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Michael P Devereux
University of Oxford

John Vella
University of Oxford

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Are we heading towards a corporate tax system fit for the 21st century?

Michael P. Devereux
John Vella

Oxford University Centre for Business Taxation[1]

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Abstract

The most significant problems with the existing system for taxing the profit of multinational companies stem from two related sources. First, the underlying "1920s compromise" for allocating the rights to tax profit between countries is both inappropriate and increasingly hard to implement in a modern economic setting. Second, because the system is based on taxing mobile activities, it invites countries to compete with each other to attract economic activity and to favour "domestic" companies. The OECD Base Erosion and Profit Shifting (BEPS) initiative essentially seeks to close loopholes rather than to re-examine these fundamental problems. As a consequence, it is unlikely to generate a stable long-run tax system. We briefly outline some more fundamental alternative reforms.

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[1] Contact details: michael.devereux@sbs.ox.ac.uk and john.vella@sbs.ox.ac.uk; Oxford University Centre for Business Taxation, Said Business School, Park End Street, Oxford OX1 1HP.

1. Introduction

The international system for taxing the profit of multinational companies is beset by criticism. The immediate problem is the perception of governments, commentators, the media and the general public that multinational companies are able to arrange their affairs to take advantage of deficiencies in the tax system to reduce their aggregate tax liabilities. This is on top of long-standing criticisms, which cut in the opposite direction, that the tax is particularly distorting to economic activity, affecting investment, financial and location decisions, and economic growth.

This paper spells out some of the most significant problems with the existing system. These stem from two related sources. First, the underlying framework of the system is based on an inadequate compromise in allocating the rights to tax profit between countries; and the system has become more complex and less suited to collecting an appropriate amount of tax as steps have been taking to shore up the compromise. Second, the system is subject to being undermined since the interests of national governments conflict with the basic tenets of the system.

When commercial activity moves beyond a purely domestic setting, many countries can potentially claim jurisdiction to tax the income. In principle this could lead to multiple taxation of income. The first problem stems from how the international tax system seeks to address this potential multiple taxation, which it does by essentially agreeing to allocate primary taxing rights between "residence" and "source" countries. Very broadly, the residence country is where a person who has the right to receive the profits of the activity resides while the source country is where the economic activity takes place; we discuss these terms in more detail below. And broadly again, in a "1920s compromise"[2] in the League of Nations[3], source countries were allocated primary taxing rights to the active income of the business, and residence countries the primary taxing rights to passive income, such as dividends, royalties and interest.[4]

Today this compromise is reflected in the OECD Model Treaty[5] on which the great majority of bilateral double tax treaties are based. Article 7 of the Model Treaty allocates the right to tax business profits to the country of source if the "permanent establishment" threshold is met; whilst articles 10, 11 and 12 allocate the right to tax dividends, interest and royalties to the recipient's country of residence, subject to the source country's circumscribed right to impose a withholding tax on dividends and interest.

Theoretical and practical arguments have been articulated in favour of this allocation of taxing rights.[6] For example, it has been argued that the ability to pay principle justifies taxation in the country of residence and the benefits principle justifies taxation in the country of source. However, these arguments do not stand up to much scrutiny. The ability to pay principle might reasonably apply to individuals resident in a country who should make an appropriate contribution to the public purse. But to apply such a principle to a tax on corporate profit it is necessary to look through the

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[2] Graetz, 2001.
[3] See Graetz and O'Hear, 1997and Jogarajan, 2013.
[4] See for example Warren, 1994 and Avi-Yonah, 1996.
[5] OECD, 2010 a.
[6] See for example Avi-Yonah, 2007, pp. 11-13.

corporate form to see which individuals ultimately bear the tax. Since a tax on corporate profit may at least partially fall on its shareholders, then in an open economy with international portfolio investment, the individuals who ultimately bear a tax on a resident company may be non-residents. So a tax on the profit of a company resident in country R will not necessarily fall on individuals resident in R, and hence cannot be justified by applying the ability to pay principle to those individuals in R.[7] It might also be argued that businesses that benefit from public goods and services in the place in which they operate should make a contribution; but it is less clear why that contribution should be based on their profit.[8] In fact, the allocation of taxing rights at the heart of the international tax system is best viewed as an arbitrary compromise, albeit one which has come to be accepted by large parts of the international community.

It is becoming increasingly evident that this system has been undermined by a number of factors. In particular, they have led to a system which has effectively moved from the prevention of double, or multiple, taxation, to one in which non-taxation is commonly believed – not least by the OECD itself[9] - to be rife. In fact, the need for reform rose to the top of the political agenda following extensive press coverage of the tax affairs of a few well-known multinational companies, including Starbucks, Google and Amazon, and the consequent public furore. In response, the G20[10] called on the OECD to produce a report on "Base Erosion and Profit Shifting" (BEPS), which it published in February 2013[11] and which it followed up with an Action Plan[12] in July of the same year.

But there is a second, important, problem with the existing system: the system allows countries to compete with one another in a manner which destabilises the system itself. Countries compete to attract economic activity and to favour "domestic" companies, which for at least thirty years has led to gradual reductions in effective rates of taxation of profit. The current UK coalition government has been explicit on its strategy in this regard; it came to office in 2010 with the declared "aim … to create the most competitive corporate tax regime in the G20"[13] and it acted on that aim by slashing the rate of corporation tax from 28% to 20%, introducing a patent box with a tax rate of 10%, and reforming CFC rules in a way that is generally perceived to be generous to business. Such a goal is not easily reconciled with another goal often explicitly held by governments: ensuring that companies should pay to some country or countries a reasonable amount of tax on their global profits. This tension is evident in the UK, where the goal of having the most competitive corporation tax regime in the G20 is held concomitantly with an active role in pushing forward the OECD's BEPS Action Plan.

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[7] On the other hand, the ability of a corporation tax to indirectly tax foreign residents might in itself be thought of as a rationale for the tax.

