# The **BEPS** Monitoring Group

**UK Parliament, All-Party Parliamentary Group**
**Examination of the OECD'S BEPS recommendations to the G20**

**SUBMISSION ON BEHALF OF THE BEPS MONITORING GROUP**

The BEPS Monitoring Group (BMG) is an international network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. Its reports and submissions are not approved in advance by these organizations, which do not necessarily accept every detail or specific point made in them, but they support the work of the BMG and endorse its general perspectives.

These comments have been prepared by Sol Picciotto on behalf of the BMG, based on its previous submissions and reports on the BEPS project and related initiatives. In particular, our *Overall Evaluation* of the BEPS Project reports, published in October 2015, is available in full here. This submission will focus particularly on the UK, and especially on measures to implement the BEPS proposals.

## A. The BEPS Project and Beyond

The G20 mandate for the BEPS project was that international tax rules should be reformed to ensure that multinational enterprises (MNEs) could be taxed 'where economic activities take place and value is created'. This implied a new approach, to treat the corporate group of a MNE as a single firm, and ensure that its tax base is attributed according to its real activities in each country. Unfortunately, the BEPS project has continued to emphasise the independent entity principle, which starts from the fictitious assumption that affiliates of a corporate group act like separate legal persons, while attempting to counteract its harmful consequences.

The BEPS outputs will provide considerable strengthening of the existing rules, giving better tools to tax authorities if they have the capacity and will to use them. Overall, however, the proposals offer a patch-up of existing rules, making them even more complex and in many cases contradictory, and do not provide a coherent and comprehensive set of reforms. Nevertheless, **this is an important first step on a longer road**. The G20 project itself is continuing, both to supervise and coordinate implementation and to work on some key issues which were not dealt with in its main phase. These include the **profit split method**, and the much wider issues raised by the **digitalised economy**. The UN Tax Committee is doing important work especially on **services taxation**. The EU Commission's Action Plan is potentially ambitious, including its relaunch of the proposal for a **Common Consolidated Corporate Tax Base** (CCCTB), which could be a major step forward.

The UK should aim to play a major, and constructive, part in these developments. Unfortunately, its contribution until now has been contradictory. Although the UK has supported international reforms, it has also sought to defend its 'competitive' and 'business-friendly' tax system. Too often this has put the UK in the same camp as countries such as Luxembourg, Ireland, the Netherlands and Switzerland, trying to defend beggar-thy-neighbour policies and measures which give tax breaks to particular companies or sectors, instead of aiming for rules which are fair for all. The concept of tax competition has been misused to justify measures which provide tax breaks benefiting some firms rather than others, and/or operate in a beggar-thy-neighbour way, undermining the tax base of other countries. Revelations in the past few years, especially the LuxLeaks, have shown how all countries have been damaged by this mistaken defence of the right to offer selective tax advantages to MNEs

Fair and effective rules for taxing MNEs require international coordination. Such coordination is necessary to defend each country's sovereignty to ensure fair taxation, which is undermined when countries compete with each other to offer special advantages or provisions of which MNEs can take advantage. Coordination should therefore focus particularly on rules for defining the tax base. Within such a coordinated framework countries can remain free to decide on the appropriate tax rates for corporate profits, which should apply equally to all companies. Opinions obviously differ on whether and how far it is appropriate to reduce corporate tax rates, but this is a legitimate policy debate to conduct within countries, balancing the effects on corporate tax revenues with the impact on other revenue sources and on desirable expenditure levels.

> **Recommendation**: UK international tax policy should be based on the clear understanding that coordination between states and strong international tax rules are essential to ensure effective taxation of multinational enterprises (MNEs), and hence for national sovereignty over tax.

## B. Implementing the BEPS Project Proposals

### 1. Country by country reporting (CbCR).

Some of the BEPS project proposals do mark a significant step forward, enabling the MNE to be considered as a single firm and to ensure that taxable profits relate to its economic activity in each country. The proposed template for CbCR, as well as those for standardised transfer pricing documentation, are a major advance. However, the arrangements for access to the CbCR by all relevant tax authorities create unnecessary obstacles, requiring a cumbersome system of agreements for exchange of CbCRs. Publication would be a far easier and better solution.

Draft Regulations were issued by the UK Treasury in October 2015 for filing of CbCRs by MNE parent companies resident in the UK. The scheme provides for the home jurisdictions of MNEs to supply the reports to other countries where the MNE has affiliates, under agreements for exchange of tax information, with a secondary mechanism if a jurisdiction fails to do so. However, the draft UK Regulations provide only a 'voluntary' procedure for the MNE to file in the UK if the parent's jurisdiction does not conclude an agreement to exchange, or 'persistently fails' to supply reports. This could create major gaps as some countries, such as Switzerland, may be slow in implementing the system, and others, especially the USA, may be hindered by legal challenges. Countries, such as Australia and China, have enacted stronger provisions which require filing by the MNE's local affiliate if their tax authorities do not obtain the CbCR from the parent's jurisdiction.

