A New Earth…

Taking the Tax Justice debate forward,

including learning to digest the

'Double-Irish Dutch Sandwich'

Sol Picciotto

Foreword by Paul Brannen MEP

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FOREWORD

The revelations around Amazon, HSBC, Google and Facebook in 2015, and the Panama Papers along with Sir Philip Green, his wife, and BHS in 2016 - and Apple in Ireland - have shifted the debate about tax justice on to a new level. A wider public is beginning to realise how widespread is the practice of tax dodging, and how easily wealthy individuals and powerful Transnational Corporations (TNCs) have been avoiding paying – in some cases – any corporation tax at all.

This whole situation has been damaging especially to less developed countries (LDCs). They do not have the relatively sophisticated tax structures of richer countries, even if these are often not as effective as they ought to be. Therefore tax bases are eroded and LDCs find themselves dependent on aid rather than the income from their own resources.

When I worked at Christian Aid this was one of our concerns. Far fewer countries would need as much overseas aid if they received the taxes that transnational corporations should pay. Now I am in the European Parliament some of us are working hard to put in place the structures needed to make this happen. The Christians among us are committed to the Methodist Presidency's theme for 2016/7, 'Holiness and Justice'.

One process seeking to create these structures is Base Erosion and Profit Shifting (BEPS), initiated by the G20 and developed by the rich countries' think-tank, the OECD (Organisation for Economic Co-operation and Development). Civil society organisations set up the 'BEPS Monitoring Group' and this booklet by Professor Sol Picciotto, an adviser to the Tax Justice Network, has grown out of a report presented in early 2016 by that Group to a UK All-Party Parliamentary Group. Some of it, rightly, needs concentration but it suggests that only limited progress has been made so far through the BEPS process.

We in the European Parliament will be monitoring the implementation of the BEPS recommendations. We will also be looking further at Professor Picciotto's proposals for a unitary taxation system which treats TNCs as a single entity rather than allowing them to pretend they are legion – note the diagram of the Double-Irish Dutch Sandwich! I am happy to warmly commend the booklet and encourage Christians, and all lovers of justice, to make representations to your MPs and MEPs on this very important area.

I note also an update on the Methodist Tax Justice Network Cadburys campaign. It is essential to maintain pressure on the companies. I am told one defence by Cadburys for paying no corporation tax in 2014/5 was that their employees pay tax. Of course they do, and so should the companies, if they wish to be decent corporate citizens of the 21st century. Let us continue to work for 'a new heaven and a new earth' to which we are challenged by the Revelation of St John, and of which justice will be a fundamental part.

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The MTJN is very grateful for his providing this amended version of his recent Paper on Unitary Taxation, and also to Matt Jones for the diagrams. It is not the easiest read but Christians and others committed to economic justice must wrestle with the challenges of creating a fair global tax system, en route to the New Earth we seek.

1. THE RHETORIC AND REALITY OF INTERNATIONAL TAX

Political Pressure and Government Actions

Tax has come to the top of the political agenda, especially since the financial crisis, now nearly a decade ago. In addition to the direct costs to taxpayers of bailing out the banks, ordinary people have had to endure the subsequent austerity policies, which have been unnecessarily harsh.

The resulting political pressures have finally forced world leaders to support moves to combat tax dodging by wealthy families and large transnational corporations (TNCs).

While some of this is outright illegal evasion, much of it tries to stay within the law, by exploiting grey areas of legal ambiguity. The wealthy and powerful can exploit the tax haven and `offshore' secrecy system, which was originally devised by and for TNCs. The latest example of this was Sir Philip Green who, as the inquiry by the House of Commons committees showed, reduced the UK tax liability of BHS by paying rent and interest to companies registered in Jersey and the British Virgin Islands, siphoning hundreds of millions of pounds of BHS profits tax-free to Lady Green, resident in Monaco.[1]

The offshore system is also used for all kinds of evasion, not only of taxes, but of other laws, facilitating money-laundering for public and private corruption, terrorism, and other criminal activities. TJN's Financial Secrecy Index has estimated that between $21 and $32 trillion of private financial wealth, much of it untaxed or lightly taxed, is located in secrecy jurisdictions around the world.

Combating this system requires both political will and international cooperation. Too often, however, governments have preferred to hide behind the need for such cooperation, and its technical complexity, to conceal their own lack of commitment. The work has mainly been done through the Organisation for Economic Cooperation and Development (OECD), a club of richer developed countries, although it has now also brought in the G20 emerging economies and some developing countries. Although TNCs claim that they simply obey rules laid down by states, in fact business lobbies have been very active in pressing governments and the OECD to ensure that any new rules will continue to suit them. Proposals have been written in unnecessarily technical jargon, and consultations have been dominated by paid professional advisers working for TNCs and business groups, who have generally succeeded in greatly weakening the initiatives.[2]

This pamphlet aims to explain and evaluate the measures that have been developed, and outline the more radical alternatives that are still needed.

1. FIGHTING OFFSHORE SECRECY

The first attempt by the OECD began in 1996, at the urging of the G7 leaders, resulting in a report on *Harmful Tax Competition – An Emerging Global Issue* (1998). This project was effectively derailed by a change in US policy, when the Bush administration accepted arguments from right-wing think tanks that the initiative entailed dictating tax policy to states. The project then refocused on obtaining information from tax havens, pursued at first through negotiation of bilateral tax information exchange agreements (TIEAs), overseen by the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes.