[8] A much more detailed discussion of these points is provided in Schön, 2009.

[9] See, for example, the references to "double non-taxation" in OECD, 2013 b.

[10] G20, 2012.

[11] OECD, 2013 a.

[12] OECD, 2013 b.

[13] Cabinet Office, 2010. In his 2014 Conservative Party Conference speech of October 1, 2014, David Cameron intimated that if elected, the Conservative party would be willing to introduce further cuts to maintain the UK's competitive position: "[s]o here is a commitment: with the next Conservative Government – we will *always* have the most competitive corporate taxes in the G20…lower than Germany, lower than Japan, lower than the United States" (emphasis added).

This fundamental tension is at the heart of whether the existing international tax system can be reformed to provide a reasonable and stable system for taxing the profits of multinational companies in the 21st century. The issue is one of incentive compatibility. If countries acting in their own interests believe that they have an incentive to undermine the international consensus, then that international consensus cannot provide a stable long-run system. There is ample evidence that countries have been doing precisely that. Furthermore, quite beyond the current uncertainty surrounding the outcome of the OECD BEPS initiative, even if it is successful on its own terms the BEPS initiative will not eliminate these competitive forces.

The OECD BEPS initiative is essentially seeking to close some loopholes rather than to re-examine the fundamental structure of the system. It is partly doing so through the overlay of a new 'substance' requirement over the existing system. The current system does not allocate taxing rights according to substance; therefore this requirement departs from the general principles underpinning the international tax system. To this extent, we will argue that this test will lead to an even less coherent international tax system. More significantly still, it will introduce real economic distortion. We discuss these issues below, and briefly outline some more fundamental alternative reforms.

This paper is organised as follows. In the next section we set out what we believe to be basic flaws in the design of the international tax system, and explain how they have undermined the ability of governments to create a stable system for the taxation of multinational profit. In Section 3, we address the proposals being considered by the OECD as part of its BEPS Action Plan. In Section 4, we briefly consider broader options for reform. Section 5 concludes.

2. Fundamental flaws in the international tax system

This section examines two broad factors which undermine the international tax system. The first is the continuing support for the arbitrary allocation of taxing rights first agreed in the 1920s, which over time has generated considerable additional complexity, and further distortions, as attempts have been made to preserve it. The second is the inherent weaknesses of a system prone to competition between individual governments, which has led not only to progressively reduced tax rates, but is increasingly leading to progressively reduced tax bases as well. We discuss each in turn.

a) Supporting and developing the 1920s compromise

The basic allocation of taxing rights between source and residence countries might arguably be a reasonable compromise in a simple world in which there are no multinational companies, and where there are clear conceptual distinctions between, for example, active and passive income. This may or may not have been the case in the 1920s; but it is certainly not true in the 21st century. Change, including in technology, transport, finance and business practise, has undermined the effectiveness and stability of the international system. This has weakened some fundamental

concepts and design features of the system. Critically, the concepts of source and residence, which are at the heart of the system, have been eroded over time.[14]

The conceptual basis for the existing system in the 21st century

A modern multinational company has shareholders scattered across the world, a parent company resident in one country, a potentially large number of affiliates undertaking an array of activities, such as research and development, production, marketing and finance that are located in many different countries[15] and consumers that could also be scattered across the world. In such a scenario, there is no clear conceptual basis for identifying where profit is earned; all those locations may be considered to have some claim to tax part of the company's profit. Conceptually, the residence / source distinction does not offer much help. For example, ultimately the individuals who have the right to receive the profit are the shareholders, and so their countries of residence could reasonably be thought to be the set of "residence" countries for the company. And the "source" of income is ultimately a sale to a final consumer, and so the consumers' place of residence could be thought of as the set of "source" countries.

Of course, the existing system does not define residence and source in these ways. Rather it generally attempts to apply the concepts to transactions between related entities within the multinational group. However, the concepts are simply not suited to inter-group trade. Suppose two wholly-owned subsidiaries of the same multinational company, S1 and S2, resident in different states, State A and State B respectively, trade with one another. Then the system requires one of the countries to be designated as the residence state and the other to be designated as the source state. If S1 holds a patent which is exploited by its sister company S2, and the latter pays a royalty to the former, then State A is designated as the country of residence giving it the right to tax the royalty (which will be deducted from S2's profits in State B). But this situation seems unlikely to be what the originators of the system had in mind in the 1920s. Instead the residence / source distinction is being applied to a context of intra-group trade which is quite different to that for which it was designed.

The allocation of the right to tax royalties in the country of residence and active business income in the country of source gives rise to difficult pricing issues, which are at the heart of many of the ills afflicting the current international tax system. But the allocation of different types of passive and active income is far broader and more problematic than this. A clear example is provided by the development of hybrid instruments, which render the distinction between debt and equity difficult to maintain.

Developments designed to support the Arm's Length Principle

The existing transfer pricing rules, and in particular their reliance on the Arm's Length Principle (ALP), are a particular concern. Under the ALP, companies within the same group are treated as if they were unrelated, independent entities and intra-group prices are expected to be aligned with the prices which would be charged by independent parties. The practical weaknesses of the ALP are well known and have been frequently pointed out. For example, such an approach necessarily struggles with

[14] See the discussion in Schön, 2009, pp. 68-70.
[15] See OECD 2013 a, Chapter 3 on global value chains.

transactions which are undertaken by related but not by unrelated parties, as comparables cannot be found. It fails to provide a satisfactory solution to the division of profits arising from synergies, which are multinational profits which a group of companies acting independently would not create. It can justify wildly varying prices, thus undermining its legitimacy and creating uncertainty. Finally, the rules on the application of the ALP are complex and impose extremely high compliance costs.[16]

These various points all relate to the difficulty in applying the ALP in practice although they ultimately stem from the conceptual foundation of the approach. But there are difficulties that arise even when the ALP *is* satisfied, that is, in cases where the prices for transactions between related entities *do* conform to those between independent parties, but nevertheless result in profits being shifted to low tax jurisdictions.

