



tax structures.”

Even California’s governor Jerry Brown joked about Ireland’s creativity when it came to tax and Apple’s Irish operations.

“We thought they were a California company but when you look at their tax return, they are really an Irish company,” he said, to laughter from the audience at a networking event in San Francisco on a

visit by Enda Kenny, Irish prime minister, in June 2012.

“Creative accounting” had lured much of Apple’s business to Ireland, said Brown. If California could have Ireland’s tax rate, the state could very well become “an independent country”, he said. There was nervous laughter from the Irish delegation at Brown’s “jokes” but the pummelling

Ireland took at the Senate hearing will take some time to recover from.

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Operation BEPS

The OECD has launched a project to tackle tax avoidance by companies. **Helen Miller** looks at how it will work and its chances of success

In his keynote speech at the World Economic Forum last year, David Cameron, the prime minister, said “companies need to wake up and smell the coffee”. This was a dig at Starbucks and a response to the public outrage over how little corporation tax the company pays in the UK. Starbucks announced a payment of £5m in corporation tax in June 2013, its first corporate tax payment since 2009. In 2012, it had UK sales of £400m. Other multinationals, notably Amazon, Apple and Google, have also faced public disapproval about their use of tax avoidance strategies.

It was in this climate that the OECD launched the Base Erosion and Profit

Shifting (BEPS) project, which considers how to modify current tax rules to achieve an appropriate allocation of taxable profits across countries. In 2013, at the behest of G20 leaders, the OECD published a 15-point action plan on the steps necessary to address the BEPS challenge.

What’s all the fuss about?

Tax avoidance is a somewhat slippery concept. It encompasses activities that are legal but are at odds with the “spirit” of the law. There are a range of activities that could be deemed to be avoidance and large differences in how aggressive tax avoidance strategies are.

Broadly, multinational companies can

avoid corporate tax by shifting profit streams to relatively low-tax countries and/or increasing the tax deductible allowances given in high-tax locations. Much of the recent controversy over multinational tax avoidance can be traced to the income associated with intangible assets, and specifically intellectual property, which often has no clear geographical location.

For example, Starbucks’ UK corporate tax payments are low relative to the income that is earned from the sale of coffee in the UK largely because of tax-deductible royalty payments made for the use of the Starbucks brand. The payments go to a subsidiary in Amsterdam that manages the intellectual property used in the European market.

This raises questions. Is the royalty set at the correct level, or is the return to UK functions being undervalued? Have there also been appropriate payments to the US, where the brand originated, or has intellectual property been located in the Netherlands with a view to shifting profits?

It is often difficult, both conceptually and practically, to disentangle the value of complementary activities that occur in

different countries (in this case, the design of the brand in the US, the management of the brand in the Netherlands and the UK sales functions) and, therefore, to determine what is the appropriate split of taxable profits.

The tax system deals with these types of issues by requiring that all inter-group transactions (eg royalties) are priced as if they take place between unrelated parties. This is the arm's length principle. However, companies have the scope, and superior knowledge relative to the tax man, to organise their activities in a way that reduces tax payments. The more aggressive tax avoidance strategies are, the more likely it is that income streams are divorced from any substantive economic activity.

The OECD report highlights that many of the opportunities for using BEPS arise from the interaction between rules in different countries. In particular, multinational companies can structure themselves in such a way as to take advantage of "hybrid mismatches". These are situations in which a company exploits the fact that a transaction or entity is treated differently in different countries. One prominent example is when a transfer of money is treated as debt in one country but equity in another.

Avoidance can also flow from the application of domestic tax rules. For example, the rules surrounding interest deductibility can make it possible for a company to shift income by making an inter-group loan from a subsidiary in a low tax country, where interest will be taxed as income, to a subsidiary in a high tax country, where interest payments will be tax deductible.

There are educated guesses as to how much is lost to multinational tax avoidance and the sum may be substantial, but the real answer is that we do not know. We do not have good measures of how much tax "should" have been paid in the UK. Nor do we know how much tax could actually be collected if all avoidance were prevented because we do not know the extent to which companies would adjust their behaviour.

However, we do know that avoidance takes place. As well as having a fairly clear picture of how companies do it and anecdotal evidence from tax professionals, we have academic literature that provides empirical evidence.

For example, we see that intangible assets are more likely to be located in a low-tax

country, and that royalty flows and foreign direct investment to low-tax jurisdictions are substantially higher than expected given the size of these economies.

As a stark example, a recent UN report showed that in 2013 the British Virgin Islands saw the world's fourth largest inflow of foreign direct investment, most of it representing cash that was transferred through the country, which was as much as the sum that went to Brazil and India combined.

There is disagreement over whether avoidance is a problem. One argument is that avoidance activities work to provide a lower de facto rate of tax on activities that are more internationally mobile and that this in turn increases efficiency and reduces tax competition. However, the ongoing concern is that avoidance works to reduce the amount of tax revenue that is collected and can undermine the credibility of the tax system.

Avoidance can also create distortions between different companies. For example, highstreet retailer WH Smith recently

There is disagreement over whether tax avoidance is a problem

organised a petition among domestic UK retailers to highlight that it is at a competitive disadvantage to Amazon because it faces higher corporate income tax.

Are we 15 steps away from a solution?