Since its foundation in 2003 the Tax Justice Network has pointed out that this approach was ineffective. TJN argued for a **comprehensive** and **multilateral** framework for **automatic** exchange of information, not only bilaterally on request. TJN has also continually stressed the need for all states to introduce effective measures of corporate transparency for tax enforcement purposes, such as registers of ownership, without which there can be little information to exchange about tax evaders. The lack of such transparency has meant that leading states such as the USA and the UK have in practice been among the main secrecy jurisdictions.

Moving to a Global Approach

Finally, politicians responded to the pressures of campaigners, and in 2013 the G8 summit meeting in Lough Erne agreed to establish a new global standard of multilateral and automatic exchange of tax information, as well as transparency of beneficial ownership of legal entities such as companies and trusts.[3]

In 2014 the OECD issued a Common Reporting Standard (CRS). This requires banks and other financial institutions to supply financial account information to be exchanged automatically between countries, through a Multilateral Competent Authority Agreement. So far, 101 countries have made commitments to begin this automatic exchange of information (AEoI), 54 by 2017 and 45 by 2018. These paper commitments need to become reality, with effective checks on compliance. This is carried out by the OECD through a ‘peer review’ process which grades each country; by July 2016, 94 out of 122 jurisdictions had been reviewed. 22 had been rated ‘Compliant’, 60 ‘Largely Compliant’, and 12 ‘Partially Compliant’.[4] However, to be ‘partially compliant’ the country need only pass some laws, even if they are only given lip-service, yet this is enough to avoid being designated a ‘non-cooperative’ jurisdiction under recently proposed OECD criteria.

This system relies largely on ‘naming and shaming’, which has limited impact. Much more effective pressure has been put on secrecy havens by the disclosures of whistleblowers, such as the Panama Papers. That information was from just one law firm, but its publication created much greater public awareness, as well as bringing home to tax dodgers that their secrecy could be penetrated. Only following the revelations did Panama agree to commit to the AEoI standard.

A much bigger problem is obtaining information about the real owners of accounts, since they can be in the name of legal entities such as companies or trusts. As the Panama Papers showed, these can easily be formed in offshore jurisdictions such as the British Virgin Islands (BVI). In fact, however, it’s possible to conceal ownership of assets through such entities in virtually any country. To its credit, the UK government has taken the lead in establishing a public register of ‘people with significant control’ of any company, which went live from July 2016.[5] However, the UK government has failed to persuade or oblige UK dependencies to do the same, although many (such as the BVI) are major providers of shell companies. In 2015, the EU agreed that each country should create central registers of the beneficial owners of companies and trusts and provide access to members of the public who could show a ‘legitimate interest’. However, these measures still left loopholes,[6] and fell well short of the full public access that would be truly effective.

No Level Playing Field

Unfortunately, the main country dragging its feet has been the USA. Studies have shown that creating an anonymous shell company is easiest in the US,[7] where company formation is governed by state laws. Most US states do not require filing of information on shareholders or managers when forming a company, and in some (such as Nevada, Delaware and Wyoming) agents offer shell company formation services to non-residents, boasting that no information is sent to tax authorities.

These defects have been pointed out in peer reviews by international bodies such as the Financial Action Task Force. The Obama administration has tried to remedy some of them, but has been blocked in Congress. Furthermore, the US has not joined the global Common Reporting Standard, preferring to stick with its Foreign Account Tax Compliance Act (FATCA) system. However, the FATCA has lower

Tax Haven USA?

- The US ranks 3rd on TJN's Financial Secrecy Index. Nevada is the 8th most mentioned jurisdiction in the Panama Papers.
- Limited Liability Companies can be set up in states such as Delaware, Nevada and Wyoming for as little as $200.
- LLCs are 'owned' by nominee officers or directors provided by a local agent. The ultimate beneficial owner remains secret.
- 2 million LLCs/Corporations formed in the US each year, many by foreign owners.
- Nevada and Delaware have no IRS information-sharing agreements, and no tax on profits made outside the state.

reporting requirements than the CRS, and the exchange of information is not through the OECD’s multilateral framework, but via bilateral agreements. Many of these are not reciprocal, so the US receives but does not provide information, and the US still has no agreements with many developing countries, e.g. in Africa.[8]

This is a major loophole, since the US accounts for some 20% of the global market for non-resident financial services, twice that of the UK. Although the OECD notes that the US has not adopted the CRS, it accepts the US system as equivalent, which it plainly is not. This reveals a political bias in the OECD’s supposedly independent and technical methodology. It is hardly surprising that smaller countries such as Panama and Liberia have been reluctant to comply with global standards, if they are not applied fairly to all. The UK dependencies also cite the US's lax corporate transparency rules in justifying their refusal to adopt public registers of beneficial ownership.

This has also contributed to a weakening of the approach to defining ‘non-cooperative jurisdictions’. This concept can be used to create blacklists, which may be a basis for coordinated counter-measures against such countries. At the request of the G20 again, the OECD in July 2016 proposed three fairly weak criteria,[9] yet a country need only comply with two in order to avoid designation as non-cooperative.[10] The result is likely to be a very short list, which of course would not include the US. Instead of ‘black’ or ‘white’ lists, TJN’s Financial Secrecy Index uses graded rankings, with a weighting for the size of a country’s financial sector relative to its GDP, an important factor in judging its role in the offshore system. In this index, the USA ranks third, Cayman Islands fifth, and the UK fifteenth. The UK would be top if assessed together with its dependencies, but the introduction of public registers will greatly improve its ranking.