We illustrate the problems that arise with two relatively recent developments in the international tax system, which seem to have been developed to support what appears to have become the fundamental ALP principle of following practice observed in transactions between unrelated parties, irrespective of whether such practice is appropriate or relevant within multinational groups.

The first involves the use of Cost Contribution Agreements (CCA).[17] The OECD's Transfer Pricing Guidelines (TPG) define a CCA as "a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services, or rights, and to determine the nature and extent of the interests of each participant in those assets, services, or rights."[18] CCAs are required to be consistent with the ALP, and, therefore, "a participant's contributions must be consistent with what an independent enterprise would have agreed to contribute under comparable circumstances given the benefits it reasonably expects to derive from the arrangement."[19] The problem is that ALP-compliant CCAs provide a relatively simple mechanism to shift profits amongst affiliates.

Consider the following example. P, a company resident in State A, a high-tax jurisdiction, is in the process of developing valuable intangible property. It funds, through equity, a wholly-owned subsidiary, S, resident in State H, a tax haven. P and S enter into a cost-sharing agreement, whereby S contributes to the cost of developing the intangible property and in return it will receive a proportionate share of the income generated by the intangible property. Unrelated parties might well enter into such an agreement, and to that extent, therefore, the transaction complies with the ALP. In this case, however, the transaction merely serves to shift profits from a high to a low tax jurisdiction. It is only a fiction that S actually contributes to the cost since the funds simply go round in a circle from P to S and back again.

A similar result would be achieved if S funded P through debt. Subject to anti-avoidance rules in State A, profits would be shifted to S through interest payments. CCAs, however, offer more flexibility than debt as the latter is limited by the amount of interest that can be charged as a return. CCAs allow S to receive a share of the

[16] See for example, Avi-Yonah, 1995; Avi-Yonah and Benshalom, 2011; and Keuschnigg and Devereux, 2013.
[17] See Brauner, 2010, p. 554.
[18] OECD, 2010 b, para. 8.3.
[19] Ibid. para. 8.8.

profits, making it akin to an equity investment by S in P. Normally in an equity investment, the income generated would first be taxed in State A. However, the CCA allows it to be subject to tax in State H.

A second mechanism involves shifting risk from one affiliate to another. Risk has become increasingly important in international tax law. It plays a significant role in transfer pricing as well as in the taxation of permanent establishments, and has been included in the new CFC regime which has been recently introduced in the UK. In establishing the ALP for a transaction, the TPG require multinationals to undertake a "comparability analysis" by virtue of which the economically relevant characteristics of the "controlled transaction" (i.e. the transaction between the related parties) are identified. A comparability analysis, which has been described as being "at the heart of the application of the ALP",[20] serves a dual purpose: first to seek for comparables between independent parties which have the same characteristics, and second, to make adjustments which eliminate the effect of any such differences.[21] The TPG lists five comparability factors which ought to be taken into account, including a functional analysis, which "seeks to identify and compare the economically significant activities and responsibilities undertaken, assets used and risks assumed by parties".

Risk thus forms part of the functional analysis required by the TPG. Its assessment is important because "in the open market, the assumption of increased risk would also be compensated by an increase in the expected return".[22] However, this means that multinationals can shift profits from group companies in high tax jurisdictions to group companies in low tax jurisdictions by shifting risk from one to the other. It comes as a no surprise that "risk allocations today are at the heart of much tax avoidance planning."[23] The OECD itself recognizes that many corporate tax structures focus on allocating significant risks to low-tax jurisdictions, where their returns may benefit from a favourable tax regime."[24] Critically, risk transfers amongst wholly-owned group companies offer an attractive tax planning route for multinationals, because from an economic perspective the transfer is of no consequence for the group as a whole.

Consider the following example. P, a company resident in State A, a high tax jurisdiction, is the parent of a wholly-owned subsidiary, S, which is resident in State H, a tax haven. S engages P to develop intangibles but retains the risk on the project. This allows S to pay P a lower price than it otherwise would and, therefore, allows a greater portion of the profits to arise in State H. If P and S were unrelated parties, risk would be an influential factor in establishing the price. However, in this case risk is not borne by S in any meaningful sense. Ultimately the risk is borne by the shareholders of the company. Risk cannot be passed on or shared by a company with its wholly owned subsidiary, just as companies cannot bear tax incidence and therefore cannot be worse off by paying corporate tax.[25]

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[20] Ibid., para. 1.6.
[21] Ibid., para. 1.33.
[22] Ibid., para. 1.45.
[23] Durst, 2012.
[24] See OECD, 2013 a, p. 42.
[25] If S relied on debt-funding from third party creditors as well as equity funding from P, then risk would be partly borne by the creditors who may demand a higher rate of interest. Similarly, if a third

Both of these examples - Cost Contribution Agreements and the treatment of risk – illustrate how blindly following an apparent principle – in this case the ALP – can lead to outcomes that make little or no sense from an economic perspective. The problems of the existing system cannot solely be laid at the door of the founders in the 1920s; there are clearly examples where the system has subsequently been developed in ways that are designed to conform to what is believed to be a basic principle, but which is far from any economic reality.

b) Competitive Tax Policies of National Governments

National governments have various objectives when deciding their international tax policies. Raising revenue is of course one objective. However, it is not the only one; governments may also seek to attract inward investment and to provide domestic companies with a competitive advantage.[26] There are many examples of policies aiming to meet such objectives.[27]

For example, the UK coalition government's objective of attracting investment has been actively pursued through aggressively lowering its headline corporation tax rate, introducing the Patent Box regime, and reforming the Controlled Foreign Companies regime,[28] in particular the Finance Company Partial Exemption (FCPE) regime. This ought to make the UK an attractive place for companies to locate their headquarters. However, given that capital allowances in the UK are amongst the least generous of all OECD and G20 countries,[29] the UK appears to be less committed to attracting inward investment by capital-intensive companies.

