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Multinationals And The Great Tax Debate

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Contents

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John has always had an interest in the development of the law and served for many years on the committee of the British Venture Capital Association, being a member the team which agreed the BVCA memorandum in 1987. His paper (with M O'Reilly) suggesting how to index capital gains shortly preceded the introduction of indexation schemes in Eire and the UK, and he led the discussions leading to the introduction of pension fund pooling vehicles on behalf of the investment management industry.

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For references and sources, please see the bibliography at the end of the report.

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1 Introduction: the great tax debate

1.1 A general clamour

Few readers of this paper, however far removed they be from the arcane world of taxation, will be unaware that executives of Amazon, Google and Starbucks were grilled by the Public Accounts Committee of the House of Commons on the levels of UK corporation tax paid by those groups. However, the cut and thrust of the questioning was only a noisy interlude in a more general clamour. After years of being ignored, the whole subject of tax evasion and avoidance has risen to the top of the political agenda and whether multinational enterprises are paying their "fair share" of tax has become a matter of public concern. Politicians, of course, are always keen to come up with proposals which fit the public mood and thus there have been plenty of reports and initiatives both in the UK and internationally.

The proposals emerging from this hubbub fall into two distinct categories.

1.1.1 Tax evasion

First, there are those designed to combat tax evasion, broadly the hiding of the true position from the authorities. It would be too much to say that that the battle here has been won, but very considerable progress is certainly being made. Following the introduction of The Foreign Account Tax Compliance Act (FATCA) by the US in 2010 and the consequent adoption of corresponding regimes by other jurisdictions, those who wish to hide their income have a decreasing number of holes to run to. Presumably, then, the failure to pay tax which is due will gradually fade as a problem. In any event, the topic of tax evasion, which relates more to wealthy individuals than it does to multinationals, is not the subject of this report.

1.1.2 Tax avoidance

The second category comprises proposals designed to combat abusive tax avoidance and it is here that the multinationals are under the spotlight. Tax avoidance involves taxpayers arranging their affairs with a view to reducing their tax to the lowest possible amount. Unlike tax evasion, this is not illegal and much of it is not in the least antisocial. Tax systems are created with exemptions and loopholes which are designed to ensure that they do not snag bona fide commercial transactions; ensuring that their clients are properly placed to make use of these is the principal function of the tax adviser. Less attractive though is the abuse of the system, whether by exploiting the legislation in ways which can never have been intended, or by creating artificial structures to ensure that profits arise in ways or places which secure that they will not attract the normal incidence of tax.

A number of governmental bodies have undertaken work on how abusive tax avoidance should be combated. In the UK, the Public Accounts Committee has been joined in the fray by the House of Lords Select Committee on Economic Affairs, with its report entitled "*Tackling corporate tax avoidance in a global economy: is a new approach needed?*" At an international level, the OECD published its "*Action plan on base erosion and profit shifting*" on 19 July 2013, setting out the work which it needs to do to construct the necessary programme of reforms. The OECD's approach was endorsed at the St Petersburg summit of the G20 in September 2013; progress is not going to be fast, however, as the OECD is only promising to report piecemeal over the next two years. There are also doubts as to whether the scope of the work to be undertaken by the OECD is wide enough and whether its proposals for reform will be too orthodox. However that may be, the OECD is unlikely to be the only body seeking to chart a way forward. This is a topic on which the EU has views, as no doubt do many others. At paragraph 93 of its report, the House of Lords Select Committee said:

> "We recommend that the Government should continue to play its full part in encouraging the OECD's reform agenda to an early successful conclusion. At the same time the Government – and the Treasury review we propose – should explore the scope for more radical alternative approaches to corporate tax."

Although it is understood that the UK Treasury is unlikely to take up this challenge, others will doubtless step forward.

1.2 The academic papers

Those making suggestions for the reform of the tax system rely, as they inevitably must, on reports and papers prepared by those distinguished economists who have examined the various options and compared their relative merits.

1.2.1 The Meade report

The best known of these is the report of a committee chaired by Professor James E Meade, Emeritus Professor of Political Economy at Cambridge University, which was published by the Institute of Fiscal Studies in 1978 under the title "*The structure and reform of direct taxation*" and is better known as "the Meade report".

The aim of the committee was to produce a coherent structure that would achieve the following:

- a development of social welfare to remove the poverty trap and to set an effective and satisfactory floor to standards of living;
- arrangements for the taxation of wealth, in particular of inherited wealth, which would effectively encourage a wider dispersal in the ownership of property; and
- a basic reform of direct taxation to levy a charge on what people take out of the economic system in high levels of consumption, rather than on what they put into the system through their savings and enterprise.

Although that goes far beyond anything which we propose to address, the Meade report contains a detailed analysis of possible corporate tax systems and compares their economic effects. The committee recognised that there could not be an overnight change, but hoped that its report would be seen as a blueprint which would take the whole tax system to a better place.

Reading the report today is like opening a window onto a far distant land, unrecognisable to the modern day taxpayer. In 1978, individual tax rates rose progressively towards a maximum of 98% on investment income; the basic rate of income tax was 33%; and the rate of corporation tax was 52%. That compares with 45%, 20% and 23%, respectively, today. The tax base too has been transformed. Capital allowances are no longer generally available at the rate of 100% and corporate tax systems in the UK and elsewhere have moved from a worldwide basis towards a source basis, as countries compete to attract business.

Outside the tax system, the changes are just as great. The UK no longer has exchange controls and the requirement to seek Treasury consent before changing the residence of a company has had to be abolished as being in breach of EU law. Unprecedented improvements in communications mean that the modern multinational enterprise has a freedom to move its profit centres between jurisdictions on a scale which would not have been dreamt of in 1978.

You may wonder what relevance this report holds for us today. What can we learn from a report published 35 years ago when so much has changed? The answer is that many of the proposals put forward in the Meade report are still possible solutions and that Meade's concepts form the basis for much of the more contemporary research.

1.2.2 The Mirrlees review

Fast forward then to 2010 and we have an updated series of papers, presented again by the Institute for Fiscal Studies, this time under the auspices of Sir James Mirrlees, another distinguished emeritus professor from the same department at Cambridge as Meade. This report, "*Mirrlees review: reforming the tax system for the 21st century*", contains as its first volume a series of essays under the heading "Dimensions of Tax Design". At Chapter 9 is a paper "*Taxing corporate income*" by Alan Auerbach, Michael Devereux and Helen Simpson. This paper is referred to several times in the House of Lords report; but many of the ideas referred to there, such as taxation based on corporate cash flows, are firmly rooted in Meade. Perhaps there is an irony in the House of Lords looking to a 35 year-old report for a "new approach".

1.3 The current predicament

The changes of the last 35 years have raised issues with which Meade did not have to grapple. The freedom to choose the jurisdiction in which work is carried out and the greater range of legal structures available have both greatly increased the scope for multinational enterprises to reduce their global tax bills. Sometimes that is done by placing a profitable operation in a tax haven; sometimes it is done by using the inconsistency between tax regimes to ensure that profits are not taxed at all; and sometimes a payment can be made from a jurisdiction where it is deductible to another jurisdiction where it does not amount to a taxable receipt.