2. Taxing TNCs where their economic activities take place

Also in 2013, the G20 leaders backed another major effort by the OECD, aiming to reform international tax rules, called the project on Base Erosion and Profit Shifting (BEPS). The G20 leaders called for international tax rules to ensure that TNCs could be taxed 'where economic activities occur and value is created'. But they also added 'while respecting the sovereignty of each country to design its own rules'.[11] These aims are contradictory. Ensuring that taxation is in line with economic substance requires stronger coordination between states. This inevitably restricts the freedom of states, although it is the only way to restore their effective power to tax TNCs.

Given this ambivalence, it's not surprising that the outputs of the BEPS project released in October 2015 are weak and contradictory.[12] Generally, they aim to strengthen the system, and give better tools to tax authorities if they have the capacity and will to use them. Overall, however, the proposals are a patch-up of existing rules, making them even more complex and dependent on technical expertise to administer, and do not tackle the more fundamental flaws of the system. Nevertheless, this is an important first step on a longer road. The G20 project itself is continuing, both to supervise and coordinate implementation and to work on some key issues that were not yet dealt with. In particular, the project's outputs have not resolved the fundamental problem of how to apportion TNC profits.

The Fundamental Flaw

The role of tax avoidance by TNCs in the creation and continuation of the tax haven and offshore secrecy system results from a fundamental flaw in the international tax rules. Designed almost a century ago, these rules have failed to adapt to an increasingly globalised world economy, dominated by integrated TNCs operating under central direction. The tax treaty provisions require tax authorities to start from the accounts of each local subsidiary or branch of the TNC. Since it is understood that these entities are not actually independent, tax authorities have powers to adjust these accounts. However, the principle to be applied is that the income should reflect what might be expected if the entities were independent of each other, operating at 'arm's length'.

This is a perverse incentive which TNCs have increasingly exploited to minimise their taxes. They began, since the 1930s and increasingly from the 1950s, to form intermediary entities in convenient jurisdictions, to hold assets and shift profits through conduits to base companies. This helped create the tax haven and offshore secrecy system. Today, most TNCs typically consist of often hundreds of affiliates, forming complex corporate groups.

The shift to the knowledge economy and digitalization has further facilitated the restructuring of TNC operations around global 'value chains', which can be tax driven. This enables the fragmentation of different functions (research, design, assembly, marketing, distribution, back office). The independent entity principle enables TNCs to attribute only 'routine' levels of profit to entities in high-tax countries, while channelling large revenues for payments for intangibles, finance and fees to low-taxed affiliates. Countries now compete to offer tax advantages to attract the location of entities which perform such 'high value adding' functions. A typical structure is the 'double-Irish Dutch-sandwich', used for example by Google (see Fig 1 on following page).

The measures adopted by tax authorities to counteract these strategies have remained ambivalent. Some provisions override the fiction of separate entity, such as rules allowing taxation of the undistributed income of a controlled foreign corporation (CFC) as part of the tax base of its parent, first introduced by the US in 1962. Others, particularly the rules on transfer pricing, have increasingly emphasised the independent entity principle.

As corporate tax strategies have become more sophisticated, the counter-measures have become increasingly inadequate. Governments are no match for TNCs in terms of resources, especially of expertise. This problem is obviously particularly great for poorer countries, but the large OECD countries have also faced increasing administrative strains.

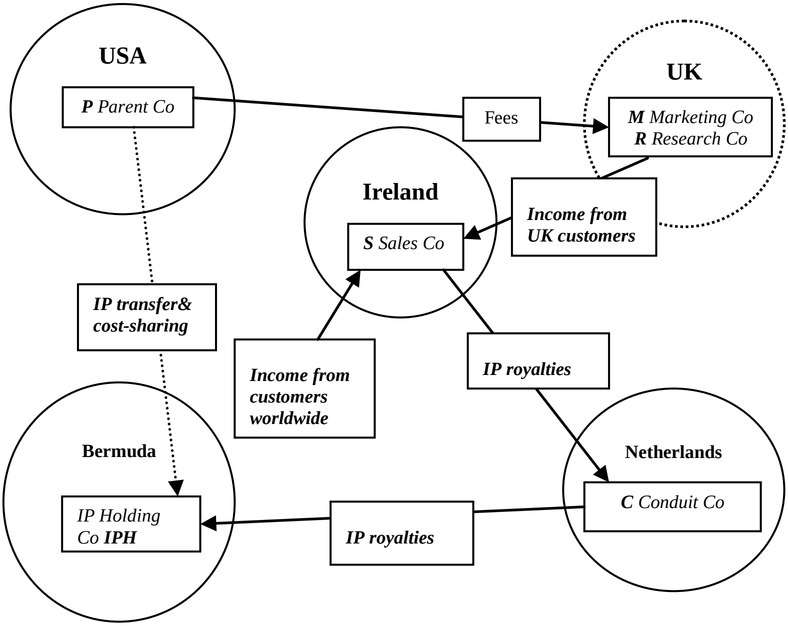

Fig. 1: The Double-Irish Dutch Sandwich*. The US Parent (P) transfers intellectual property rights (IP) to a company formed in Ireland but controlled from, and treated under Irish law as resident in, Bermuda (IPH). IPH has a cost-contribution contract with P to finance further development of the IP from its income, justifying the original sale of the IP under US transfer pricing rules. Another company (S) both formed and controlled in Ireland receives large income flows from operating the worldwide business (e.g. selling advertising). However, the net profits of S are low, because it pays large royalties for the IP rights. These are channelled through a Netherlands Conduit company (C), so that no withholding taxes are paid to Ireland. C deducts a small handling charge and pays the bulk of the IP royalty income to IPH in Bermuda. Although customers in countries such as the UK deal with another local affiliate company M, it is treated as providing only marketing or other customer support services. Actual sales contracts are concluded with the Irish sales company, which pays M a fee for the marketing services. Similarly, research done in the UK is treated as under the control of P, which pays the research affiliate a fee.*