The UK's commitment to making its corporate tax system more competitive can be understood as both attracting corporate locations to the UK and also providing domestic companies with a competitive advantage. By the Government's own admission, for example, the UK maintains generous interest deductions in order to give UK businesses a competitive advantage.[30] The UK thus allows a deduction for interest, even when the returns generated by the debt-funded activities are not taxed in the UK. This can be seen as a form of state-approved base erosion.

However, domestic measures aiming at attracting inward investment and giving domestic businesses a competitive advantage also undermine the international tax system. This can be seen in two examples we now consider: the UK FCPE regime, and the US "check-the-box" regulations.

The UK FCPE regime has been recently introduced in the UK. The regime will provide an effective tax rate of 5 per cent (by 2015) on finance profits from overseas

party insures S, then the risk would be partly borne by the insurer. There may therefore be a role for risk in allocating profit; however, not in the way the TPG currently deal with it.

[26] See for example: Devereux, Lockwood and Redoano, 2008; Devereux, Griffith, and Klemm, 2002.

[27] In response to the report by the House of Lords Select Committee Economic Affairs [House of Lords, Select Committee on Economic Affairs, 2013] on the corporate tax system, HM Treasury was explicit about its range of objectives for corporation tax. See Government response to House of Lords Select Committee on Economic Affairs 1st report of Session 2013-14. (SC/13-14/EA66).

[28] Note that a number of multi-nationals cited the previous CFC regime as one of the reasons for re-locating their holding companies out of the UK.

[29] Bilicka and Devereux, 2012.

[30] HM Treasury and HM Revenue and Customs, 2010, p. 14.

intra-group financing. The regime has been described by the Government as a "competitive and pragmatic approach",[31] and by a leading tax practitioner as "almost government-approved tax avoidance".[32] In effect, it can be seen as facilitating the use of offshore finance companies by UK multinationals to erode the tax base of other states. The same tax practitioner gave the following example: "a UK-headed group with some bank debt has a genuine operating company, elsewhere in the world, that needs finance for its business. If the UK plc sets up an offshore finance company, it can funnel that bank debt through the finance company to the operating company, get a deduction in the UK for the bank interest, a deduction in the operating company for the loan, and then the really good news – the tax in the finance company will only be 5.5%. That's a quarter of the corporation tax rate of 22% which we're now heading for. In summary, a double deduction in exchange for just a 5.5% charge."

This example also brings to the fore the unclear underlying objectives of the current international tax system. Under the setup described above, and subject to anti-avoidance rules in the operating company's country of residence, the profits are taxed at a low rate by the UK. However, if a different legal set up is employed to achieve the same economic outcome, the profits might be taxed in a different jurisdiction. If the UK parent funded the operating company directly through debt, the interest payments would reduce the taxable profits of the operating company and the profits would be taxed at a full rate in the hands of the parent in the UK. If the UK parent funded the operating company through equity, the profits would be taxed in the operating company's country of residence and dividends received by the UK parent would be exempt. There is no clear reason for having these different tax outcomes for economically equivalent transactions, and this, in turn, raises questions about the coherence and justifiability of the underlying tax rules.

A key point about the FCPE regime is that the UK government appears to have introduced it both to benefit existing UK businesses by lowering their overall tax charge abroad, and also to attract other business to the UK by a more generous tax regime. The incentives for a government to undertake such a strategy will remain; any proposal leading to greater taxation by the UK of such income as part of a cooperative move towards reducing base erosion and profit shifting is therefore likely to meet with difficulties.

Our second example is the US "check-the-box" regulations. Consider the following arrangement. P, a parent company resident in the US develops intellectual property. P wholly owns S1, an operating company resident in State A, a high tax jurisdiction, which, in turn, wholly owns S2 a company resident in State H, a tax haven. S2 acquires from P rights to the intangible property outside the US through a "buy-in" payment[33] and a cost-sharing agreement. S2 then grants a licence over the IP to S1, receiving a royalty in return. S1 is afforded a deduction for the royalty payment; however, S2 does not pay tax on the royalty income as it is located in a tax haven. This arrangement thus allows the income represented by the royalty to avoid taxation.

[31] HM Treasury and HM Revenue and Customs, 2012.
[32] Goodall, 2012.
[33] The scheme partly works by exploiting the well-known difficulties in pricing intangibles.

Until 1997, the US controlled foreign company regime, "Subpart F", would have defeated this scheme by taxing P on S2's income. The check-the-box regulations introduced in 1997 allowed US multinationals to avoid this regime in such situations. They essentially gave US multinationals an election as to whether a foreign entity would be treated as opaque or transparent for US tax purposes. In the example given above, by checking the box for S2, it would be ignored for US tax purposes. As a result, from a US corporate tax perspective there is only one company, S1, with a branch in State H, and transactions between the two are generally ignored. Crucially, Subpart F does not come into play.[34]

It has been observed that the check-the-box regulations "revolutionized the US international tax practice".[35] Grubert and Altshuler provide empirical evidence in support of this claim.[36] Their evidence suggests that the introduction of the check-the-box regulations had a significant effect on US multinationals' tax planning behaviour: in 2002 US multinationals paid $7 billion less in host country taxes than they did in 1997 as a result of intra-group payments which are deducted by the payor and not taxed in the payee's country of residence. The position of the US has been that if US multinationals are avoiding non-US tax, then it is not a concern for the US, and this has led to the abandonment of proposals to repeal the check-the-box rules.[37]

From one perspective, it could be argued that the UK and the US are merely enforcing their systems to ensure that they collect their own taxes. Accordingly, an outbound equity-financed investment from the UK which yields a dividend back to the UK is not liable to UK tax. The fact that the income was initially in the form of an interest payment between two other countries could be argued to be irrelevant. Similarly, the US will tax any dividend arising from the royalty that is eventually distributed back to the US (although this means that the profits tend to remain overseas in the expectation of a future tax holiday).[38] Again, the fact that a royalty was paid by one foreign subsidiary to another could be regarded as irrelevant for US tax purposes. In this view, the UK and the US are only passive accomplices to this base erosion. The income in question arises in high tax jurisdictions, and is extracted from those jurisdictions through a deduction provided in their domestic law. The UK merely chooses to tax the payment giving rise to a deduction at a low rate, and the US chooses to refrain from taxing it at all. The high tax jurisdiction would be in the same position if the payment had been made into a jurisdiction which would have taxed it at a full rate.