Planning of this sort gives the world's finance ministries difficulties at two levels. First, if profits which would normally give rise to substantial tax are eroded or diverted elsewhere, the country which would have received the tax on those profits will lose funds. Both for developing nations, seeking to transform their economies, and for richer countries, hungry for funds to pay off substantial debt, this is a serious matter. But that is not all. There is a political dimension too. Faced with lower standards of living as the world seeks to contain the consequences of the financial debacle, the public, in the UK and elsewhere, has grown impatient with the recent levels of tax avoidance. After years of laissez-faire, people want to see solutions. Something is going to have to be done.

1.4 The need for practitioner input

In putting together their proposals, the OECD and others will have plenty of economic analysis to draw upon. There is the Meade report; there is the subsequent research which builds upon it; and by the end of the process, academic economists will have generated much more. However, rather less material is written from a practical point of view and, in putting together systems designed to limit tax avoidance, it is practical questions which will govern how robust those systems are.

That the practical commentary has fallen behind the economic should occasion no surprise; because it requires experience of structuring transactions, rather than academic credentials, it is not a particularly good subject for research. Also, generally speaking – and there are honourable exceptions – practitioners are reluctant to get drawn into a debate about how best to proof the tax system against exploitation. That is partly because of time constraints and also, perhaps, because their clients would not wish them to do so.

The purpose of this report is to look at various proposals which have been canvassed, trying to get a feel for whether or not they would work well in practice. Since none of them appears to deal with the issues comprehensively, part 7 of this report supplements them with a proposal for a destination based top up tax which seems to be well worth considering.

1.5 The scope of this report

This report is limited to the taxation of corporate profits and to various ideas which have been canvassed for changing the way such taxation is applied, both in the UK and elsewhere. It is inevitably incomplete. No claim is made to have picked up every angle in relation to the proposals in question and it may be that those who work in this area subsequently will see further into the subject and come to more percipient conclusions. However, the amendment of the tax system is an iterative process. If this report makes a contribution to the debate, helping or encouraging those who come later to produce something better, it will have achieved its purpose.

The subject matter will be addressed in the following stages:

- **Part 2:** a general discussion of the taxation of corporate profits, including why company profits are taxed and the different ways in which that tax could be levied;
- **Part 3:** an outline of the way in which the double tax treaty network allocates group profits between different group companies and a discussion as to whether this should be changed;
- **Part 4:** a discussion as to whether the meaning of "permanent establishment" should be extended to make it harder to avoid tax in the customer's jurisdiction and whether arbitrary limits should be placed on certain deductions;
- **Part 5:** a consideration of the problems caused by preferential tax regimes and whether a destination based tax might provide the answer;
- **Part 6:** a look at the possibility of constructing a destination based tax using principles borrowed from VAT and other ways suggested by the academic research;
- **Part 7:** a scheme for a new destination based top up tax; and
- **Part 8:** conclusions.

1.6 Housekeeping

It may be helpful at this point to mention the following terms which will be used in this paper.

From time to time, reference will be made to an "economic chain" and to companies above and below each other in that chain. The convention adopted is that where Company B supplies goods or services to Company A, Company B is described as being above or before Company A in the chain. Obviously, if Company A is selling goods or services to consumers, it will be at the bottom of numerous economic chains running upwards to each of its suppliers and beyond.

Reference will also be made to "participating countries" in the context of various proposals to introduce new tax regimes. Here, the participating countries are those countries which adopt the new regime or initiative. Those which do not and remain with current systems are referred to as "non-participating countries".

That out of the way, let us start by considering some general points regarding the taxation of corporate profits.

2 The taxation of companies

2.1 Why retain the taxation of corporate profits?

Companies pay any number of different taxes in respect of their activities. In the UK, these range from stamp duty land tax on their acquisitions of land to national insurance when they remunerate their staff. If they buy shares, they pay stamp duty or stamp duty reserve tax. If they quarry, they will pay aggregates levy. If they insure, there will be insurance premium tax. Depending on how their operations impact the environment, they may pay landfill tax or climate change levy; and if they make taxable supplies, they will pay VAT on that part of their turnover.

These taxes relate to specific activities and would be paid even if those activities were carried out by individuals. The taxes on which this report will focus are different. They are taxes on the profits of the company itself and are thus specific to the corporate sector. That does not mean, of course, that they are not interchangeable with other taxes as potential revenue raisers. The state can choose whether to raise money by, on the one hand, increasing the rate of VAT or income tax, or by taxing corporate profits on the other. VAT and income tax both have the advantage that they are probably harder to avoid; there are practical difficulties in moving real people, such as consumers and employees, overseas. However, VAT and income tax also bring the disadvantage of political sensitivity, because they are seen as levies on the consumer and the individual. For that reason, a proposal to get rid of taxes on company profits and to replace them by increasing VAT or income tax rates is unlikely to be adopted. Taxes on company profits are universal among developed nations and will provide an important part of government revenues for the foreseeable future.

2.2 The alternative route: taxing shareholders

Deciding how companies' profits should be taxed is not so much an issue of principle as a question of finding the right machinery. A company is an artificial entity and its existence, as a thing separate from its shareholders acting together, is a legal fiction. By taxing a company, one is simply arranging that a first level of tax should be charged on its profits, on the basis that the rest will be taken from the shareholders as and when they receive distributions.

It would in theory be possible to abolish corporation tax and to compensate for this by increasing taxes on shareholders. There are two obvious ways of doing this, although, as will be seen, both are beset by difficulties – at least in the context of very large companies.

2.2.1 The transparent analysis

The first possibility is to treat companies as transparent so that profits are taxed on the shareholders as they arise. In the UK, this treatment has long been afforded to partnerships and their members; and it has now been extended to LLPs which are corporate in nature. Here, members are taxed on their shares of profits, as and when those profits arise, and whether or not they are distributed. There are a number of difficulties with adopting this system more generally.

To begin with, a system under which shareholders are taxed on profits which are reinvested rather than distributed is unsuitable for large public companies. Stock exchange investors are very different animals from the members of a partnership or small company and they do not generally invest in something which requires ongoing funding. In any case, the tax would prove hard to collect from an international shareholder base. It is one thing for a company's own jurisdiction to deduct withholding tax from dividends paid to non-residents; indeed, that is commonplace. It might even be possible to go one step further and levy a higher tax charge on foreign recipients whose income exceeds a certain level, although that would involve those shareholders having to file a return in the company's jurisdiction. It is quite another matter, however to pursue each member of the wide shareholding base of a multinational for tax based on income which is not actually received. That is not a sensible way forward.

However, it isn't just the mechanics of collecting tax which make transparency difficult; imposing a charge to tax at individual rates on retained profits reduces the amount available for reinvestment. This might be mitigated by giving a 100% deduction for capital expenditure so that profits reinvested in capital assets escape tax, but that only brings partial relief. What about money reinvested in trading stock or added to reserves to reduce risk? If this type of reinvestment is not to be discouraged, one must work on the basis that money will only be taxed when extracted. That points to the taxation of distributions rather than to tax transparency.