For example Kenya, with help from the OECD, created a transfer pricing unit of some twenty staff; but the same number of people are employed to advise on transfer pricing in one single private sector firm in Nairobi – KPMG. In the UK, HMRC has increased its transfer pricing specialists from 65 in 2012 to 81 in 2016. Although between 10 and 30 staff worked at various times on the 6-year investigation of Google, the settlement announced in 2016 was for only £130m. This was described by the Public Accounts Committee as ‘disproportionately small when compared with the size of Google’s business in the UK, reinforcing our concerns that the rules governing where corporation tax is paid by multinational companies do not produce a fair outcome’.

The mandate for the BEPS project implied that TNCs should be treated in accordance with the business reality that they operate as single firms. Although the final BEPS project proposals did not accept this explicitly, some did move in that direction. However, on the crucial question of criteria for allocating profits, the proposals remained unclear and complex. Hence, although they open up a new road for the international tax system, the direction of travel is uncertain.

Some Steps Forward...

A number of the proposals in the final BEPS package do imply a shift towards treating TNCs as unitary firms. The major achievement is the formulation of templates for country-by-country reports (CbCRs) and transfer pricing documentation. These will, for the first time, provide all interested tax authorities with a clear overview both of each TNC as a whole and the details of its inter-related components. The scheme establishes a global standard, which the UK and other OECD countries are implementing in local law, as should developing countries.

However, CbCRs will be required only for the largest TNCs (turnover higher than €1bn), at least until the scheme is reviewed in 2020. Furthermore, once delivered to the home country tax authorities, CbCRs will only be shared with others subject to confidentiality and appropriate use protections. These arrangements create unnecessary obstacles, especially for developing countries. Publication would be a far easier and better solution, and should be the eventual outcome, although this is being strongly resisted by TNCs, particularly in the US. TJN has advocated CbCRs since 2004, and will continue to campaign that all TNCs should prepare and publish such reports..

The adoption of a unitary approach was easier for apportionment of costs, since TNCs themselves would like a guarantee that they can be deducted somewhere. However, the adoption of a ‘simplified method’ for pooling and allocating central service costs within a corporate group has been limited to low-value-adding services, because many tax authorities rightly consider that such deductions can be used to reduce the tax paid by operating affiliates at source.

Another important shift to a unitary approach came in the proposals on limiting interest deductions. The initial draft suggested a group ratio rule: i.e. that each affiliate's tax deductable interest payments should be capped at its share of the TNC group’s net consolidated interest payments, proportional to its earnings before interest, tax, depreciation and amortisation. However, the final report recommended a fixed cap of between 10-30% of earnings, with an optional group ratio rule. Data submitted by business groups themselves has shown this to be ineffective, since over half of nonfinancial TNCs had net consolidated interest expenses below 10% of earnings, while around 4/5ths were below 30%.[13] Yet the UK and and other countries have opted for a 30% cap, which will allow TNCs to continue to deduct excessive interest.

... and Some Steps Back

The greatest reluctance to abandon the independent entity principle is seen when it comes to the allocation of profits. Three of the fifteen BEPS Actions dealt with transfer pricing, and the reports on these have resulted in a substantial rewriting of the *OECD Transfer Pricing Guidelines* (TPGs), extending them from around 370 to nearly 500 pages. These guidelines are applied in practice by countries around the world, indeed, most African countries have in recent years introduced transfer pricing rules which are based on the OECD’s TPGs.

Despite the extensive rewriting of the TPGs, they still stress that the starting point should be the various entities in the TNC group and the transactions between them. Nevertheless, the TPGs now allow re-examination of the ‘true nature’ of these transactions, based on an analysis of the ‘facts and circumstances’ of each business. This ‘requires a broad-based understanding of the industry sector in which the TNC group operates ... including its business strategies, markets, products, its supply chain, and the key functions performed, material assets used, and important risks assumed’.[14]

This poses many problems, especially for developing countries. Tax authorities must carry out individual audits of firms, analysing their group structure and business model - this requires specialist knowledge of each type of business, as well as of the various complex transfer pricing methods. Furthermore, while functional analysis aims to identify the specific functions performed by different affiliates, this is difficult or impossible when applied to knowledge-based intangibles or risk, both of which are spread through the firm as a whole. This flows from the basic theory of the firm, and is also borne out in practice. As German-based chemicals firm BASF explained in their submission:

> "Quality management and controls relating to the risks, functions and assets employed are to a wide extent part of corporate procedures which are generally valid group-wide and are fully integrated in the business processes. The research and development process is managed by electronic systems which track the allocation of projects to specific research centres, the adherence to budgets, the sign-off processes and the registration of IP rights. “Control” is therefore to a large extent built in to group-wide guidelines and operating systems, and can therefore be performed anywhere as such systems enable a decentralised, collaborative organisation."[15]

Indeed, TNCs pride themselves on being both ‘global and local’, able to benefit from their coordination of activities worldwide, while their central management teams may be relatively small.