However, from another perspective, the income arising as interest in the offshore finance company could be thought of as being diverted from the UK; in the absence of the diversion the income would be subject to tax in the UK as an interest receipt. Similarly, the royalty that is received in S2 could be thought to have been diverted from the US, where it would have been subject to tax. From a global perspective, the multinationals achieve non-taxation or very light taxation.

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[34] This simplistic example is intended to capture the basic effect of the check-the-box rules. For detailed examples of the actual use of these rules in the notorious "Double Irish Dutch Sandwich" and similar structures see, Kleinbard, 2011 and Ting, 2014 and sources quoted therein.
[35] Lokken, 2005, p. 196.
[36] Grubert and Altshuler, 2005.
[37] Oosterhuis, 2013.
[38] See for example, Fritz Foley, Hartzell, Titman, Twite, 2007.

The underlying rationale for providing a competitive advantage to domestic multinationals also merits closer examination. Domestic multinationals are of benefit to a jurisdiction at least to the extent of the activities they are required to undertake to be headquartered there. But from a domestic political perspective it is harder for politicians to deny domestic multinationals these planning opportunities. For example, in relation to Subpart F, Kleinbard explained that "U.S. business firms were incredulous that the United States would deliberately discourage U.S. firms from reducing their foreign tax liabilities."[39] On the other hand, as a result of the increase in international portfolio investment "domestic" companies are only partly owned by individuals resident in that state, meaning that the ultimate beneficiaries of these actions include foreign individuals. There is, however, considerable variation amongst countries in this respect, including between the UK and the US. According to the Office of National Statistics, "rest of the world investors" owned an estimated 53.2% of the value of the UK stock market at the end of 2012.[40] The US Treasury estimated the percentage of total outstanding equities which are "foreign-owned" at 13.6% at the end of June 2012.[41] However, this has been challenged on the grounds that "the existing constellation of disclosures and reports about the ownership of US equity—though in some respects surprisingly detailed—reveals almost nothing about the foreign ownership share of large US multinationals."[42]

c) Conclusion

This analysis leads to the conclusion that the international tax regime is in dire need of reform. It seeks to address the double or multiple taxation of income arising from cross border transactions but the reliance on a source / residence dichotomy as well as an active / passive income dichotomy makes it unfit for purpose. Not only is the allocation of taxing rights along these lines arbitrary, it is ill-suited to dealing with multinationals operating in a truly global business environment. The regime is further undermined by national rules that facilitate its exploitation and by specific international tax rules that are easily manipulated and hard to justify. Overall the system is manipulable, distortive, often incoherent and unprincipled and encourages countries to compete with each other.

3. What is the OECD BEPS project trying to achieve?

The OECD BEPS project focuses on the need to change the existing legal system.[43] This is movement in the right direction since other commentators, notably NGOs, journalists and politicians, have often sought a different route, based on increased transparency, morality,[44] and naming and shaming. The public disclosure route

[39] Kleinbard, 2011, p. 730.
[40] Office of National Statistics, 2013.
[41] Department of the Treasury, Federal Reserve Bank of New York and Board of Governors of the Federal Reserve System, 2013.
[42] Sanchirico, 2014.
[43] Although Actions 12–14 deal with administrative issues.
[44] For example, "Starbucks, Amazon and Google accused of being 'immoral'" The Daily Telegraph, 12 November 2012.

through country-by-country reporting is problematic and unlikely to succeed. It would provide information which would be very difficult to interpret. To properly understand why a company pays a certain amount of tax in a particular country one requires information at a level of detail which runs into confidentiality and competition issues. Making less than this amount of information publicly available is unlikely to be very useful and easily leads to misinterpretation and misinformation. Once conclusions from this information are drawn they are hard to dislodge from the public's collective memory even if they are repeatedly and convincingly exposed as being incorrect.[45] By contrast, although the BEPS Action Plan (BEPS AP) includes an action aiming at increased transparency through disclosure by multinationals, the information is to be disclosed to tax authorities and not to the public.[46]

The OECD's focus on the need to reform the existing international tax system is thus to be welcomed. But the question then is whether the reform being considered is as radical as the analysis in Section 1 suggests it needs to be. A starting point is provided by the OECD's articulation of the central problem it is addressing: "double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it".[47] Framing the problem thus suggests a focus on the symptoms of the ailing regime and not the structure of the regime itself.

In the first document produced by the OECD in this process (OECD, 2013 a) it intimated a willingness to take a bold approach: "it is also important to revisit some of the fundamentals of the existing standards. Indeed, incremental approaches may help curb the current trends but will not respond to several of the challenges governments face."[48] The second document produced, (the OECD BEPS Action Plan: OECD, 2013 b) also spoke of "a bold move by policy makers [being] necessary to prevent worsening problems"[49] and of the need for "fundamental changes".[50] However, it made it clear that there was a limit as to how bold and fundamental the proposed reform would be. This document explained that although "a number of countries have expressed a concern about how international standards on which bilateral tax treaties are based allocate taxing rights between source and residence States" its proposed actions "are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income."[51]

The reform proposed by the OECD is both less and more radical than the statements cited above make it out to be. It is less than a "fundamental" and "bold" reform because the Action Plan proposed by the OECD seeks to bring change within the