Finally, there is the general question of complexity. With corporation tax, it is easy. The tax is simply collected from the company at the corporate rate, with a further charge on shareholders by reference to their own position when the money is distributed. If a transparent system were used, transactions within the company would need to be reflected in a shareholder's tax returns and transactions between the company and other shareholders would have to be taken into account too. Issuing shares to a new shareholder would involve each existing shareholder giving up a fraction of its interest in each of the company's assets, with questions of whether income or capital gains arose on those disposals. These difficulties already arise in respect of partnerships and other tax-transparent entities; in the UK, this gives rise to much complexity. The solutions used here would be very difficult to operate amongst the shareholders of a large multinational company. (See TCGA 1992, s 59 and Statement of Practice D12.)

2.2.2 The withholding tax system

The second possibility is to replace corporation tax by charging a high level of withholding tax on dividends. That withholding tax would be creditable in the hands of shareholders, so that in the case of a pension fund it would be a final tax but a top rate taxpayer would pay the difference between his or her personal tax and the amount withheld.

This system goes to the other end of the spectrum in terms of tax revenues. Here, nothing is paid until a distribution is made. That is unlikely to be acceptable to cash hungry governments. Using a withholding tax in this manner would also disrupt the system of international tax treaties, which normally restrict withholding tax levels. Renegotiating treaties would be particularly difficult when one party wished to change its system and the other was content with the status quo.

2.3 Justification for retaining corporation tax

No doubt it would be possible to find ways round these issues when structuring a new system, but the real question is: why do it? Taxing the company gives an easy collection point for a basic level of tax, which does not require any investigation into the circumstances of the shareholder. The ability to set corporation tax and income tax rates separately means that one can choose how much should be raised directly from the company, that being a burden on all shareholders, and how much should be raised from shareholders at the point of distribution by reference to their separate circumstances. The system has been in use for years. It fits with the international tax treaties. Why change it? It is here to stay.

2.4 Where should tax on corporate profits be levied?

If corporate profits are to be taxed at the corporate level, the next question is in which country that tax should be levied. A traditional starting point is the "source" of the profits, but it is important to understand what is meant by that.

To the tax specialist, "source" has a highly technical meaning which varies from one type of profit to another. In the case of interest, it is often, although not always, the place where the debtor is resident. In the case of trading profit, it is where the operations which generate the profits take place, although, as will be seen when we come to discuss permanent establishments in part 4, a company which generates profits in a jurisdiction in which it does not reside will generally only pay tax there if it carries on its business through a local permanent establishment.

This paper focuses on the trading profits of multinationals, and the expression "source-based" is used to describe those tax systems where companies are charged on such profits by reference to where they carry on business. In the examples used in this paper, that will normally be their jurisdiction of residence as well.

2.5 The UK's system

The UK's system recognises source as the primary place of taxation but, save where an election to exempt branch profits is made, backs this up by charging corporation tax on all the profits of a UK resident company. Accordingly:

- the trading profits of a UK resident company are subject to corporation tax, as are the profits of a non-resident company which arise in respect of a trade carried on through a UK permanent establishment; and
- other profits, interest or capital gains, for example, suffer corporation tax where either the company realising those profits is resident in the UK or they are effectively connected with a UK permanent establishment through which it carries on a trade.

Passive income which arises to an overseas company but does not attract corporation tax (because it is not associated with a relevant permanent establishment) will escape UK tax altogether, be subject to UK withholding tax or in some cases suffer income tax by assessment.

Relying on a combination of the residence of a company and the place where its business is carried on would once have provided corporation tax with a stable base. However, things have moved on. Modern communications allow a multinational to place many of its functions wherever it will receive the best tax treatment. If it does this and it also arranges for those functions to be carried out by subsidiaries in low tax jurisdictions, it may reduce its tax bill substantially. This has caused commentators to ask themselves whether a better basis for liability can be found.

2.6 Levying tax on the owners of the company

One possibility is to levy tax on all profits on the top company of the group. This is the line taken by the UK's controlled foreign companies legislation, albeit that the tax charged at parent company level is just a top up of the tax already paid by subsidiaries.

Unfortunately, multinational groups can be constructed with holding companies anywhere in the world, so a tax charge based on the residence of the holding company does not really hold water, limiting what can be achieved by controlled foreign company regimes generally.

The possibility of taxing the shareholders of the top company on a transparent basis has already been rejected.

2.7 A destination basis

If ownership doesn't work, then what about the place where the customers reside? After all, there is little room for manipulation here. A firm cannot move its customer base at will and if it decided to serve different markets, then it would be a different business. This approach also chimes with public opinion. Outrage has recently been expressed in the UK at the low rate of tax paid by multinationals on the profits they make out of the sale of goods and services to the UK public. There is an element of confusion in this response. Taxation by reference to UK turnover is collected through the VAT system and is quite different from a tax on profits. Nonetheless, the possibility of a destination based tax, where profits are charged by reference to where the customers reside, has been widely canvassed.

2.8 Tax avoidance

In the public perception, and in the perception of the OECD, it has become too easy for a multinational to avoid tax on its profits and this paper will be looking at ways of combating this. It does so in two stages. First, parts 3 and 4 try to assess possible reforms to existing rules on transfer pricing, permanent establishments and deductible expenses. Then parts 5 to 7 address the possibility of destination based taxation and introduce the idea of a top up tax.

3 Double tax treaties and the attribution of profit

It is by no means unusual for the profits realised in a company to be taxable under the domestic tax regimes of a number of different states. The country in which the company is resident may well claim tax on all its profits, wherever they arise. If the company trades through a permanent establishment in another jurisdiction, that jurisdiction is likely to tax the profits attributable to that establishment. Suppose that the company is incorporated somewhere completely different, however; perhaps its country of incorporation will want to tax its profits too. Clearly, priorities and boundaries need to be established, together with rules as to when one form of tax is to be credited against another to prevent the tax burden being duplicated. An international framework is required to bring things under control.

3.1 Double tax treaties

That framework is provided through the network of double tax treaties or, more formally: "Conventions for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital gains". These bilateral agreements are each entered into between two countries and allocate the taxing rights where, under their domestic laws, both countries would have the right to tax the same income or gains.

For example, the treaty will define the "permanent establishment" which a company resident in one country (the country of residence) must have in another country before that second country can tax part of its trading profits. It will also include measures to prevent that part of the profits being taxed twice. This is done either by requiring the country of residence to give credit for the tax paid in the other country against its own tax on the same profits; or by requiring the country of residence to exempt those profits from tax.

Double tax treaties don't just deal with corporate profits; they govern the taxation of all forms of income or gains. If you want to know how long you can teach in the US without being subject to US tax, read the US/UK treaty. If you want to know whether the interest paid by a UK company to a Canadian company is subject to the withholding tax due under the UK's domestic legislation, read the UK/Canada treaty.

Since each double tax treaty is negotiated by the two countries that sign it, they are all different. Nevertheless, they are generally based on one of a number of models.