Control functions are over-emphasised in the revised TPGs. They specify that the important functions regarding intangibles are ‘design and control’, ‘direction of and establishing priority’, and ‘management and control’ (revised TPGs para. 6.56). Similarly, for identifying the location of risk, the key test is ‘capability and authority to control’ (para. 1.67). This ‘control’ test for locating key functions favours the home countries of TNCs. Countries where the corporate headquarters, chief financial officer, or main research centre are located are likely to claim ‘control’ of decentralized functions such as finance and research. A TNC could therefore treat its numerous worldwide affiliates, employing large numbers of people in research and development, as conducting ‘routine’ research functions with relatively low profits.[16]

This may indeed explain the low HMRC settlement with Google. Google UK employs 1000 software specialists, yet it seems to have been taxed simply as a research sub-contractor. Similarly, its 3000 customer service staff were apparently considered to perform only ‘routine’ marketing functions. In reality, Google’s enormous profits are due to the power of its search engine, which depends on inputs from both its software specialists and its users worldwide.

Yet, in practice, the bulk of these profits may not be taxed anywhere. In the Double-Irish Dutch-Sandwich structure used by Google (Fig. 1), they were routed to an affiliate formed in Ireland but considered resident in Bermuda. It remains to be seen whether Google’s reorganisation, under a new umbrella holding company called Alphabet, will make significant changes to the tax it pays.

The OECD aims to stop the allocation of profits to ‘cash box’ affiliates, but TNCs could work around this by relocating a few senior people to carry out ‘control’ functions in countries offering low effective tax rates for such activities. Already, countries are competing to attract research hubs, with low rates on structures such as the ‘patent box’.

Adopting a Unitary Approach to TNC Taxation

Several alternative approaches are available which involve treating transnational corporate groups as unitary firms. These approaches could be compatible with or build on some of the current rules. One is the adoption of residence-based worldwide taxation (RBWT). This would apply home country tax directly on a current basis on the consolidated worldwide profits of a corporate group, but with a full credit for foreign taxes paid.[17] This would effectively treat all foreign affiliates on a full-inclusion basis as Controlled Foreign Corporations (CFCs). RBWT gives the residual right to tax to the firm's home country, but the initial right to the source country. Hence, it can strengthen source country taxation, since any reduction of source taxation would lead to an equivalent tax increase in the home country, removing the incentive for profit shifting. This also removes the temptation for the source country to offer tax advantages to attract inward investment.

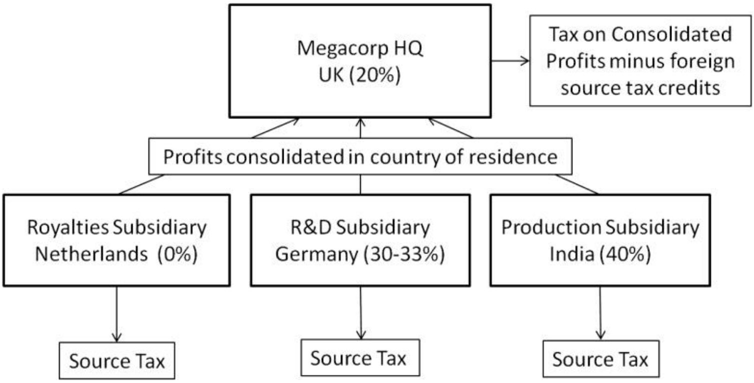

Fig 2: Diagram of Residence-Based Worldwide Taxation (RBWT).

Such provisions could, from a legal perspective, be formulated and implemented unilaterally, without the need for agreement between states, and probably also without alterations to tax treaty rules. Indeed, strengthening of CFC rules was Action 3 in the BEPS project, but the final proposals were very weak. In practice, unilateral adoption is difficult especially for a country with a high corporate tax rate, due to the risk of relocation or 'inversion' of the group headquarters. This could be counteracted legally, through appropriate residence rules, but corporate residence is increasingly hard to define. Also, this approach does not clarify the level of income which should be attributed to operating affiliates, and hence the appropriate amount of the tax credit.

A shift towards RBWT would be easier if done on a more coordinated basis, e.g. by the US and the EU. However, in the present climate, there seems little appetite for such coordination, as the BEPS proposals showed. The Anti-Tax-Avoidance Directive adopted by the EU in June 2016 included common CFC rules, but only very weak ones.

Another approach is the concept of a Destination Based Cash Flow Tax (DBCFT), advocated especially by some economists.[18] This is not a tax on profits but akin to a value added tax (VAT), with full and immediate deduction of labour costs and other cash expenses including investments permitted. Applied on a destination basis it could therefore be regarded as favouring exports and conflicting with world trade rules.

From the perspective of international tax this is a unitary approach, since it ignores internal transfers within corporate groups, and the tax base is both defined and apportioned by ultimate sales to third-parties. Allocating the corporate tax base according to the location of final consumers has some economic attractions: notably, firms' decisions on where to make investments or employ workers could ignore tax rates. On the other hand, it would obviously hit tax revenues for countries with relatively small consumer markets.

