

## Key Questions for Civil Society Dialogue on BEPS

*Answers in italics supplied by Richard Murphy FCA of Tax Research LLP on 8 April 2013*

### 1. General questions

- Do NGOs agree with governments that base erosion and profit shifting is a significant problem? If so, is this contributing to the instability of the international tax system?

*Yes: the evidence is overwhelming that this is an increasing trend. Specific cases such as Google and Amazon highlight it. TUC research in *The Missing Billions*<sup>1</sup> was an early indicator that taking country specific information was in inappropriate method of calculating tax gaps: when viewed internationally these were always higher than expected nationally because profits had been shifted before any further avoidance techniques could be applied.*

*The biggest factors that permit profit shifting are:*

- *Taxing each member of a group separately (the separate entity approach) which conflicts with the economic reality of group of companies;*
  - *Treating each group member as independent which encourages arbitraging rules between them;*
  - *The flawed logic of seeking to apply a separate entity approach to each group entity which means that the super-normal profits a group makes can never be taxed;*
  - *The arms length based transfer pricing rules which do not work because there are too few comparables to determine arms length prices meaning the system is fundamentally flawed;*
  - *The residence rules for companies;*
  - *The permanent establishment rules for branches;*
  - *The failure to address electronic trading;*
  - *The failure to effectively tackle issues relating to intellectual property and mobile capital.*
- What role can the OECD play in the BEPS project, and in restoring stability to the international tax system?
    - *Adopt a single entity approach to taxing group companies i.e. treat them as one company that requires its profits to be apportioned based on key allocation drivers such as where sales, people and assets are located;*
    - *Require consolidated reporting from companies to all tax authorities requiring the submission of group worldwide data showing on a country-by-country basis where the company trades, where profits arise, where sales are from and too, where people are employed, where profits arise and where tax is paid as well as where assets are. Third party and intra-group transactions should be separately disclosed. Then appropriate risk assessments to determine whether there are issues relating to misallocation of profits can be more easily assessed than at present and the companies will be required to place all their cards face up on the table from the outset of any such negotiation saving time, cost and effort for all involved;*
    - *Change the rules on residence;*
    - *Change the rules on permanent establishments;*
    - *Create specific rules for internet and other distance selling operations;*

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<sup>1</sup> <http://www.tuc.org.uk/touchstone/missingbillions/1missingbillions.pdf>

- *Tackle unfair tax competition from tax havens;*
- *Permit and encourage tax withholding on payments for royalties, licences, interest, management fees and related services when paid to low tax jurisdictions;*
- *Cooperate with the UN Tax Committee to ensure the interests of developing countries are fully taken into account;*
- *Demand full country-by-country reporting for accounting and taxation purposes.*

## **2. Assuming that there is a BEPS issue, and that the issue should be addressed by multilateral action:**

### **Countering base erosion**

- How should economic substance be taken into account as a criterion for evaluating the tax treatment of transactions?

*In two ways:*

- *By moving to a preferred comparable profit split allocation of profits between states instead of using an arm's length comparable pricing model. This is already permitted under OECD rules but is considered a secondary method and should become the preferred method of income allocation between states;*
- *By using allocation keys to determine fair bases for profit splitting. These could include sales, labour and assets but may involve other factors e.g. reserve usage in the extractive industries. These need not be applied universally: just as arm's length prices are determined individually so can profit split allocation keys, although norms might well develop. Advance agreements could and maybe should be encouraged based on full and open disclosure.*

- How should governments deal with hybrid mismatches and arbitrage? How can governments ensure legal certainty while doing so? What kind of instrument is the most effective/appropriate?

*If the approaches already noted were adopted this problem would probably cease to have much of its current significance. It is a problem of the flawed separate entity approach that should be abandoned.*

- Would a general LOB clause (within tax treaties) be useful? Are there any restrictions that should be placed on the use of tax treaties which can be implemented without overkill/unbalanced negative effects on sound business practices?

*LOB clauses have the effect (to some degree) of general anti-avoidance rules. They might be considered statements to 'keep off the grass'. Their impact is largely one of deterrence. There is some evidence that they work. They should be encouraged. Reasonableness and economic substance tests should be used to determine when they should come into operation.*

- How would NGOs react to more uniformity in the way rules limiting interest deductibility operate? Would NGOs favour a more internationally coordinated approach on other deductible expenses, such as headquarters expenses?