3.2 The OECD Model Convention

There are some differences between these models, but for present purposes it will suffice to focus on the most important of them; that is the Model Tax Convention on Income and on Capital published by the OECD in July 2010 ("the OECD Model Convention"), which is adopted as the basis of most modern treaties.

Countries which are particularly dependent on international trade tend to have lots of double tax agreements. Other countries have fewer, which means that sometimes there is no double tax treaty governing the tax on an international transaction. What happens then?

Often, it makes little difference. Many countries have incorporated rules analogous to those set out in the OECD Model Convention into their domestic tax systems. For example, the UK's domestic rules for taxing a UK permanent establishment of a foreign company attribute to the establishment those profits which it would make if it were independent from the rest of the company and dealt with it on an arm's length basis. That gives much the same tax charge as would be collectable by the UK under the terms of a typical double tax treaty.

In the context of protecting corporate tax against base erosion, two aspects of double tax treaties need to be considered. The first is transfer pricing, which we will deal with in this part. The second is what amounts to a permanent establishment; that will be dealt with in part 4.

3.3 Transfer pricing

Where a supplier and its customer are associated enterprises (for example, corporate members of the same multinational enterprise but located in different countries), the tax authorities will be concerned to check whether the price paid in respect of transactions between them is the same as it would have been had the parties been independent. If that is not the case, profit will have been shifted from one jurisdiction to the other. If the supply is being made from a country with a tax rate which is higher than that in the customer's country, the authorities in the supplier's jurisdiction will want to check that the price is not too low, because that would shift profit to the customer. If the tax rate is higher where the customer is resident, the risk is that the price is too high.

Most developed countries allow their revenue authorities to make adjustments, known as "transfer pricing" adjustments, to the reported profits of companies and businesses which deal with associated enterprises. The basis of these adjustments, whether made under double tax treaties or under domestic law, is to calculate what the profits would have been if the commercial and financial relations between the parties had been those which would have existed between independent enterprises.

Unfortunately, this basic rule leaves a great deal of scope for interpretation and it is quite possible that the transfer pricing methodology agreed with one country will not be respected by another.

3.4 The OECD guidelines

To encourage international consensus, the OECD publishes guidance on how to apply the rules. The most recent version of the "*Transfer pricing guidelines for multinational enterprises and tax administrations*" ("the OECD guidelines") was approved by the OECD on 22 July 2010.

The OECD guidelines detail five possible methods to choose from when making transfer pricing adjustments. These are set out below and break down into three **traditional transactional methods** (comparable uncontrolled price, resale minus and cost plus) and two **transactional profit methods** (profits split and transactional net margin).

Additionally, the guidelines accept that none of these may be appropriate and so allow for other methods to be used where they can be justified on the facts of the case.

3.5 Which transfer pricing method to use?

Although the 2005 OECD guidelines contained a hierarchy of transfer pricing methods, the OECD's 2010 guidelines merely express a preference for the traditional transaction methods over the traditional profit methods. As will be seen, the comparable uncontrolled price method is preferred where different methods are equally appropriate; otherwise, simply follow the most appropriate method.

3.5.1 The comparable uncontrolled price method

One can easily see that the traditional transaction methods address the test being applied more exactly. If we are seeking the price which would be paid between independent parties, the best evidence must be the terms on which transactions between unconnected parties actually occur. Accordingly, the starting point has to be to use the **comparable uncontrolled price** ("CUP"), if there is one. That is the price reached by independent parties in similar transactions.

3.5.2 The resale minus method

The difficulty is that if supplies of the goods or services being sold are unique to the parties, there may not be any suitable transactions for comparison. Still, it may be possible to come at the point indirectly, where there is evidence of the margin made by comparable traders dealing with unconnected parties. Thus, the value of goods or services purchased from associated enterprises may be computed by deducting from the sales price the commercial margin realised in such cases (the **resale minus** method).

3.5.3 The cost plus method

Similarly, the value of goods or services sold may be calculated by adding a commercial margin to cost (the **cost plus** method).

3.5.4 The profit split method

The **profit split** method does not depend upon making direct comparisons with market transactions or using market profit margins, but is generally used where such comparisons are not available. Perhaps the transaction involves trading relationships which are so dependent upon the connection that they would never take place between unconnected parties. Instead, the method looks at the relevant contributions of the entities between which the profit is to be split, assessing this by analysing such matters as the functions performed, the assets contributed and the risks borne by each party. These contributions would be valued by reference to market data.

3.5.5 The transactional net margin method

The **transactional net margin** method, as its name suggests, looks at net profit (ie the profits derived from comparable businesses) rather than gross margins (ie the margins on particular transactions). Using net profits introduces a whole range of business variables and can make finding appropriate comparators difficult.

3.6 Problems with the existing regime

The preference for CUP has logic. Not only is a simple comparison with uncontrolled transactions the most direct route, but it produces a neutral result in economic terms. When CUP is applied, it makes no difference to the tax position of a manufacturer whether it sells a widget to a subsidiary or to an independent party. In theory, that should prevent tax distorting the market. Still, the way in which the system currently operates has been criticised from a number of perspectives.

3.6.1 Developing economies

One suggestion is that the system is unfair to developing countries. It is, of course, right to say that tax collectors in rich countries tend to be better resourced than their colleagues in less affluent parts of the world. It may also prove more difficult to obtain comparables in the latter. As the UN says in its 2012 transfer pricing report:

> "One of the foundations of the arm's length principle is comparative pricing. Proper comparability is often difficult to achieve in practice, a factor which in the view of many weakens the continued validity of the principle itself. The fact is that traditional transfer pricing methods (CUP, resale price, cost plus) directly rely on comparables. These comparables have to be close in order to be of use for the transfer pricing analysis. It is often in practice extremely difficult, especially in some developing countries, to obtain adequate information to apply the arm's length principle."

With mutual agreement procedures pushing tax authorities to negotiate over how much of the combined profit of vendor and purchaser each country may tax, these factors may result in bias. Would something more formulaic level the playing field? It is doubtful whether it would. As will be seen below, unless tax rates are unified across the globe, even a formulaic system would require a commercial override needing expert operation. The only way to give all countries equality of arms would be to make the allocation of profits a matter for an independent body.

Another legitimate concern for developing countries is that pricing, and thus taxable profit, may be distorted by location specific advantages – ie special factors such as cheap labour and lower levels of environmental protection. If you apply the cost plus method to a very low cost base, you will get a much lower tax charge than if the equivalent work had been done somewhere more expensive. Some developing countries have sought to compensate for this. For example, Brazil, whose methodology is largely based on the cost plus and resale minus methods, uses a standard margin of 20%. Higher rates of 30% and 40% apply for a few specified sectors (including pharmaceuticals, tobacco products, petroleum and natural gas, and chemicals).

The Chinese tax authorities argue that where services have a low cost base, the mark up percentage used in the cost plus method should be grossed up. For example, if the cost of providing services in the US was 150 and in China it is 100, then the mark up should be grossed up by multiplying the normal mark up by 150/100. A normal mark up of 8%, for example, would be increased to 12% to arrive at the same level of imputed profit.