It also raises considerable practical problems. First, it requires the identification of customer location, a tall order in the era of electronic commerce, although it may be possible to do this through payment intermediaries such as banks. A stronger objection is that a high proportion of exports consist of sales of intermediate goods to businesses, and not finished products to final consumers. This could encourage the location of assembly industries in countries with low corporate tax rates, to reduce the cost of high-value inputs. Similarly, high-cost items could be sold to finance companies in low-tax countries and leased to users, as aircraft already are (see Fig.3).

Another major problem is that, since it apportions income based entirely on sales, taxing rights under DBCFT could be allocated to countries where a company has little or no physical presence. This would make it impossible to collect the tax without international cooperation, involving a joint system of collection, enforcement and netting out of corporate taxes. Given the experience to date of attempts to reach agreement between states, this seems extremely ambitious.

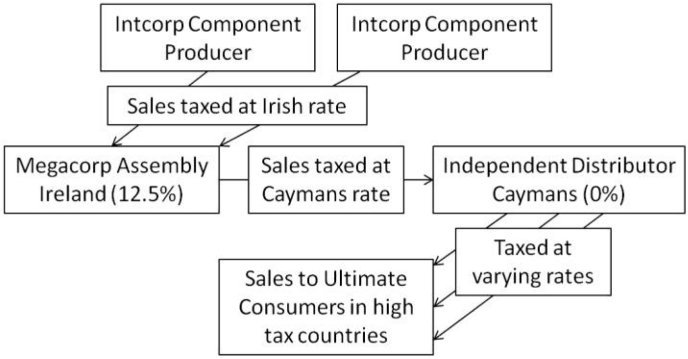

Fig 3. Diagram of Destination-Based Cash-Flow Tax (DBCFT). *Megacorp subcontracts the production of high-value components to Intcorp, and locates its assembly plant in a low tax country. The profits on Intcorp's sales to Megacorp are lightly taxed. By selling finished products to an independent distributor in a zero-tax country, Megacorp also pay little tax. Only the distributor would be taxed where ultimate consumers are located, but Intcorp and Megacorp earn most of the profits. No tax would be payable in the countries where the component production is located.*

The most radical alternative is unitary taxation with formulary apportionment (UTWFA), an approach long advocated by a variety of independent commentators. It would have the enormous advantage of providing a comprehensive approach, replacing the complex and subjective transfer-pricing and source-of-income rules and dispensing with other elaborate anti-avoidance rules such as anti-hybrid provisions and limitations on deductions. Above all, it would be easy for tax authorities to administer, and provide predictability for companies.

It is not a panacea, however, and more research is needed on its main elements.[19] There is no space here to evaluate UTWFA in any detail. However, a few comments can be made in response to some of the objections that have been made to this approach.

It is often argued that it would be impossible to reach political agreement on the apportionment formula, and that without such agreement there would be an unacceptable level of double taxation. A related argument is that unitary taxation would not end tax competition between states, or tax planning by companies, but shift them onto new ground. However, these overlook the point that, in choosing a suitable formula, states would need to take into account not only the tax revenue it would produce but also the likely effect on their ability to attract foreign direct investment. Since firms would have an incentive to shift labour-intensive activities away from countries which emphasise labour in the apportionment factors, states would need to balance the effects of the formula on tax revenues with those on investment. The incentive effects on both national tax policies and corporate strategies could therefore be mutually supportive, and potentially benign.

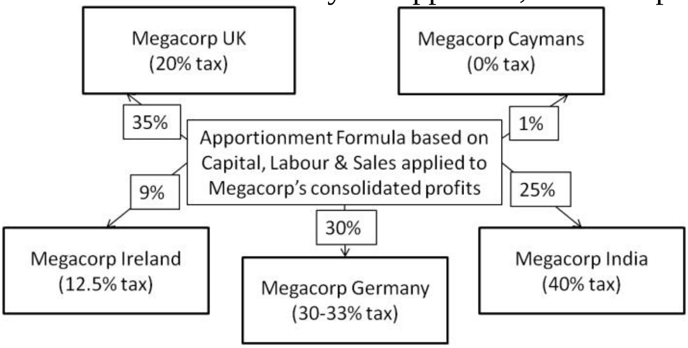

Fig 4. Diagram of Unitary Taxation with Formulary Apportionment (UTWFA).

Unlike the situation under current international tax rules, these decisions would concern real and not paper activities. This has important implications. It means that this revenue-investment trade-off would create a basis for convergence or agreement between states in the choice of apportionment factors, and that this choice is not "you-win I-lose". States with a labour-intensive economy would not necessarily choose a high labour weighting in the apportionment formula, for fear of driving away investment, and discouraging improvements in productivity. Hence, even if there is no formal agreement on the apportionment formula, double taxation is unlikely to result.

Indeed, there is perhaps a bigger danger of double non-taxation, unless states can learn from experience, notably in the USA. There, states have shifted towards a sales weighting, aiming to encourage investment and hence increased employment in the state. However, this effect has faded over a longer period, as competitor states adopt similar policies. It should also be borne in mind that the DBCFT (discussed above) would allocate the entire tax base to the country of destination of sales.

A sales-only formula could still be a concern for developing countries, where much inward investment involves production or extraction for export without significant local sales. However, they are also significant importers of goods, and especially services, from TNCs, often with little or no local value added, so that such activities contribute little or nothing to the tax base under current rules. Thus, the net effect of a sales basis for apportionment for them would depend on the balance of exports to imports by TNCs, taking account also of whether TNCs responsible for imports have a taxable presence in the country. The destination basis should also apply to sales of services, provided the services supplier has a significant business presence. Developing countries have lost out from the shift towards a services economy, due to the difficulty of taxing profits of foreign suppliers of services under current tax rules, even though such a claim to tax can be justified by the importance for services of close relations with clients. On the other hand, they would be justified in applying a source basis for sales of minerals and hydrocarbons, since these are anyway heavily taxed at and after processing in the countries of consumption.