[45] For example, it was claimed by the press and NGOs that the UK revenue authority reached a settlement of £1.25 bn with Vodafone over a tax bill of £6 bn. The revenue authority dismissed the figure of £6 bn as an "urban myth", however the figure was still repeatedly used. Godall, 2010.
[46] OECD, 2013 b, Action 13. The objections raised here to increasing public information do not apply to increasing the information disclosed to the authorities.
[47] Ibid., p. 13 (emphasis added).
[48] OECD, 2013 a, p. 8.
[49] OECD, 2013 b, p. 10.
[50] Ibid., p. 13. In September 2014 the OECD produced a set of reports and recommendations to address seven of the actions in the BEPS Action Plan. They follow the general approach laid out in the BEPS Action Plan. See the Explanatory Statement accompanying the September 2014 deliverables: OECD, 2014 a.
[51] OECD, 2013 b, p. 11.

existing international tax framework. The OECD is not setting out to change the framework itself. It is not even questioning the desirability or logic of a regime centred on the residence / source and the active / passive income dichotomies in the 21st century. Indeed, it only mentioned one alternative to the current framework, formulary apportionment, and gave it very short shrift.

On the other hand, it is more radical than might at first appear because whilst purporting not to be changing the current allocation of taxing rights, the changes proposed do depart from it to some extent. This is done by adding a qualification to the current allocation rules where abuse is perceived. Specifically, although there is no clear unifying theme that covers all actions, a number of the actions focus on "economic activity", "relevant substance", "substantial activity" or "value creation"[52] and the general analysis in OECD 2013 b repeatedly speaks of the need for "a realignment of taxation and relevant substance … to restore the intended effects and benefits of international standards."[53] This is not surprising given the central problem identified by the OECD and quoted above. Indeed the OECD explained that "no or low taxation is not *per se* a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it."[54]

At a general level, therefore, OECD 2013 b explains that "this Action Plan should provide countries with domestic and international instruments that will better align rights to tax with economic activity".[55] At a more specific level, the Action Plan proposed by the OECD consists of fifteen actions which cover a wide range of issues and which are expected to lead to different types of outcomes.[56] The actions dealing with harmful tax practices (Action 5) and transfer pricing (Actions 8, 9 and 10) introduce the notions of "substantial activity" and "value creation". Action 5 thus includes "requiring substantial activity for any preferential regime", Action 8 includes "ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation" and in the context of intra-group risk transfers and capital allocation Action 9 includes requiring the "alignment of returns with value creation."

The use of a new notion of economic activity, substantial activity, or value creation raises a number of problems. We first discuss six specific problems with this approach. We then turn to the more general issue of whether such an approach is compatible with the important issue of tax competition raised above.

a) A test based on the location of economic activity: some issues

First, the desired outcome of better "align[ing] rights to tax with economic activity" constitutes a departure from the current regime. Put simply, the international tax

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[52] The four terms appear to be used interchangeably. Indeed at times, different versions are used in the same sentence "The Action Plan aims to ensure that profits are taxed where *economic activities* generating the profits are performed and where *value is created*." (emphasis added) OECD, 2014 a p. 4.

[53] OECD, 2013 b, p.13.

[54] Ibid., p. 10.

[55] Ibid., p.11.

[56] These include further reports, changes to the OECD Model Treaty and commentary, and recommendations to change national law.

system does not currently allocate taxing rights to countries according to where "economic activity" takes place. Indeed, when passive income is paid across borders it will be taxed in the recipient's country of residence solely by virtue of the recipient's residence in that country. No economic activity in the country of residence is required. This change thus overlays a new and completely different principle onto the existing structure. As the new principle points in a different direction the inevitable conclusion is that the OECD is proposing a shift in the taxation of certain forms of passive income from a residence basis to a "place of economic activity" basis. Whether this is a sensible policy is open to discussion. However, the BEPS Action Plan does not attempt a proper analysis of such a change.

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

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

> "From an inbound perspective, the concern regarding interest expense deduction is primarily with lending from a related entity that benefits from a low-tax regime, to create excessive interest deductions for the issuer without a corresponding interest income inclusion by the holder. The result is that the interest payments are deducted against the taxable profits of the operating companies while the interest income is taxed favourably or not at all at the level of the recipient, and sometimes the group as a whole may have little or no external debt."[57]

This explanation suggests that the OECD's desired change might entail making S1's ability to deduct interest paid in State B[58] dependant on whether State A taxes the interest and at what rate.[59] If by "economic substance" the OECD means more than a mere extension of credit, taxing rights presumably will be deemed to be aligned with "economic substance" if State A has a "regular" tax regime, but not if it has a zero or low tax regime. This might address the problem of profit shifting through the use of

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[57] Ibid., p. 16.

[58] This will of course determine whether A or B will ultimately tax the profits generated by S: A, indirectly as a result of a deduction for S and taxing rights over the interest payments received by P, or B directly by denying or limiting the deduction for the interest paid by S or imposing a withholding tax on it.

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

debt but it does not appear to be principled and also introduces further incoherence into the system. As shall be discussed below, competitive pressures might also undermine this change altogether.

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

The above discussion by the OECD of the issues created by inbound funding qualifies "interest deductions" with word "excessive". In fact, Action 4 explains that the OECD will provide recommendations on how to deal with base erosion through, amongst others, "the use of related-party and third-party debt to achieve *excessive* interest deductions". This suggests that if interest is paid to a lender in a tax haven, it will be tolerated as long as it does not go beyond a certain limit. But if this form of payment is objected to, it is unclear why it should be tolerated up to a certain limit. There is no obvious principle to determine whether a payment is excessive or not. Any limit which is chosen is necessarily arbitrary.