**Recommendation**: The UK should as quickly as possible conclude the necessary agreements to receive and supply CbCRs automatically with all countries willing to do so. This should include small and developing countries even if they are not home countries of MNEs. Binding requirements should be established for filing in the UK by the local affiliate of any MNE if the UK does not obtain the CbCR from its parent's jurisdiction of residence.

## 2. Limitation of interest deductions

The BEPS project also made proposals for limiting deductions of interest, which could be a major step in stemming BEPS behaviour by MNEs. A common technique for such global corporate groups to reduce tax liability in countries, including the UK, is the use of intra-group structured financing arrangements to attribute excess debt to operating affiliates and hence shift earnings out of countries where they have real activities while reporting profits for their cash-box affiliates in jurisdictions where they are lightly taxed.

We support the proposal from the BEPS project for a group ratio rule (GRR), to limit interest deductions based on the consolidated net interest expense of the whole multinational corporate group to third parties, apportioned to each group member according to its earnings before tax, interest, depreciation and amortisation (EBITDA). This would treat MNEs in line with the business reality that they are integrated and centrally-directed corporate groups, and help ensure that they are taxed fairly in each country. MNEs, like other companies, should be allowed to deduct their actual interest expense to third parties, no more and no less.

However, the final report weakened the proposal by recommending the use of a fixed cap in conjunction with an optional GRR, allowing countries to fix their cap in a 'corridor' between 10% and 30% of EBITDA. In our view, a fixed cap is unnecessary and undesirable, as it would impose a one-size-fits-all rule.

Evidence put forward by business groups themselves shows that there are wide variations in the debt ratio between economic sectors and even different firms. The survey done by PwC for the Business and Industry Advisory Group (BIAC) of the OECD showed that, over 2009-2013, 55-61% of nonfinancial MNEs had interest expense below 10% of EBITDA, and 78-83% had a ratio below 30%.[1] The evidence in countries which have used a 30% fixed limit with a group ratio alternative, notably Germany, is that companies have rarely opted for the group ratio, which also indicates that the 30% cap is far too generous. Since 80% of MNEs have a group ratio below 30% and a majority is even below 10%, it is clear that fixing the cap higher than 10% would allow continued earnings stripping and tax avoidance by MNEs.

Problems such as volatility of earnings, and project life-cycles can be dealt with by flexible rules on carry-forward and carry-back. We see no valid reason for a de minimis threshold based on size, which would inevitably be arbitrary. The clear and simple criterion should be whether a company is part of a corporate group with a taxable presence in more than one country. Small companies would not have a disproportionate compliance burden, because both their corporate structure and financing arrangements should be simpler than those of complex MNE groups. Special rules should be devised for the finance sector.

**Recommendation**: The UK should apply a Group Ratio Rule, limiting the deductibility of interest to the entity's share of the group's consolidated net interest

[1] See 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

expense, apportioned by earnings (EBITDA). If this is combined with a fixed cap, it should be set at the lowest level of 10%.

### 3. Controlled Foreign Corporations (CFCs)

Ensuring taxation of a group's worldwide profits could also be achieved by stronger rules on CFCs, but the final BEPS report contains only weak recommendations, which will continue to encourage competition between countries to reduce corporate taxes, and to motivate MNEs to shift profits. However, there is now an opportunity for stronger rules to be introduced on a coordinated basis through the EU, as part of the 'anti-BEPS' Directive to be proposed this month by the European Commission.

In our view, effective CFC rules are a key way to protect the tax base of both home and host countries of MNEs. To ensure this, they should be on a full-inclusion basis, treating all foreign affiliates of EU-resident parent companies as CFCs so that the group consolidated profits are subject to tax in the resident country, with a full credit for all equivalent foreign taxes paid. They should not be limited to income from transactions with the parent company, and there should be no exemptions based on criteria such as effective exchange of information, as profits may also be shifted into cooperative jurisdictions. Full-inclusion CFC rules would be easier to apply than attempting to distinguish between active and passive income, or using a threshold such as a percentage of the taxpayer's effective tax rate. This is hard to calculate; it sets an arbitrary limit, and there is no particular rationale to any limit that could be chosen. It would encourage continued BEPS behaviour, as companies would still have an incentive to shift profits out of high-tax source countries into countries offering an effective tax rate just above the CFC limit; and would create a downward ratchet as tax competition leads states to reduce their tax rates, in turn reducing the CFC tax rate limit.