The UTWFA approach would allow the apportionment formula to balance production as well as consumption factors. Some have argued that UTWFA would result in stronger competition to reduce the tax rate, but this would be reduced by inclusion of a sales factor, since firms need to seek out customers regardless of the tax rate in the state of consumption. The central point is that UTWFA addresses directly the issue of criteria for apportioning the tax base, and does this according to measurable factors reflecting real presence in each country.

The Current Period of Transition

Regrettably, the BEPS project failed to establish a clear and cogent approach to the central issue of how to allocate the income of TNCs according to their activities and the value added in each country. This was discussed however in the report on Action 1, which recognised that digitalisation of the economy means that TNCs have come ‘closer to the economist’s conception of a single firm operating in a co-ordinated fashion to maximise opportunities in a global economy’ (para. 232). It identified some far-reaching possibilities for dealing with these challenges, including a 'substantial rewrite of the rules for attribution of profits' (para. 286). However, the OECD asked for another five years to continue this work. Work is also taking place on the profit split method, and some countries may use this to move towards apportionment methodologies, based on value chain analysis.

In the meantime, states are taking unilateral measures. The UK has enacted a Diverted Profits Tax, which aims to dissuade TNCs from using some tax avoidance structures. Australia is already following suit, Germany and others have their own ideas, while a proposal for a DBCFT has been tabled in the US Congress. Developing countries also can and should design suitable strategies to protect source taxation, such as withholding taxes on interest and on fees for services. However, these are blunt measures, as they apply on a gross basis rather than on net profit, and are more easily passed on to consumers. As regards the allocation of profits, what developing countries need above all is a clear, simple and easily administered method. One such approach has been suggested by Michael Durst, which would require each TNC affiliate to declare taxable profits (or losses) based on a benchmark of the consolidated profits of the TNC group as a whole.[20]

Amidst all these contending approaches, what is needed is a clearer lead on the direction of travel. Without a more coherent approach, TNCs will be subjected to increasingly conflicting claims to tax. If these burdens come to outweigh the tax savings from BEPS strategies, perhaps TNC senior managers will begin to throw their weight behind effective reform proposals. Perhaps also the expansion of participation in the BEPS project to all interested states will create a basis for a more balanced and global perspective.

What is clear is that effective reforms will be impossible without continued and sustained public pressures. We hope that this report will help improve the understanding of the issues necessary to support such pressures.

Four Campaign Asks:

1) Formulation of clear and simple methods, suitable especially for developing countries, for apportioning profits of TNCs according to where their real activities take place;
2) Serious work by the OECD and other relevant parties to develop a transition towards Unitary Taxation of TNCs, including Formulary Apportionment;
3) Greater focus on the specific needs of developing countries in relation to BEPS and similar initiatives, including upgrading of the UN's Tax Committee;
4) TNCs to begin to publish Country by Country tax reports based on the OECD template.

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[1] House of Commons, *BHS*, First Report of the Work and Pensions Committee and Fourth Report of the Business, Innovation and Skills Committee of Session 2016–17 (HC 54).

[2] To try to redress this imbalance, tax justice campaigners including TJN have supported the BEPS Monitoring Group, a global network of independent researchers, to provide independent commentary.

[3] This was later supported also by the G20. It aimed to build upon but go well beyond more limited earlier measures, especially the EU Savings Directive of 2003, to enable taxation of bank account interest, and the US Foreign Account Tax Compliance Act (FATCA), which came into force in 2014 and required all banks operating in the US to supply information to the US authorities about interest paid to US residents. Both of these required negotiation of agreements with other countries, especially offshore jurisdictions, to become effective, which was only partially successful.

[4] OECD Secretary-General's Report to G20 Finance Ministers, 23-24 July 2016. http://www.oecd.org/ctp/oecd-secretary-general-tax-report-g20-finance-ministers-july-2016.pdf

[5] Global Witness, 'A first look at the UK beneficial ownership data', July 2016. https://www.globalwitness.org/en/blog/first-look-uk-beneficial-ownership-data/

[6] Knobel & Meinzer, *Drilling down to the real owners*, 2016. http://www.taxjustice.net/wp-content/uploads/2013/04/TJN2016_BO-EUAMLD-FATF-Part1.pdf

[7] Findley, Nielson, & Sharman, "Global Shell Games: Testing Money Launderers' and Terrorist Financiers' Access to Shell Companies", 2012.