One way or another, these are attempts to tax a fair proportion of the overall profit, irrespective of the low local cost base.

3.6.2 Unfair advantages to the taxpayer

Another criticism of the existing transfer pricing regime is that the taxpayer has unfair advantages. First, many of the issues are factual and the taxpayer will naturally have a better grasp of the facts relating to his business than will the tax inspector. Second, the accountants who advise multinational companies are more experienced and better resourced than the revenue authorities with which they are dealing.

This point was made vividly in the sixth recommendation of the report by the Public Accounts Committee of the UK on

"*Tax avoidance: the role of large accountancy firms*", published in April 2013. This included the following passage:

> "HMRC is not able to defend the public interest effectively when its resources are more limited than those enjoyed by the big four firms. The four firms employ almost 9,000 people as part of their UK tax practice. For instance, HMRC has 65 transfer pricing specialists, whereas the big four firms alone have around 250."

One can see justice in these points, but again it is not entirely clear that removing the primacy of traditional transactional methods in favour of profit sharing methods would improve matters. Any formula, if it were not to be manipulated, would require an override, and negotiating whether that override applied would be every bit as difficult as finding comparators.

3.6.3 Complexity

There is no doubt that agreeing transfer pricing is a major burden on multinationals. In practice, the results are often arbitrary, with the potential for different authorities to take different views in relation to the same transaction. Producing more and more guidance is clearly not the answer. There is already too much.

The OECD transfer pricing guidelines currently run to 371 pages and a new "*Handbook on transfer pricing risk assessment*" has just been published in draft form. Even the OECD itself acknowledges that "transfer pricing compliance and administration is often complex, time consuming and costly." And yet the United Nations has produced its own "*Transfer pricing manual*", running to just 330 pages. This is not a finished product and a second stage is needed to cover intangibles; even then, it will require constant updating.

The result of this complexity is that, in the end, the system depends as much on compromise as it does on science, something which is illustrated in the UK by the infrequency of litigation. This is hardly a satisfactory basis for taxation, which should be based on the predictable application of well understood principles. In practice, most major multinationals will seek to avoid contention by entering into Advance Pricing Agreements with the jurisdictions in which they deal.

3.7 Is it time for change?

Should we persevere with this system which, however logical in theory, is difficult and costly to operate? There can only be one question. Can we find a better one? And by "better", in this context, we mean cheaper to operate, while remaining fair between the parties and making avoidance more difficult.

3.8 Unitary tax – a new way?

Professor Sol Picciotto is a leading advocate for unitary taxation. In his view, it makes little sense to tax individual entities within a major multinational enterprise by reference to their individual, locally produced, accounts. The multinational enterprise sees itself as a unitary entity and so it would not be unreasonable to base the tax charge on the consolidated accounts of the whole group.

This is not quite as radical as it might sound. Tax would still be charged on profit, although it would no longer be computed, entity by entity, by conforming the prices and margins on transactions between associated enterprises to those of the market. Instead, the system would hinge on an economic apportionment of global profit and, as the profit split method, this is already one of the (less favoured) alternatives offered by the current OECD guidelines. As Picciotto put it in his evidence to the House of Lords: "In a sense, we have a unitary system struggling to get out of the present complicated arrangements."

In deciding whether a unitary system would be better, we need to keep the focus on the needs of the main stakeholders. Politicians in every country seek a way of bringing more taxable income into their jurisdiction; this can only be achieved across the board if the changes result in a significant rise in the global tax base. For multinationals, the issue is not primarily how much tax they pay (although inevitably, given any degree of choice, a multinational will organise itself to pay the smallest amount of tax consistent with the relevant tax legislation). For them, the essential requirements are business certainty and reduced costs of compliance.

So how are these miracles to be achieved? In approaching the structure of a unitary tax, four key elements need to be considered. These are:

- a common tax base;
- a common tax rate;
- a method of allocation; and
- a satisfactory administrative structure.

The starting point must be to look at those multinationals where all activities take place within a bloc of states which is implementing a unitary system. Then, we must examine the position of those multinationals which are carrying on business both within that bloc and also in non-participating states. Lastly, a word needs to be said about the interests of developing countries.

3.8.1 A common tax base

In a unitary system, taxable profits will be computed across the group and then split between the jurisdictions in which group members are active. Here, it is essential that each jurisdiction computes its tax in the same way; otherwise, a central allocation of commercial profit would have to be followed by a separate adjustment to taxable profit in each jurisdiction, according to its own tax rules. That is theoretically possible, of course, but it would be hugely complex, particularly in the treatment of capital assets, as their importance to the various jurisdictions can vary from year to year. It certainly would not deliver the straightforward system which is needed.

It follows that where a group of countries works together in adopting a unitary system, those countries need to agree a common tax base and relinquish their ability to make unilateral changes. For example, they would no longer be able to introduce accelerated rates of capital allowances or special tax credits for research and development costs, unless they did it together. Clearly, this type of cooperation can only take place within a tightly knit political bloc.

Within Europe, the standardisation of tax rules is seen as an extension of the European project, and the European Commission has produced a blueprint for a common consolidated corporate tax base (CCCTB). The idea is for this to be a voluntary system which multinationals can adopt if they wish, although as the decision will presumably be made after comparing the tax payable under the CCCTB with that payable under local rules, it will only be used where tax is likely to be saved or where any increase in tax is more than offset by administrative savings. In any event, the reason for the initiative purports to be a concern that "the interaction of national tax systems often leads to over-taxation and double taxation, [and] businesses are facing heavy administrative burdens and high tax compliance costs."

If a common base is a sine qua non, the next question is how that base should be designed. One cannot just take the group's consolidated financial statements. As Deloitte noted in its written evidence to the House of Lords committee:

> "It is worth noting that the International Financial Reporting Standards (IFRS) is not a suitable system for assessing and taxing profits due to the complex valuations inherent in those accounting principles. Fundamentally, the best system is for tax to be based on realised profits which translate to cash or near-cash, which is needed to pay the tax due. It is clear that some of the tax avoidance in the UK over the last few years has arisen through the exploitation of IFRS concepts."

Whether the use of mark-to-market valuations makes global accounting standards inappropriate depends upon the business being considered. In the case of banks, for example, it may well be the best way to measure taxable profits, but it would be less appropriate for companies which carry physical stock. There, an opt-out from mark-to-market valuations could permit a reasonably straightforward tax adjustment to the accounting profits. Such adjustments are common in the UK, where accounts have moved on to IFRS standards, but many companies are still taxed on "old UK-GAAP" standards.

Whatever the details, consolidated accounting profits would be the starting point in measuring profits, and adjustments to those profits would be needed.

3.8.2 A common tax rate

A common tax base does not mean everyone adopting the same tax rates; indeed the CCCTB proposed by the EU has no pretensions in this direction. Would it be necessary for a group of countries adopting a unitary system to standardise their rates? In theory, no. Each jurisdiction could apply its own rate to that part of the overall tax base which was allocated to it and tax could be paid to that jurisdiction accordingly.