*This capitalisation and other such rules have not worked well. There is a need for much tighter regulation in this area, but a starting point is to provide the right for any state to withhold tax at source on interest payments at a rate of not less than 20% and an encouragement that they do so. This is to some degree of source and residence based priority: the source state should have a right to tax interest paid. The same approach should be applied to royalties, copyright fees and other such charges and all management expenses.*

- How can MAP processes, including arbitration, be improved to address uncertainties or inconsistencies in how anti-avoidance/abuse rules are applied?

*The greatest weakness of current approaches is their lack of transparency. It is vital that procedures be more open.*

### **Jurisdiction to tax**

- What challenges exist in implementing the existing treaty standards?
  - *Data availability;*
  - *Tax authority capacity;*
  - *Weaknesses in permanent establishment and residence rules;*
  - *The separate entity approach that encourages abuse and that does not reflect economic reality, meaning all settlements are inherently artificial and so flawed: international tax should not be based on a myth;*
  - *Inflexibility in updating treaties because of their bilateral nature: multilateral updating is essential.*
- Are there artificial arrangements that some businesses use to avoid jurisdiction to tax (e.g. PE status or withholding at source)?
  - *Yes: Google and Amazon are perfect examples, and well documented.*
- For purposes of concepts such as PE, is the on-line sale of a digital product (e.g. e-books) different than the on-line sale of tangible products (e.g. printed books)? What are the key differences?
  - *The right of destination states have to be recognised but because of the widespread abuse of PE rules (e.g. Amazon). The problem for physical and online sales is broadly similar: taxing at the point of sales origin is clearly failing in these cases to ensure fair taxation results. The change required covers all trading.*
- Should governments coordinate their CFC legislation, and if so, what criteria are appropriate for income that is included in such regimes?
  - *Yes: CFC coordination is vital. Parent entities should be assumed to control all their subsidiaries without exception (as they clearly do, which is the reality that group accounts recognises but which taxation does not) and a single entity approach to taxation should ensure profit is allocated not on the basis of legal constructs but on the basis of real key allocation drivers such as sales destination, labour location etc. If this were done the problem of CFCs would largely disappear because the activity they supposedly undertake would in many cases cease to have profit allocated to it.*

### **Transfer Pricing**

- Are there circumstances in which transfer pricing rules do not currently result in profit being aligned with the location of i) substance, or ii) “core value-driving activities” of a trade union? If so, what are the best ways to address that?
  - *Whenever there are no comparable prices misallocation of profit is likely, especially when wholly artificial transactions constructed solely to shift profit e.g. on intellectual property, are being priced using this method. Artificial methods of pricing based on*

*false assumptions as to the nature of the contracting entities using fictional prices for which there is no third party comparator are bound to misallocate profits and leave the system wide open to abuse;*

- *The changes required to deal with this situation have been noted above.*
- In analysing the risks of a global business, what are the relevant differences between branches and subsidiaries?
  - *There aren't any: the choice of legal entity used within a group should not impact economic profit allocation which should be based as far as possible on economic fact, not legal construction.*
- In what circumstances is it appropriate to disregard or recharacterise the form of a related party transaction for transfer pricing purposes?
  - *In each and every case where there is no genuine comparable price in a large and open market.*
- Can NGOs identify best practices in the current transfer pricing practices by individual jurisdictions that can be used to address key transfer pricing issues (including the use of risk assessment tools to reduce the burden associated with transfer pricing documentation requirements)?
  - *China's preference for profit sharing may be considered a move in the right direction on these issues. Brazil's attempts are notable, but may be too arbitrary. Those working within existing constraints are bound to end up with flawed taxation bases.*

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Contact details:

Richard Murphy  
Director  
Tax Research LLP  
The Old Orchard, Bexwell Road, Downham Market  
Norfolk, PE38 9LJ, United Kingdom

+44 (0) 1366 383500  
+44 (0) 777 552 1797  
richardmurphy1572 on skype  
richardjmurphy on twitter

[www.taxresearch.org.uk/blog](http://www.taxresearch.org.uk/blog)

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