In another example, in the context of transfer pricing, Action 8 specifically includes "ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation". The OECD does not explain whether the concept of value creation is different to that of economic activity. If it is not meant to be different, the use of different terms can only create unnecessary confusion. If it is meant to be different it is not at all clear what the difference is.[60] Action 8 further demonstrates that the OECD's proposals in its BEPS Action Plan constitute a departure from the current international tax regime because the ALP does not necessarily lead to an allocation of taxing rights according to value creation. At the time of writing it is not clear if the shift to "value creation" is intended to override the ALP in all cases or simply in cases of double non-taxation or low taxation, which is what the BEPS project is meant to address.[61] If it is only the latter, the addition of a rule in a circumscribed number of cases would no doubt create problems of its own.

[60] One of the documents produced by the OECD as part of the 2014 deliverables package uses both terms in the same sentence. This could suggest that they are viewed as being synonymous, but this is not entirely clear. "Due consideration will be paid to make sure that the revised rules reconcile the location where profits are reported for tax purposes with *economic activities and value creation*, without increasing uncertainty." (Emphasis added). OECD, 2014 a, p. 7.

[61] The OECD has suggested that there will be departures from the ALP in certain situations only: "In completing the transfer pricing work required by the BEPS Action Plan, the OECD will, as directed by

In sum, the post-BEPS international tax system is likely to be more incoherent, with taxing rights being aligned with economic substance in some cases but not in others. There does not appear to be any principle for distinguishing between the two sets of cases; at best, reliance will be placed on vague and arbitrary tests such as "artificial" and "excessive".

Third, if applied too narrowly an "economic activity" test might wrongly identify instances of low or no taxation. Consider the following example. P is a parent company resident in State A, a high tax jurisdiction operating an IP Box regime which taxes royalty income at 5%. S is a wholly-owned subsidiary of P, resident in State B, a high tax jurisdiction. S develops intellectual property which it sells to P for a fair price; and S pays tax in State B on the transfer. P grants a licence over the intellectual property to T, an independent company resident in State C, another high tax jurisdiction. T pays royalties to P which it can deduct from its taxable profits; P pays tax on the royalties at the low tax rate of 5%.[62]

As a result of this arrangement, royalties which might otherwise have been taxed at a high rate in State B, where the IP was developed, are taxed at a low rate in State A. Focusing narrowly on the transactions between P and T, one could reach the conclusion that there is low taxation as a result of taxable income (in State A) having been segregated from economic activity (in State B). However, if the transfer of the intangible to P were priced correctly, with State B collecting appropriate tax on that transfer, single taxation on the intangible would have already taken place.[63] This is not therefore a case in which there is "no or low taxation … associated with practices that artificially segregate taxable income from the activities that generate it."[64] But to identify this, one cannot focus only on the royalty payment and ignore the tax paid on the transfer of the intangible. By contrast, the OECD's approach does not appear to consider any tax paid in B in the transfer of the IP;[65] indeed, the example given above appears to be targeted by the OECD in its work on Action Plan 5 dealing with harmful tax practices.

Fourth, the focus on economic activity suggests a misdiagnosis of the problem in some situations. In the last example given above, if P pays S less than the fair price for the intangible, there would not have been single taxation of the intangible and the concern over low or no taxation would be warranted. However, this problem is not due to a lack of economic activity in State A. The problem here stems from the inability to price inter-company transfers such as that between P and S. If this is the

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the Action Plan, consider both the application of the arm's length principle and special measures in order to identify effective responses to the concerns raised in the BEPS Action Plan." OECD, 2014 b, p. 11.

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

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

[64] OECD, 2013 b, p. 10.

[65] OECD, 2014 c, p. 33.

real cause of the problem it should be addressed directly.[66] If it is not possible to remedy that situation, then the soundness of a system which relies on the correct pricing of such transfers should be questioned. If the real problem here is that the system itself is unsound then a stable, long-run solution cannot rely on keeping the system but amending one part to correct for the failure of another part.

In other instances, the problem may instead arise not from the difficulty in pricing but from applying the system to its logical conclusion. As discussed above, under the ALP affiliated entities are viewed as independent and so prices for intra-affiliate transactions are expected to conform to the prices that would have been agreed by independent entities. This approach leads to permitting Cost Contribution Agreements, as described above. The OECD now appears to recognise that such agreements allow multinationals to artificially segregate income from economic activities, and it aims to address this problem.[67] However, it is likely to do so through some form of economic activity test, which will still be subject to the drawbacks discussed here.

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

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

b) Problems of interaction with tax competition

Even if all the problems with the approach proposed by the OECD were solved, however, there remains the problem that it will conflict directly with the policy of national governments in competing with each other. To see this, let us return to the last example given above where P, resident in State A, acquires intellectual property from its wholly owned subsidiary, S, resident in State B. T, resident in State C acquires a licence over the IP and pays a royalty to P in return. It might be argued that

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

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

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

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

4. Are there any alternatives?

The conclusion reached in the previous part is that even if the actions proposed by the OECD are successfully implemented, the international tax regime will still not be fit for purpose. The regime will consist of a confused, complex mass of arcane, arbitrary and sometimes illogical rules, competition will still drive rates down and reliefs up, location of real economic activity will still be distorted and it is likely that cross-country arbitrage opportunities will remain.

To maintain a stable and long-run tax on the profits of multinational companies it is therefore necessary to search for alternatives which go beyond changes within the

existing framework to changes to the framework itself. Given the effect of competitive forces described above, it would be preferable to adopt a framework which could not be undermined by countries acting in their own interests. Such a framework would be incentive compatible. Admittedly, a shift away from the current framework is difficult because strong path dependencies have developed over the past hundred years in which the current framework has been in place. Any shift requiring international cooperation will be particularly hard to implement. However, whilst not underestimating these difficulties, exploring these options is important. Here we provide only brief comments on three possible alternatives.[68]

The first is formulary apportionment. To some extent, formulary apportionment may be held up as evidence of the difficulties inherent in obtaining international agreement in this area; for example, the European Commission has been unsuccessfully pursuing this option within the EU for a number of years through its proposal for a Common Consolidated Corporate Tax Base (CCCTB). The debate on the CCCTB and the support lent to formulary apportionment by a number of NGOs and some prominent academics have led to the strengths and weaknesses of this alternative to be canvassed at length. The frequently made criticism that a formula based allocation does not reflect a true allocation of profits is misguided because it assumes not only the existence of "a true allocation of profits", but a supposition that the existing system somehow captures this true allocation, even if imperfectly. Identifying where profit is generated even conceptually is a complex, if not impossible, exercise; certainly, however, the current international tax regime does not itself allocate profits on this basis. Whilst this criticism does not stand, other concerns do have some justification. For example, the system requires international agreement on the tax base, the allocation of taxing rights and administration. This would be hard to achieve, as a careful consideration of the incentives for a country to join such an international system of taxation demonstrates. In any event, even if international agreement were achieved, the system would still lead to a distortion of real economic activity and to competition on tax rates.