Since almost all avoidance behaviours happen at the boundaries between tax jurisdictions, an internationally coordinated solution is needed. For the past five decades, the OECD has been at the forefront of efforts to facilitate policy coordination. Most notably, the OECD Model Tax Convention, launched in the 1960s, has provided a framework for eliminating double taxation of multinationals' income streams and the OECD Transfer Pricing Guidelines, formalised in 1979 and regularly revised since, are now used by most countries as the basis for implementing the arm's length principle. The focus of the BEPS project is on providing guidance on the solutions to double non-taxation – that is, a situation in which income goes untaxed in all countries.

The OECD has highlighted that facilitating coordinated action is important to ensure that tax revenues are not further eroded and that unilateral measures, which may add uncertainty or increase the frictions between tax systems, are avoided.

The 15-point action plan will result in a range of outputs. Seven will offer specific recommendations for how domestic tax rules and, where relevant, model treaty provisions, can be modified to reduce opportunities for profit shifting.

These will include measures aimed at preventing the use of hybrid mismatches and limiting the scope for using interest deductibility for tax avoidance purposes. There will be guidance on the design of Controlled Foreign Company rules, anti-avoidance rules that aim to tax income that has been artificially shifted to a low tax country, and on mandatory disclosure rules for aggressive or abusive arrangements.

Four of the actions will lead to changes in the Transfer Pricing Guidelines. The focus of these areas of work is on ensuring that when intangible assets or risk are transferred within a company the allocation of taxing rights continues to be based on the location of value creation.

One of the most challenging points relates to the digital economy. With internet-based sales, profits can arise from products or services sold in a country where the seller has no physical presence. In such cases, there are no taxing rights in the countries where final sales are made. Examples can include e-books, music downloads or the use of social media networks. This has raised questions over whether the current rules lead to a fair allocation of taxing rights and whether companies can organise digital activities so as to avoid tax altogether.

The BEPS project will make a report on the characteristics of the digital economy that particularly hinder taxing related companies and present a range of options for reform.

Will the BEPS project succeed? That depends in part on the definition of success. It is unrealistic to think that all opportunities for profit shifting will be prevented in the post-BEPS world. However, the range of reports and recommendations are expected to lead to changes in at least some tax rules to make some forms of avoidance more difficult. There will likely be a focus on preventing the most egregious and contrived structures.

We will have to wait to see how big a difference BEPS makes both to companies' behaviour and to corporate income tax revenues. In recent decades, one of the surprises has been that corporate tax revenues have been relatively robust, in large part buoyed by an increasing and increasingly profitable corporate sector. One of the difficulties with measuring the success of the BEPS project on revenues is that we will not observe what would have happened had no policy action been taken. Revenues may increase, but BEPS actions may also just work to prevent a decline.

When it comes to limiting factors for BEPS, there are two that matter. The first is political will. Success will require implementation of new tax rules by a sufficient number of countries. The BEPS project is being undertaken on a relatively short timetable: the action plan was

published in July 2013 and all actions are due to be complete by the end of 2015, with many being concluded by September this year.

The ambitious time frame was chosen to try to ensure that the cause benefits from political momentum. This should help. However, in some cases, countries may face trade-offs between wanting to prevent tax avoidance on the one hand, and wanting to be competitive on the other.

For example, the BEPS project will provide a review of OECD member states' preferential regimes, which, broadly, are special regimes designed to attract certain kinds of activities. If the OECD judges, as it has in the past, that some such regimes create "harmful tax competition" and should therefore be removed, there may be a direct conflict with competitiveness aims.

The second factor is the tax system itself. The current corporate tax rules were

designed at a time when most companies conducted all of their business within a single country. Now, multinationals operate not only with different parts of their business in different locations but often with the same function spilt over many locations. As a result, around 60 per cent of world trade occurs within companies.

Globalisation, as well as the increasingly digital and intangible nature of activities, has continued to raise challenges for the design of corporate income taxes. Under the auspices of the OECD, tax rules are being put place and amended with a view to properly allocating taxable profits in the face of these challenges. This has produced a workable but imperfect system. A more satisfying solution to the BEPS problems may require a different type of tax system.

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Shadow boxing

Colin Williams argues that tougher action may not be the best way to reduce the size of the illicit economy

Nothing is certain but death, taxes and tax avoidance. The world over, businesses and individuals hide monetary transactions from public authorities, be it for tax, social security and/or labour law purposes. Clearly, they have incentives to do so, but there is also a cost. The shadow economy creates risks for the health and safety of workers and damages working conditions, hinders employment creation, puts at greater risk the financial sustainability of social protection systems and undermines the legitimate business environment through unfair competition (Williams, 2014).

How big a problem is it and what should policy makers do about it?

Measuring the size of the shadow economy is a little like trying to count the number of rodents in a city – by definition, it is not out in the open. Indirect methods often use proxy indicators such as tax rates,

regulatory burden and tax morality. The most widely used indirect method – DYMIMIC (dynamic multiple-indicators multiple-causes) technique (Schneider, 2005), Figure 1, estimates that the average size of the shadow economy across the 27 member states of the European Union (EU-27) is 18.4 per cent of GDP, about a quarter of which is composed of prostitution and drug dealing.

However, the size ranges from 7.6 per cent in Austria to 31.9 per cent in Bulgaria, with a clear east-west and north-south divide. No western and northern European countries have shadow

economies larger than the EU-27 average and most east-central and southern European nations have above average shadow economies.

This means that, if the shadow economy was to come out into the open and declare itself, European public expenditure could increase by around one-fifth, and, for example, healthcare expenditure could be doubled (Murphy, 2012).