The trouble with this is that this dilutes the benefits gained by adopting a unitary system. Yes, the common computation might save professional costs, but the difference in rates would mean that a multinational's total tax bill would depend on how profits were allocated. Inevitably, there would be costly disputes with the authorities, as groups sought to allocate as much of their taxable profits as possible to low tax jurisdictions. A system which remained contentious would remain expensive and leave scope for profit shifting. This hardly meets the criteria we set for a better system. Perhaps then, the real answer is that any differences between the tax rates of participating jurisdictions must not be sufficient for arbitrage to be worthwhile.

3.8.3 A method of allocation

At the heart of unitary tax is the allocation system. Its significance depends upon whether the tax rate is the same or almost the same across all participating jurisdictions. If the tax rate is not the same, multinationals will seek to minimise the proportion of their profit allocated to high tax jurisdictions; if it is, the allocation does not affect the aggregate tax taken from the multinational, but merely the extent to which the various countries profit from it. Here, the multinational itself has no reason to manipulate the allocation.

Whether tax rates are unified or not, the starting point must be the allocation of group profits, according to a formula which works by reference to fixed and verifiable inputs. These are likely to include such factors as physical assets, employees, wage costs and sales. The OECD consultation currently in progress for a standardised country-by-country tax report includes a discussion on the inclusion of these and other measures of economic activity to supplement returns of income and taxes.

Deloitte questioned the effectiveness of formulaic allocations in its written evidence to the Select Committee of the House of Lords:

> "Global formulaic allocations (sometimes called global formulary apportionment or unitary tax) are unlikely to be realistic. In most models proposed, the formulae are based on a combination of sales by destination, tangible assets and employment costs. One challenge is that the large variances in costs (such as of people, property and sales values) across jurisdictions means that high cost

> countries would attract more profits under a formulae method. Such costs could be rebalanced via a purchasing power index to give a meaningful result but there are doubts that this can be achieved in a fair manner. It would certainly be complex."

One can see the shadow of the current Chinese system here. Still, the short point is that, while a formulaic approach to profit allocation has the obvious attractions of simplicity and objectivity, it is likely to be a little arbitrary and will sometimes produce results out of line with the contributions of the companies involved.

Where tax rates are so uniform that the multinational has no interest in the outcome, this should not matter and it should be sufficient to treat the results of the formula as final. In the absence of a systematic bias in favour of low tax jurisdictions, the advantages and disadvantages which accrue to each country over all the multinationals doing business there should ultimately balance out. This assumes, of course, that the formula is not accidentally skewed, but no doubt we can rely on the economists who design it to make sure that there is no problem of that sort.

Where there is a significant variation in tax rates, it will be necessary to supplement formulaic apportionment with a second stage, allowing the tax authorities, and possibly the taxpayer, to substitute a more rigorous allocation. If that is not done, multinationals will game the formula. Although it would be consistent with the principles of a unitary tax to carry out that second allocation using a profit split method, it would also be expensive and awkward. The profit split method is generally more difficult to use than the traditional transaction methods favoured by the OECD guidelines. It is relatively easy to use a comparative price or profit margin; a full economic analysis of the business is a much more substantial undertaking. That is one reason why one often sees taxpayers struggling to use the cost plus method, basing their calculations on comparators which are not really appropriate.

Anyway, the long and short of it is that a significant disparity in tax rates means that there has to be a second stage to the allocation. Cost considerations dictate that this second stage allocation would have to be carried out by reference to the OECD guidelines, with their bias towards traditional transaction methods. If that is to be the outcome, why not stay with the allocation methods we have now?

It is beyond the scope of this paper to analyse the circumstances in which the UK would win or lose from any move to an allocation basis. That would depend upon which other countries joined the system and on the criteria used in the apportionment formula. The membership of the "unitary bloc" would be a political matter, but the formula would no doubt be designed by participating countries to give an overall split of revenue similar to that which we have today. Otherwise, it would be very difficult to persuade potential losers to join the bloc.

3.8.4 A satisfactory administrative structure

The way in which a unitary tax would be administered also depends upon whether there is a uniform tax rate within the unitary bloc.

Where all tax rates are the same, the most straightforward solution would be for the multinational enterprise to file its tax return where its head office is located and to pay all the tax due to the tax authority there. That tax authority would then be responsible for notifying the other bloc countries in which the multinational does business of the amount of tax apportioned to them under the formula. Payments would be made periodically between the various countries to settle the sums due.

Companies would benefit from not having to deal with multiple tax jurisdictions and also from a greater certainty that they have fully dealt with their tax liabilities when they file their returns. They would, of course, not have to worry about transfer pricing within the bloc. There would also be another benefit: changes in the tax base and rate would have to be agreed by a number of governments, providing a welcome friction, increasing predictability and making it easier to plan for the future.

Where the tax rates of participating countries vary, the position would be more complicated. Here, the allocation would be made before the tax rates are applied and someone would need to check whether the formula gives a fair result. That is quite a difficult job. To prevent multinationals from stealing a march by filing in jurisdictions where the authorities were known to be technically weak, it would be necessary to arrange matters so that all filing for the participating bloc was with a central authority or alternatively with all relevant jurisdictions on the basis that a central authority was given the role of adjudicating on any discrepancies which arise.

Whichever method is adopted, taxpayers will be anxious to ensure that the information they provide to the authorities remains confidential. The position is intrinsically much riskier than under the present system. Each national tax authority will receive information regarding the whole business of the multinational group, rather than just about those subsidiaries resident and trading in its territory.

3.9 Boundaries

So far we have only dealt with how taxes could be allocated within a unitary bloc. We have not looked at the position of a multinational which has subsidiaries in the bloc and also in non-participating countries.

If a bloc such as the EU adopted a unitary system in an otherwise non unitary world and a multinational had operations on both sides of the divide, the calculation of its tax in the unitary states would be carried out as follows:

- First, it would be necessary to work out how much of the multinational's profits were attributable to

EU member states. This would be done by using the existing OECD guidelines, with their preference for the use of traditional transaction methods, to price transactions which cross the border between participating and non-participating states.

- After that, the EU profits would be divided between member states using the unitary principles described above.

That way, there is no real conflict between coexisting unitary and non-unitary systems.

3.10 Developing countries

At first sight, one might expect a profit split method to improve the position of developing countries. After all, the idea is that one looks back to see where value is created. If, say, a product grown in Country X by the local subsidiary is sold to other group companies, it might be thought that a profit split should give a chunky proportion of the overall profit to Country X. In fact, it is doubtful how this would pan out. Any formula taking costs into account would carry a bias towards the developed world where costs are higher. To boost the take of developing countries, that formula would need to be adjusted. India and China are already doing this in relation to the present system. It seems doubtful whether the process would really be much different.

3.11 Conclusion

The above discussion outlines how unitary tax could be introduced for a bloc such as the EU. As we have seen, there are two models: the first involves a unified tax rate; and the second does not. Probably only the first model pays real dividends in simplicity and a reduced prospect of avoidance.

