Funding the Future

Is BEPS the end of the line for the OECD taxation model...

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I was asked to do on interview on various aspects of the OECD's Base Erosion and Profits Shifting (BEPS) process on Good Friday and actually gave it yesterday. In the intervening three days I had ample time to consider issues over above and beyond the subject of hybrid entities that we were meant to be discussing. Since I have no doubt only a few selected quotes will be used from the interview let me offer some of the broader thoughts here.

First, let's be clear that BEPS is a G20 initiative, not just an OECD one. That means it involves a slightly bigger participating range of countries than usual but for all practical purposes the fact that this work is being done by the OECD in Paris makes this feel like an OECD project and it is not for nothing that the OECD is known as a club of rich nations.

Second, let's be aware that this is meant to provide a global tax solution even though only a subset of all nations that are developing it.

Third, let's be very aware that not all nations are equal when it comes to the OECD. Candidly, there is the USA, maybe the UK, and then there are the rest. Like it or not, if what the OECD comes up with is not Congress friendly, then nothing works. As a result, if the US stamps its foot then everyone jumps. That is massively destructive, not least because Congress is hostile, not least to the OECD. Many right wing Americans think it a profoundly socialist organisation because it produces regulations.

Fourth, let's also note that the OECD has very mixed form. It is completely wedded to the arm's length pricing method of allocating profits between companies within a multinational enterprise even though this makes two absolutely absurd assumptions, the first being that all companies within a group are independent of each other when they very obviously are not and the second of which is that there are comparable prices in the world's market places for any trade undertaken within a group when that is now very obviously untrue given that maybe 70% of world trade is intra-group.

Next, the OECD is opposed to anything looking like formula apportionment of profits between states because that is the alternative to arm's length pricing. The fact that very often this has to, in effect, happen because there is no data to achieve any other result is beside the point: the OECD has a closed mind on this issue.

It has much the same closed mind when it comes to country-by-country reporting although it has been told to address it. That closed mind is because it thinks it feels like formula apportionment.

And the OECD also lives in a time warp when not comes to accounting. That's because arm's length pricing was chosen as the bias for profit apportionment before most countries in the world required multinational companies to prepare consolidated group accounts and as such no one could apportion group profits between states because no one knew what group profits were. The OECD's accounting logic has never, as a result, moved into the post World War 2 era when group accounting became the norm, and the level of accounting illiteracy in the discussions I have witnessed at the OECD has been staggering.

Add all that to the fact that the OECD simply does not have a prevailing philosophy on tax competition and we have a problem. By that I mean that whilst the organisation is supposedly dedicated to making sure that tax is paid once and once only it was in practice for a long time obsessed only with eliminating double taxation and rarely if ever considered the possibility of double non-taxation. That means it is the architect of many of the problems for which it is now supposed to provide solutions.

And then also consider the fact that when tackling tax havens whilst it said these caused 'harmful tax competition' it has never been able to agree if there is a benign form and what that looks like. The consequence has been crippling confusion as states are allowed to undermine each other. The goal of ensuring fair international taxation is compromised as a result with the consequence that the process of base erosion and profit shifting from internationally mobile resources to nationally static tax bases like labour (in particular) has been tacitly encouraged by the OECD. No wonder big business has some liking for it.

Enough of the background to the current problems though: What of the present issues? It seems to me a number of recurring issues are emerging in the BEPS discussions as policy draft after policy draft is rushed out of the various OECD working parties tackling BEPS related issues.

Take the problems of the digital economy. These have been virtually sidelined by saying there is no distinct digital economy. That may be true, but it hardly helps.

And then there are the problems with transfer pricing. However big they are, the commitment is to keep the system, come what may. The US is adamant on this and its will must be done. The same may be true in the digital economy, of course.

Then there is country-by-country, one of the particular issues where the politicians spoke. This suffers the problem of being a tax solution not thought up in either the US Treasury or the OECD itself. It is, as a result, being steadily gutted of all meaningful content as discussion progresses through the OECD. The proposed 15 indicator template is now down to 7. Even then the US is seeking categoric assurances that no one will ever use the data to undertake formula apportionment calculations to see if the profit allocation of a multinational group reflects the likely location of the place where profit was actually earned - even though that is the whole purpose of the exercise.

