0.6m

Tax lost Country A = $3 million
Tax lost Country B = $4 million
Tax gained Offshore = $0.6 million

Global Tax revenue lost (compared to Scenario 1):
$6.4 million loss
Scenario 3: New Economy, New Tax Rules

Simplified operations of Widget Global Corporation under a Unitary Taxation Model

The Widget Company is really just one global company, with a global brand, global accounts and global shareholders. Under a Unitary Tax System, all of The Widget Corporation subsidiaries will be considered part of the same global business, and taxed as a single entity.

Under these rules, the tax outcomes are simple, fair and predictable, saving millions in compliance costs for corporations and governments. It doesn’t matter how complex a Corporate structure is (or how many shell companies exist): they will be taxed on the same, global profit. This is great for the economy as, instead of restructuring to dodge taxes, companies structure themselves in the most productive way.

But where are the profits reported – and which country gets the tax revenue?
How Unitary Taxation would allocate the Widget Corporation’s $30m global profits

In line with the OECD principles, Unitary Taxation allocates taxing rights to where economic activity takes place.

This requires a formula based-on key business and production factors:

<table>
<thead>
<tr>
<th>Employees</th>
<th>Country A</th>
<th>Country B</th>
<th>Offshore</th>
<th>Profit allocation</th>
<th>Profit allocation from $30m:</th>
<th>Country tax-rate:</th>
<th>Tax collected by country:</th>
</tr>
</thead>
<tbody>
<tr>
<td>500 (83%)</td>
<td>100 (16%)</td>
<td>3 (0.5%)</td>
<td></td>
<td>44.3%</td>
<td>$13.29m</td>
<td>30%</td>
<td>$4m</td>
</tr>
<tr>
<td>$100m (50%)</td>
<td>$100m (50%)</td>
<td>$0 (0%)</td>
<td></td>
<td>55.3%</td>
<td>$16.59m</td>
<td>20%</td>
<td>$3.3m</td>
</tr>
<tr>
<td>$0 (0%)</td>
<td>$150m (100%)</td>
<td>$0 (0%)</td>
<td></td>
<td>0.2%</td>
<td>$0.6m</td>
<td>2%</td>
<td>$0.0012m</td>
</tr>
</tbody>
</table>

Total Global Tax paid by The Widget Corporation: $7.3 million
END NOTES

1 See Picciotto 2017 and ICRICT 2018.

2 See the submission by the G24 developing countries proposing ‘fractional apportionment’ (G24, 2019). This was prepared by a technical group from Colombia, India and Ghana. The Indian Government has also proposed the introduction of fractional apportionment in its domestic law. See also the evaluation of alternative approaches in a policy paper for the Board of the International Monetary Fund (IMF 2019).

3 All the BEPS project reports are available at https://www.oecd.org/tax/beps-reports.htm.


5 Analysis shows that while 70% of MNEs have only one foreign affiliate, and 90% fewer than 5, the largest (accounting for 60% of value added by all MNEs) have over 100 each, and the top 100 have some 55,000 affiliates between them (UNCTAD 2016, 134-5). For further details see Picciotto 2018a, 40-43.

6 It is expected to be published in December 2019, see https://www.globalreporting.org/standards/work-program-and-standards-review/disclosures-on-tax-and-payments-to-government.


8 The report on BEPS Actions 8-10 included revisions to chapters I, II, VI, VII and VIII of the TPGs, which were incorporated into the version issued in 2017, which is now over 600 pages. The most authoritative account yet published of these changes is by Joe Andrus (the former OECD official responsible for transfer pricing during most of the BEPS project) and Richard Collier (an experienced private practitioner, who joined the OECD secretariat in 2019) (Andrus & Collier 2017). Their analysis shows how, due to disagreements among participants in the BEPS project, the TPGs have become even more uncertain and obscure. They conclude that the result has been to make the transfer pricing process ‘far more complex’, mostly due to the ‘level of factual detail’ now required for the functional analysis (paras. 7.70-71). They trace in detail how, due to these disagreements, the TPGs have been made more complex and unclear on the key points. These are (i) the notion of control of risk (‘very complex’, para. 6.35; ‘most confusing’ para. 7.32; imposing ‘only limited burdens on MNEs desiring to transfer risk to tax advantaged locations’, para. 7.13; and leaving ‘clear potential for heated disagreement’, para. 7.16); (ii) the returns which can be attributed to a cash-box entity (‘quite mysterious’, para. 6.46; ‘most confusing’ para. 7.32; will ‘give rise to substantial amounts of controversy’, para. 7.31; and leaving ‘a rather confused muddle, at least for now’, para. 7.42); and (iii) how to allocate the difference between projected and actual returns from an intangible (‘far from clear’, para. 7.56; ‘manifestly inadequate’, para. 7.58).