To put this in context, it is worth considering how a uniform tax rate would transform the system if the current OECD guidelines were retained. As with unitary tax, multinationals would no longer have any reason to press for a particular allocation. The only significance of transfer pricing would be to allocate the tax payable between the various jurisdictions. Since errors without bias tend to cancel out, the system should deliver reduced costs and a reduction in the opportunities for tax avoidance. Perhaps, then, the way to improve the system is to make progress towards a unified tax rate, rather than trying to adjust the way in which profits are allocated.

Finally, going back to the system as it is, it is worth remembering that under the current OECD guidelines, profit splitting should be adopted where it is the most appropriate method. It may well be that some tax authorities do not bear this possibility sufficiently in mind and that they are too quick to accept traditional transaction methods, such as cost plus, where the comparators are not really appropriate. A greater willingness to insist on profit splitting in the right cases could increase yields.

4 Permanent establishments and deductions

In the first conclusion to its report, "*HM Revenue and Customs: annual report and accounts 2011-12*", published on 3 December 2011, the Public Accounts Committee included the following passage:

> "Despite an increase in total tax revenues of £4 billion from last year, corporation tax revenues have fallen. Multinationals appear to avoid UK corporation tax by arranging their corporate structures, transfer payments and royalties to move money to low tax jurisdictions overseas. There is little credible information to inform public debate over the equity of corporate tax payments and HMRC lacked clarity when explaining its approach to enforcing the corporation tax regime. Since multinational companies are able to set up in any country, this may need international co-ordination to resolve."

4.1 Identifying the issues

An examination of the evidence given to the Committee throws some light on these concerns. As part of the proceedings, representatives from Amazon, Google and Starbucks were called to give oral evidence, describing the international structures put in place by those firms. Although there was nothing in their evidence to suggest that they had done anything other than comply with their legal obligations, the Committee was concerned that the tax they paid in the UK was low when viewed against the level of their presence here.

With regards to Amazon and Google, the Committee's investigation was concerned with the activity necessary to establish a UK taxable presence. In the case of Starbucks, it focused on the extent to which (1) the fees paid for intellectual property, and (2) the price at which coffee was purchased from a group company based in Switzerland, were deductible in a UK computation of taxable profits.

These are quite distinct issues and we will deal with taxable presence first.

4.2 The fiscal role of the permanent establishment

As we know, a company will normally only pay tax on its general trading profits in a country, other than its country of residence, if it trades there through a permanent establishment. Otherwise, it will not normally pay suffer local tax on such profits at all (unless they comprise interest, royalties etc. in which case they may be received after deduction of withholding tax).This may be because the country in which the company is resident and the country in which it conducts its trading activity have entered into a double tax treaty which follows one of the major models. Such a treaty would normally prevent local tax being paid on trading profits in the absence of a permanent establishment and then go on, where such an establishment is present, to limit the tax base to so much of those profits as is attributable to that permanent establishment. Alternatively it may be because the host jurisdiction has placed a similar limit on its ability to tax overseas traders as part of its domestic law.

As mentioned in part 3, the UK takes this course. The machinery can be found at Corporation Tax Act 2009, s 5(2), which provides that: "A non-UK resident company is within the charge to corporation tax only if it carries on a trade in the United Kingdom through a permanent establishment in the United Kingdom."

Section 19 then defines the chargeable profits of the non-resident by reference to their connection with that permanent establishment.

The reason for introducing this restriction into UK domestic law is to make it easier for companies resident in non-treaty jurisdictions to deal with the UK, without the worry that they will find themselves subject to UK tax despite the absence of any continuing presence here. Otherwise, they might not deal with the UK at all.

It will be appreciated that if an overseas seller of a product into the UK market can carry out its activities without a UK permanent establishment, those activities will not attract UK corporation tax although they will no doubt be taxable in the company's jurisdiction of residence. If the tax rate in the jurisdiction of residence is lower than the rate charged by the UK, that could bring a substantial advantage.

The prospect of multinationals resident in low tax jurisdictions selling into the UK market but falling outside the UK tax net because they have no permanent establishments here seems to have upset the Public Accounts Committee and the press. The way in which this tax free result may be achieved turns on the way in which "permanent establishment" is defined.

4.3 The meaning of permanent establishment

Although the term "permanent establishment" is defined in the OECD Model Convention, not all treaties follow that definition exactly; still, the essentials are generally the same and, as it follows the model treaty very closely, we will take the definition as it has been incorporated into the UK's taxing statutes.

A non-resident company has a permanent establishment in the UK if it has a fixed place of business in the UK, through which the business of the company is wholly or partly carried on; or if it has an agent acting on its behalf which has the authority to do business on behalf of the company in the UK and which habitually exercises that authority. A fixed place of business includes, inter alia, a place of management, a branch, an office, a factory, a workshop, a building site or a construction or installation project. There is an exclusion for agents of independent status. There is no permanent establishment in the UK where the only activities carried on are preparatory or auxiliary in nature.

4.3.1 The need for modernisation

While this is a rational and straightforward approach to deciding which operations are taxable in the UK, it is perhaps a little old fashioned. Modern communications and technology make it much easier for a non-resident company to do business here without any form of fixed presence. The question is, then, whether the definition of "permanent establishment" should be updated. The obvious way to start is to look at the mischief which needs to be addressed.

Consider the position of an overseas trader selling to the British public. How might he do that without a permanent establishment? Of course, it depends on exactly what it is that he is selling.

If we are talking about physical goods, servicing the business wholly from overseas would involve their delivery by international courier. Let us assume that our trader prefers to avoid this and to use UK warehouses. If he wishes to remain outside the UK's corporation tax net, he must be confident that those warehouses will be excluded from being permanent establishments, on the grounds that they are only used for "activities of a preparatory or auxiliary character". As the UK legislation stands, this should not be difficult as such activities include "the use of facilities for the purposes of storage, display or delivery of goods or merchandise belonging to the company" and "the maintenance of a stock of goods or merchandise belonging to the company for the purpose of storage, display or delivery". (See Corporation Tax Act 2010, s 1143(3).)

The wording of the OECD Model Convention is similar, so this type of exclusion will appear in most modern treaties.

4.3.2 Including warehouses

One possibility, then, would be to amend the definition of permanent establishment at both the treaty and the national level, so that it includes warehouses in the UK which store or dispatch goods. That would certainly chime with the thinking behind the definition and seems a sensible enough course – leaving aside the difficulties of amending both domestic law and double tax agreements.

There is a limit, however, to what would be achieved. Yes, to be sure, the goalposts would have been moved, but the net could still be avoided by moving storage and dispatch overseas. Some multinationals would pay; others would move their warehousing overseas. It rather depends on how much profit is to be brought into tax.

4.3.3 A notional permanent establishment

To do the job more thoroughly, and indeed to catch the purveyors of goods or services which do not need physical delivery, one must go further by deeming any company which is selling to UK consumers to have a UK permanent establishment, whether it has an actual presence in the UK or not. The trouble with is that it would catch too much. Overseas businesses who, without a thought about tax, mailed their goods to customers here would find themselves mired in the UK corporation tax system.