[8] Knobel, *The Role of the US as a Tax Haven. Implications for Europe* (2016). http://www.greens-efa.eu/fileadmin/dam/Documents/TAXE_committee/The_US_as_a_tax_haven_Implications_for_Europe_11_May_FINAL.pdf

[9] OECD Secretary-General's Report to G20 Finance Ministers meeting in Chengdu, China, July 2016. http://www.oecd.org/ctp/oecd-secretary-general-tax-report-g20-finance-ministers-july-2016.pdf

[10] TJN, *The G20 and OECD tax haven blacklist proposals risk becoming another whitewash*, July 2016. http://www.taxjustice.net/2016/07/22/g20-oecd-tax-haven-blacklist-proposals/

[11] Tax Annex to the St Petersburg Declaration, September 2013. https://www.oecd.org/g20/summits/saint-petersburg/Tax-Annex-St-Petersburg-G20-Leaders-Declaration.pdf

[12] BEPS Monitoring Group, *Overall Evaluation of the G20/OECD Base Erosion and Profit Shifting (BEPS) Project*, October 2015. https://bepsmonitoringgroup.files.wordpress.com/2015/10/general-evaluation.pdf

[13] PwC survey for the Business and Industry Advisory Group (BIAC) of the OECD: *Comments received on Public Discussion Draft BEPS Action 4: Interest Deductions and Other Financial Payments*, Part 1, p.136. http://www.oecd.org/tax/public-comments-action-4-interest-deductions-other-financial-payments.htm

[14] New para. 1.34 in chapter 1 section D of the TPGs.

[15] BASF Submission to the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, September 2013. http://oecd.org/ctp/transfer-pricing/basf-intangibles.pdf

[16] BASF stated in its evidence that it has 'numerous research hubs, located primarily in Germany, USA, China and India'.

[17] This has been advocated by a number of US-based commentators, e.g. E. D. Kleinbard, 'The Lessons of Stateless Income', Tax Law Review, 2011. http://ssrn.com/paper=1791783

[18] E.g. Auerbach & Devereux, *Consumption and Cash-Flow Taxes in an International Setting*, NBER Working Paper No. 19579. http://www.nber.org/papers/w19579.

[19] International Centre for Tax and Development, *Unitary Taxation of Transnational Corporations with Special Reference to Developing Countries*, 2014, and Picciotto, *Taxing Multinationals as Unitary Firms*, ICTD Working Paper 53. http://www.ictd.ac/index.php/unitary-taxation-of-transnational-corporations-with-special-reference-to-developing-countries

[20] *Developing Country Revenue Mobilisation: A Proposal to Modify the 'Transactional Net Margin' Transfer Pricing Method*. ICTD Working Paper 44, 2016. http://www.ictd.ac/publication/2-working-papers/96-developing-country-revenue-mobilisation-a-proposal-to-modify-the-transactional-net-margin-transfer-pricing-method

THE CADBURY CAMPAIGN

Bournville-based confectioner Cadbury is a much-loved British institution, steeped in a tradition of social and corporate responsibility, drawn from their Quaker roots. However, in recent years, the company has lost touch with this heritage, particularly when it comes to tax. In 2013, the Financial Times revealed that, even before Kraft's takeover in 2010, Cadbury had avoided tax using a complex system of interest payments on inter-company loans, shifting profits to the Cayman Islands and Ireland. As a result, they paid just £6.4m in tax per year on average annual profits of £100m between 2000-2010.

Since Kraft's (now Mondelēz International) takeover, the tax avoidance has continued apace. Kraft promised before a government Takeover Panel to manage Cadbury from within the UK - but told staff within 24 hours of the takeover that management would be moving to low-tax Switzerland. Kraft used debt bonds in their purchasing of Cadbury - these debts, listed on the Channel Islands stock exchange, enable Mondelēz UK to write off interest payments against their UK profits. They paid no UK corporation tax at all in 2014/15, in spite of £96.5m in UK profits on Cadbury products alone. Channel 4's Dispatches estimated that they should have paid around £24m.

Tax barrister Jolyon Maugham QC has described the Mondelēz accounts as 'enormously complicated' – huge networks of subsidiaries, 56 in the UK alone and 230 worldwide, shift profits around through interest payments, dividends and royalties. While Mondelēz HQ is in Chicago, the majority of their US financing subsidiaries are based in Delaware, infamous for being the US's own onshore tax haven.

We believe that tax is never optional - no matter how wealthy you may be. Ruth Cadbury MP declared herself "very angry that a company like Mondelēz can get away without paying any tax", and believes her ancestors would be "turning in their urns if they knew what had happened." We therefore encourage all of our supporters to **boycott Cadbury products**, and inform the management of our intention to do so by **writing to Ms Mary Barnard**, President of Mondelēz's Northern European operations, at: **Mondelēz UK Limited, Uxbridge Business Park, Sanderson Road, Uxbridge, Middlesex, UB8 1DH.**

MTJN DETAILS

Patrons:
Revd Alison Tomlin, Revd Dr Inderjit Bhogal, Baroness Kathleen Richardson, Ruby Beech (all former Presidents or Vice-Presidents of Conference), Paul Brannen MEP (former Head of Campaigns, Christian Aid), Bishop Ivan Abrahams (World Methodist Council).

Committee:
Acting Chair & Convenor - Revd David Haslam
Treasurer - Philip Wetherall
Co-ordinator - Matthew Jones

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Find us on Facebook:
www.facebook.com/MethodistTaxJusticeNetwork
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@Methodist_TJN or search for MTJN

Further useful websites:
Christian Aid - www.christianaid.org.uk
Tax Justice Network - www.taxjustice.net
ActionAid - www.actionaid.org.uk

Further Reading:
OECD Common Reporting Standard -
http://www.oecd.org/tax/automatic-exchange/common-reporting-standard/
Financial Secrecy Index - http://www.financialsecrecyindex.com/
Final BEPS Report - http://www.oecd.org/ctp/beps-2015-final-reports.htm
BEPS Monitoring Group - https://bepsmonitoringgroup.wordpress.com/