A second alternative is an allocation of the tax base based on the location of sales to third parties. The starting point for this proposal is the desirability of taxing corporate profits where the least mobile factors involved in the generation of the profits are located. These factors include the shareholders, the companies composing the group and the consumers, all of whom may be located in a number of different states. As individuals are generally less mobile than the elements of a multinational company, it is worth considering whether their location can be the basis of a profit allocation. The proposal for an allocation based on sales to third parties relies on the relative immobility of consumers. This would be a novel system of taxation, and requires further detailed investigation; however, a number of points can be made here.

Such a destination-based tax could operate like a Value Added Tax (VAT). By zero-rating exports and taxing imports, a VAT is also imposed where the consumer is located. Unlike a VAT, however, this tax would be levied on profit and not value added; therefore a deduction would be given for labour costs in the place where they

[68] For a more detailed consideration of these options see: Auerbach, Devereux, and Simpson, 2010.

were incurred. The tax could be brought even closer to a VAT by adopting a cash-flow treatment.

From an economic perspective, this proposal solves a number of problems observed in the current international tax system.[69] The tax would not affect the location of investment as it is levied where the consumer is located. Transfer pricing within the group becomes irrelevant because, ultimately, taxable income is determined only by a sale to the final consumer. Given that, and as long as consumers do not move in response to high corporate tax rates, countries will no longer need to compete over tax rates.

Features of the VAT can be borrowed when implementing such a system. For example, cooperating countries could set up a "one-stop shop" approach similar to that introduced in the EU for VAT from 2015. Under this approach, a company selling products in a number of countries would be taxed in its place of residence at the rates set by the countries in which the sales are made. National tax authorities would then aggregate the tax due by domestic companies to each country into which they sell and adjustments would be made at the aggregate level.[70] Clearly, however, introducing this approach will not be without difficulty and requires careful examination.

The need for international cooperation has been identified as a fundamental weakness of proposals for formulary apportionment. But it causes less concern for the proposal for a VAT-type destination-based tax. This is because in general there would be incentives for countries to join a group of other countries that had already begun to operate such a system. Companies would gain by locating their activities in a country that used a destination-based tax, and this would induce countries to introduce such a tax. In broad economic terms, therefore, if such as system existed, it would give rise to incentives for countries to join. [71]

A third alternative is to introduce a simpler tax base. For many years one of the central economic debates in corporation tax has been how to design a non-distorting tax on profit, thus achieving production efficiency. A corporation tax which does not distort business behaviour would certainly be a desirable goal. However it may not be possible to implement such a tax in practice. This suggests that we need to consider tax bases that may be further away from production efficiency, but which are simpler to implement.[72] For example, the tax base could be based on turnover, size of fixed assets, sales or wage costs. Such tax bases are relatively easy to measure and tax; it is also not clear that they are any more distorting than the existing tax on profit. However, like the existing tax system, if the tax base is itself mobile, such a tax would still be likely to be subject to tax competition between countries.

[69] See Auerbach and Devereux, 2012.
[70] See Devereux and de la Feria. 2012.
[71] See the discussion in Auerbach and Devereux (2012).
[72] Recent research investigates a simpler minimum tax scheme that operates in Pakistan: see Best, Brockmeyer, Kleven, Spinnewijn and Waseem, (forthcoming).

5. Conclusions

This paper has addressed some of the fundamental issues in the taxation of profit of multinational companies, and analysed the direction of reform of the OECD BEPS project.

The basic problems of the existing system stem from two main sources. The first is that the arbitrary compromise for the allocation of profit between countries first agreed in the 1920s is wholly inappropriate for taxing modern multinational companies. That is fundamentally because it attempts to tax very similar forms of income in different places and in different ways. As a consequence it is open to manipulation by companies seeking to reduce their worldwide tax liabilities. One example (of several discussed in the paper) is the distinction between debt and equity. Financing wholly-owned affiliates with debt has little or no economic distinction compared to financing them with equity. Yet the basics of the international tax system require the resulting income to be taxed in different locations. To prevent "excessive" tax planning, countries have responded by introducing arbitrary restrictions on financing patterns, and the OECD is devising ever more complex ways to deal with "hybrid" financial instruments. Yet the distortions and complexities that have been, and continue to be, created would be quite unnecessary if it was recognised that the initial distinction is quite without merit. Rather than propping up the existing system, there is a need to reconsider the fundamental structure of the system.

These problems are compounded by a natural process of competition between national governments – for limited real economic activity, an advantage to "domestic" business, and greater tax revenue. Such competition – especially for the first two elements - has seen tax rates falling gradually over time, but increasingly competition is taking other forms, such as the introduction of patent boxes and limitations to anti-avoidance rules.

Recognising the power of this competition is key to creating a stable long-run system of taxing the profits of multinational companies. Even if existing governments were to reach an agreement to preserve the basics of the existing system, while tightening anti-avoidance rules, there will still be an incentive for future governments to undermine that system, as their predecessors have done in the past. A stable system must remove the incentives for governments to undercut each other. In turn, that means that a stable system will require the allocation of taxing rights to be based on factors that have limited mobility; only then will the tax system in one country not be able to undermine that in another country.

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