9 The first hearing was held on 19 August, see https://ustr.gov/about-us/policy-offices/press-office/press-releases/2019/august/public-hearing-section-301. Following the G7 summit in Biarritz France announced an agreement with the US under which if an international solution is agreed, payments of this tax would be refunded or credited against tax due once such a measure is introduced.

10 Johnston 2018. Figures released in August 2019 showed an increase of 18% in UK revenues with an additional £10m of tax paid.

The UK’s dogged defence of the patent box, a widely criticised incentive, took up much of the time of negotiators under BEPS Action 5 on Harmful Tax Practices; the resulting agreement on a ‘modified nexus factor’ meant that the UK provisions had to be modified but were legitimised; this led to other states introducing similar measures (e.g. Ireland and Switzerland, and then the US in 2017), nullifying any national advantage but providing selected benefits for some multinationals. The European Commission investigation of the UK’s CFC rules eventually found that part of them, the group financing exemption, contravened EU state aids rules (EU Commission 2019), but this ceased when the UK implemented revised CFC rules in line with those adopted by the EU following the BEPS project in the Anti-Tax Avoidance Directive of 2016. There are clearly dangers that following Brexit the UK would become even more aggressive in offering such tax breaks to MNEs, a short-termist and beggar-thy-neighbour policy.

For further analysis, based on the best understanding available before publication of the proposals, see BEPS Monitoring Group 2019.

We include in this term all countries which have deliberately enacted measures that undermine the tax base of others.

De Mooij et al 2019, Figure 3. The estimates depend on both the data source and the allocation factors used. Two of these sources are from the USA, and are skewed by covering only or mainly US-based MNEs; while the third contains only financial accounting data, and does not include many middle-income and most low-income countries. Use of the assets factor produces particularly unreliable estimates, so we have excluded those from the range of outcomes reported by this study. These authors report an increase for the UK of some 30% using a 3-factor formula such as in the CCCTB, applied to data from the US Bureau of Economic Analysis; for the other data sources they apply only the assets or the employment allocation factors, which yield negative results (Appendix Table 1.1). This confirms the importance of using a balance of apportionment factors.

Cobham, Faccio and Fitzgerald 2019, Figure 3 and Appendix 1; and De Mooij et al Appendix Table 1.1.

Data available at https://osf.io/preprints/socarxiv/j3p48/, see ‘Supplemental materials’.


This study did not examine the tax paid by UK-based MNEs, which have benefited from tax breaks such as the group financing exemption in the CFC rules introduced in 2012.

The latest data from HMRC show that the DPT brought in £388m in the 2016-17 tax year (HMRC 2018a). At the same time, the cost of the selective tax reductions provided by the ‘patent box’ was £754m in its first full year (2015-6), 95% of which went to only 330 large companies (HMRC 2018b). Similarly, HMRC’s recovery from challenges to MNE transfer pricing jumped from £707m in 2014-15, and £853m in 2015-16 to £1.618b in 2016-17 and £1.682b in 2017-18. However, much of this has resulted from the increased enforcement efforts, as discussed in section 2 above. Our proposed new approach would enable HMRC to substantially increase these revenue gains, without requiring such high levels of skilled staff in this field.

The IMF study estimates that this would reduce the global tax base by up to about 10%, taking account of the counteracting effects of reduced carry-forward of losses (de Mooij et al. 2019, p.6). However, this would be substantially offset by the reallocation of income from low-tax to high-tax countries, and its estimates of gains are net of cross-border loss consolidation.
REFERENCES