Then turn to hybrid entities. Apart from the fact that I do not think anyone is happy with the intensely complex draft there is inherent in it the demand that all countries monitor each other's moves on issue. And that's where I begin to get alarm bells ringing which suggest that this whole project is just not going to work.

I have to say they've been present for a whole. The fact that OECD staff have already been saying for months that if only they had more time they might make BEPS work suggests to me they're already making their excuses in advance. And the profession is saying the problem is too complex to solve - as was said to me by someone who should know last week. That's their excuse for saying 'keep the status quo' which suits them too well. The result is that what we're seeing are some fig leaves. There will be a country-by-country template in some form. There will be some changes to arm's length pricing rules - but they happen periodically, anyway. And there will be more information exchange with tax havens, but I'm looking at substance not form when I say I have alarm bells ringing.

In my view an emerging theme is of the impossibility for many nations of achieving the outcomes the OECD is suggesting. So developing countries will not be able to monitor hybrid entity legislation in other states and deal with it, whatever the OECD wants. And nor will many developing countries be able to reciprocate on automatic information exchange as yet and so may be kept out of it. Likewise they can't create sophisticated arm's length pricing teams and have little inclination to do so when then know that however much they invest in them the system does not work and the odds are stacked against them.

Nor does it look as if developing countries will benefit from country-by-country reporting. Moves are being made to ensure that this data only goes to countries with double tax treaties with a group parent company's host nation. Those treaties are few and far between

I cold go on, but what is becoming clear is that, firstly, by refusing to make fundamental reform that is needed the OECD is piling complexity on complexity and in the process is making an already absurd system untenable in many ways.

Second, by heeding big business and the US too much the OECD is ensuring that demands are made of developing countries that they just cannot meet.

Third, and perhaps most tellingly, too much of any supposed benefit from this process is being denied to developing countries for them, in my opinion, to have any real confidence in this process, at all.

It is this last point that is the most worrying as far as I can see. The BEPS process was, at least in part, meant to tackle the enormous problem of tax being stripped out of developing countries leaving them in poverty and long term aid dependency, neither of which could possibly solve their long term economic problems. And now BEPS is beginning to look like it is going to bypass them, either deliberately on issues like CBC or by making demands of them they just cannot meet on information exchange, transfer pricing, hybrids and other issues.

How will they react? That to me is now the biggest and single most important BEPS question in very many ways. If developed countries fail to deliver a tax solution that meets their needs then I can see no reason why developing countries will then continue to play ball with the OECD. We already have Brazil operating its own transfer pricing rules. They are arbitrary in many ways, but they work for Brazil. China is clearly willing to move the same way. And I am sure many others will too. As for hybrid entities, where the corporate aim is to ensure no tax is paid I think the likely reaction is going to be to demand tax withholding at source on any income stream likely to be routed to such an undertaking.

In fact, this to me seems by far the most likely outcome of BEPS right now. The intransigence of the US position, in particular, promoted no doubt to assist the non-payment of tax by its own multinational companies is going to backfire very seriously unless some very rapid rethinking happens very soon.

The appearance of cooperation on tax across the Atlantic may well dissolve: France is gong to be the first to break ranks on that one.

Then a rapid move towards source taxation with deduction of tax in the country of origin appears to be likely in developing countries, I think.

An attitude of take the tax first and ask questions later will, I think, emerge. In some cases that may be exactly the right thing to do.

But what me will result in is a significant risk of double taxation. I am not a great fan of that, any more than I am a fan of double non-taxation which is what we have got. But the US inspired desire, backed by the OECD, to simply tinker with the existing system looks to me as if it will deliver the exact opposite of the desired outcome on international tax reform. We may be heading for international tax breakdown, and that's dangerous because protectionism and other such issues follow on very soon behind.

This will be the almost inevitable consequence of setting an agenda for change and then refusing to deliver it at cost to those who most need it.

I could be wrong, but I am worried. BEPS looks like it is failing vey badly to me. They're already now engaging in 'pasting over the cracks' exercises. The time to address the fundamentals is fast running out. We need to be worried.