The introduction of full-inclusion CFC rules would be effective if done on an EU-wide basis, and especially in conjunction with the US. Proposals for reform of US international corporate income taxation have been formulated which combine taxation of worldwide income through CFC rules with a lower tax rate. Although there has not yet been a political consensus in the Congress for this, at some point the US will have to grasp this nettle, and adoption of this approach by the EU could be an important impetus.

> **Recommendation**: The UK should support the introduction of full-inclusion CFC rules as part of the EU's 'anti-BEPS' Directive, and should itself adopt such rules.

### 4. Harmful tax practices and the patent box

The BEPS project proposals to control 'harmful tax practices' continue the approach dating back to 1998, based on voluntary rules and secretive self-policing, which has had some limited effects. There does now seem to be a stronger political impetus, but instead of phasing out tax breaks, the UK and others seem to want to regularise them. The UK's strong defence of its 'patent box' introduced in 2012 resulted in a compromise agreed with Germany, based on a `modified nexus approach'. Applying this, existing innovation boxes, including the UK's patent box, were found by the Forum on Harmful Tax Practices to be at least partially harmful, and so should be withdrawn, or modified.

The UK government seems to have decided only to amend the patent box, and the proposals issued for consultation would make the scheme far more complex. The patent box offers a low tax rate for one type of corporate income rather than others, and to one type of investment in innovation only, that resulting in patents. The complexity of the scheme means that it would be likely to benefit mainly large companies, and the Treasury originally estimated its cost at £1b in a full year. A much better way to stimulate innovation is through

allowances for actual spending on research and development. Other countries have now announced that they will introduce their own schemes (Ireland, Italy, Switzerland), and business pressures have led to proposals elsewhere also (Germany, US). It is clear that this process has essentially legitimised the concept and encouraged all countries to adopt their own regimes. The result will be a further erosion of the corporate tax revenues, harming all countries, while affecting companies differently according to whether they are able and willing to take advantage of any of the various schemes.

> **Recommendation:** The UK government should withdraw its proposals to amend the patent box, and instead phase it out. If incentives for R&D are considered desirable, they should take the form of improved investment and capital allowances which would apply to all companies, and hence be simpler and fairer. The UK should support agreement within the EU to end all innovation or patent boxes.

## C. BEYOND BEPS

### 1. Implications of the digitalised economy and the shift to services

The need for more far-reaching reforms and a wider approach was clearly shown by the work of the Task Force on the Digital Economy (TFDE) under Action 1 of the BEPS project, which will now continue for a further five years. The implications could be potentially far-reaching, especially as the TFDE rightly concluded that digitalisation has affected all economic activities to different degrees, so it would be inappropriate to apply different rules to a digital sector ring-fenced from the whole economy.

The TFDE report recognises that digitalisation 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, its analysis shows that digitalisation fundamentally undermines the concepts of residence and source on which traditional international tax rules are based, due to two main factors (para. 273). First, firms may make extensive sales of goods and services in a country without the need for any significant physical presence there, rendering the traditional concept of a PE obsolete. Secondly, despite needing a minimal physical presence, firms can now have much closer relations to customers and users, which can generate considerable value, through the systematic collection of data and contribution of content. Paradoxically, therefore, firms are more closely bound to their customers, without requiring a significant physical presence in countries where they sell.

The report identifies some far-reaching possible reforms to deal with these challenges, which will require continuing work over the next five years. First would be a new taxable nexus based on ‘significant economic presence’. This would result in a much greater allocation of the taxable base to the country of sales. The implications of this are even more extensive. It would attribute profits to the entity in the country where the sales take place, although the costs are borne mainly by affiliates located elsewhere. This makes it essential to adopt a unitary approach, or as the report says it entails a ‘substantial rewrite of the rules for attribution of profits’ (para. 286). The report canvasses several possibilities, including ‘fractional apportionment’, ‘deemed profit’ methods, a withholding tax on digital transactions, and an ‘equalisation levy’.

Two broad approaches are possible in response to these changes: strengthening of taxation in countries where consumption takes place, and a shift to profit split and formulary methods of apportioning MNE profits.

## 2. Taxation in countries of consumption

This can take several possible forms. One is to apply a sales tax or VAT on a destination basis. This shift is now taking place within the EU: since last year VAT on all telecommunications, broadcasting and electronic services is levied where the customer is based. In parallel an electronic registration and payment system (the Mini One Stop Shop), has been implemented to facilitate administration, which it is planned to extend to tangible goods ordered online both within and outside the EU. The OECD has also been working on extending this approach globally. HMRC has become increasingly concerned with the growing scale of VAT avoidance and evasion due to internet-based sales, so ensuring that these changes can be made effectively is important to maintaining VAT revenues.

A similar approach to the taxation of corporate profits has also been proposed: a Destination Based Corporate Tax (DBCT). This is in effect a unitary approach to MNE taxation, 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. Both the DBCT and a destination-based VAT pose problems, which require closer international cooperation to resolve. First, they require identification of the location of consumers, although this can be done fairly effectively through electronic systems and the use of intermediaries such as banks. More fundamentally, both involve taxing companies in countries where they may have little or no physical presence. To deal with this, advocates of the DBCT have proposed a clearing house system, modelled on the one-stop-shop for the VAT. 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.[2]

Digitalisation is also linked to the shift to a services economy. Developing countries have long been concerned about this, as they are mainly importers of services, and the ‘permanent establishment’ requirement for taxable presence under current international tax rules is easily avoided by providers of services. Many developing countries, notably India, therefore apply a tax on fees paid by their residents for services they receive. The UN Tax Committee has been formulating a new article on taxation of fees for technical services for the UN model tax convention, which is now almost finalised, and may lead to a further extension of this option. Such taxes are a blunt instrument, since they apply on a gross basis rather than on profits, and are easy to pass on so raise prices for consumers. However, they are relatively easy to administer.

The UK has in the past favoured residence-based taxation, since it has long been a capital exporting country. However, economic globalisation has made it harder to make residence taxation effective. The changes in 2012 which largely abandoned CFC rules entailed a shift to an essentially territorial basis of MNE taxation in the UK. At the same time, publicity given to cases such as Apple, Starbucks and Google has highlighted how easily such firms can avoid paying tax on profits in countries where they have enormous sales. The public concern led to the Diverted Profits Tax (DPT), which is at best a short-term palliative measure. Importantly, the DPT fails to provide a clear criterion for attribution of profits, but essentially leaves it to the firm concerned to satisfy HMRC.

> **Recommendation**: A wider debate is needed on how the UK should play a constructive role in the reform of international corporate taxation for the digital age.

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[2] See Devereux and de la Feria, (2014), ‘Designing and Implementing a Destination-Based Corporate Tax’, OUCBT Working Paper 14/07, p. 21.

**3. Unitary taxation of MNEs and the CCCTB**

Despite the arguments by some for abandoning taxation of corporate profits it remains essential both in revenue terms and to maintain the legitimacy of income taxation. An effective corporate income tax in turn needs to end the opportunities for its avoidance by MNEs. As has been widely recognised, this entails treating MNEs in line with the economic reality that they operate as single firms under central direction, or unitary taxation. Several options have been put forward which could ensure this, including residence-based worldwide taxation based on full-inclusion CFC rules,[3] and a DBCT as mentioned in the previous section.

Experience shows that the most effective system in highly integrated markets where firms have a right of establishment is unitary taxation with formulary apportionment. This has long been used in federal or confederal states such as Canada, the USA and Switzerland. A proposal for such a system has been developed in the EU, the Common Consolidated Corporate Tax Base (CCCTB). A revised proposal is due to be published this summer by the European Commission.

The CCCTB should be attractive to business, because it could provide equity between purely national companies and those engaged in cross-border investment, both from within and outside the EU. It would also level the playing field between firms which adopt responsible tax policies, and those willing to engage in aggressive tax planning. The vast majority of SMEs are not able to take advantage of the possibilities of international tax planning, yet their views may not be given enough weight, as the larger cross-border firms have much greater resources in responding to consultations, as well as finding other methods to influence policy.

However, it is crucial to ensure that the CCCTB is properly designed, not only as regards its intra-EU effects, but perhaps even more importantly its effects on international base erosion and profit shifting (BEPS). The CCCTB must include suitable rules to ensure that the common EU tax base it defines is appropriate in relation to the extra-EU activities of the firms concerned. A poorly designed CCCTB could permit or even encourage profit shifting out of the EU. As importantly, the CCCTB should be designed to ensure that EU-based firms do not shift profits out of non-EU source countries, especially poor developing countries, while keeping such profits ‘offshore’, in non-EU tax havens.

> **Recommendation**: The reluctance or downright opposition by UK politicians to the CCCTB is based on a mistaken view of national sovereignty, and should be rethought. The UK should now support the proposal, and engage constructively in its development. The CCCTB would allow each country to decide its own tax rate, and to tax MNEs based on their real economic presence in each country. Such coordination is in practice the only way to restore effective sovereignty over corporate income taxation.

21st January 2015

[3] For example Kleinbard, (2011), ‘The Lessons of Stateless Income’, *Tax Law Review*; Kadet, (2013), ‘Worldwide Tax Reform: Reversing The Race to the Bottom’, *Tax Notes International,* **69,** 1133-6.