Perhaps one could go halfway, so that only the supply of specific products to the UK consumer automatically gives rise to a UK establishment. Presumably, this would include any product which could be delivered in e-form; and careful thought would have to be given to what was in and what was out.

4.3.4 The allocation conundrum

Whether one stops at warehouses and distribution centres or goes further, a method of allocating profits to the new permanent establishment is needed. In the case of warehousing, this is fairly straightforward; one might use a comparison with the margins made by commercial warehousing operations and apply a cost plus basis. Indeed, that is what would happen under the existing attribution rules.

But what happens when there is only a deemed establishment, generated by sales in the UK without presence here? Clearly, it would not be sufficient to catch profits generated by UK activities. There probably are none. Similarly, it cannot be right to catch all profits generated by sales to UK customers. What if the goods were a specific form of garlic which could only be grown in the fair fields of France? Should the French taxman miss out entirely in respect of the profits generated by sales to the UK? Sacré bleu! Of course not!

Perhaps there are positions in between. Perhaps one could catch the profit which would have been made by an independent UK distributor. As no distributor is in fact required, that would be a highly artificial approach and in any event it might not bring in enough profits to make the change worthwhile.

All in all, it might be better to rest content with the inclusion of warehouses.

4.4 Restricting deductions

The other corporate witness examined by the Public Accountants Committee was a representative of Starbucks and here the focus did not relate to permanent establishments at all. Rather, it concerned the tax deductions available for both the amounts paid to an associated company for the use of intellectual property, and for the price paid to a company in Switzerland to supply coffee. Did these tax deductions reduce the UK tax base by an unacceptable amount?

This sort of problem arises in many different contexts. As was explained in part 3, if a UK company pays amounts to another group member which exceed the arm's length price of what is acquired for those payments, the revenue authority's answer is to substitute the arm's length price under the transfer pricing legislation.

It follows that a deduction is only given for expenses which it is commercially necessary to incur, and that no deductions are given beyond that. This seems a logical position; nevertheless, it could be decided that, as a matter of realpolitik, the denial of non-arm's length deductions should be augmented by a rule restricting particular deductions on a more arbitrary basis. The most obvious targets for this treatment are interest and also fees/royalties for the use of intellectual property and know how, as both types of payment can be used to leech profits out of trading companies and move them to low tax jurisdictions.

4.4.1 Payments of interest

Some countries, such as Germany and the UK, already have limits on interest. Generally, these are designed to ensure that the local company does not end up with a deduction for gearing which exceeds the gearing of the group as a whole.

Other possible approaches are to place arbitrary restrictions on the interest deduction, either limiting it to a proportion of profits (taken before interest or tax) or by reference to gearing ratios, or to abolish the deduction for interest altogether.

A removal of the deduction for interest would have to be accompanied by changes which mitigated the taxation of that interest in the hands of the recipient. This could be done by treating it as if it were a distribution; in the UK, at least, this would result in individuals paying a lower rate of tax than they do on other income. The interest would also have to be tax free in the hands of financial institutions. If that was not the case, financial institutions in back-to-back situations would suffer tax mismatches and parts of the banking system would become inoperable.

A less drastic approach would be to supplement transfer pricing by placing arbitrary restrictions on interest deductions for companies other than financial institutions, and accepting that the payment of surplus interest will result in double taxation. To avoid this operating too unfairly, mechanisms could be provided under which companies could adjust their debt up or down as they tailored their interest costs to the permitted level.

4.4.2 Payments for the use of intellectual property etc.

The removal of the deduction for payments for the use of intellectual property, goodwill and know how is both easier and harder to achieve than the restriction of the deduction for interest.

It is easier because, the payments not being for finance, it is not necessary to consider the effect of any change upon the banking system.

It is also harder, however, because of the ease with which payments for intellectual property can be wrapped into the value of assets acquired. This is discussed at 5.9 below. It is hard to see how one would prevent multinational groups from getting round any restriction or withholding tax by arranging for UK members to buy goods from overseas manufacturers who had already made all payments in respect of intellectual property. To attack that, one would need to disallow part of the acquisition cost of stock and that hardly sounds practical.

4.5 Conclusion

If artificial restrictions are to be placed on deductions, interest and royalties are the obvious candidates. Each has its own issues. Limitation of deductions for interest would have to be tailored to allow financial institutions to carry on business, which probably means different level of deductions being allowed for different businesses. A limitation on deductions for payments for the use of intellectual property would be hard to make watertight, although it might discourage some taxpayers who would otherwise use such deductions as a way of moving profits to low tax jurisdictions.

5 Preferential tax regimes and the attraction of destination based tax

To those who deal with international tax, the topics discussed so far will be familiar. The better allocation of group profits, the definition of permanent establishment and the limitation of deductions have long been the stuff of debate about tax avoidance, with discussion centring on how the provisions addressing these areas should operate. These provisions are buttressed, of course, by other weapons in the arsenal of the authorities. There are anti-avoidance rules, anti-hybrid rules, disclosure measures designed to give early warning of tax schemes and many other good things besides.

Yet despite this wide array of instruments available to the tax gatherer, there is a feeling that on their own they are not enough and that something different is called for. It was this feeling which led the House of Lords committee to propose that the Treasury should "explore the scope for more radical alternative approaches to corporation tax" and the OECD Action Plan to suggest that a "destination based tax" might be the answer.

5.1 The need for something more

Before looking at the possible forms of a destination based tax, we should reflect for a moment on why such a radical change is needed. How do taxable revenues escape the combined clutches of the world's finest exchequers, in a way which cannot be dealt with by conventional measures?

The answer to this is bound up with the way in which the commercial world has developed in the 35 years since the Meade report. In that period, communications have changed unrecognisably and business practices have changed with them. Improvements in telephony mean that an executive can join a meeting in another jurisdiction almost as easily as a meeting in the jurisdiction in which he or she is physically present. The development of email means that communications can cross the world much more quickly than a messenger can cross the street. The result of all this is that multinationals can place many of their profitable functions wherever they like without losing operational efficiency. In particular, they can carry out activities or hold profitable assets in the jurisdictions with the lowest tax rates.

Tax minimisation of this sort depends, of course, on some tax rates being lower than others. The scope for it is enormously increased by what are conventionally known as "preferential tax regimes" or "harmful tax practices". These terms are used to denote tax breaks or low tax rates put in place by a country in a manner designed to attract business away from its competitors.

5.2 Harmful tax practices

On page 17 of its 2013 report, "*Action Plan on Base Erosion and Profit Shifting*", the OECD addressed the question of preferential tax regimes as follows:

> "In 1998, the OECD issued a report (OECD, 1998) on harmful tax practices in part based on the recognition that a 'race to the bottom' would ultimately drive applicable tax rates on certain mobile sources of income to zero for all countries, whether or not this was the tax policy a country wished to pursue. Agreeing to a set of common rules may in fact help countries to make their sovereign tax policy choices. The underlying policy concerns expressed in the 1998 report as regards the 'race to the bottom' on the mobile income tax base are as relevant today as they were 15 years ago. However, the 'race to the bottom' nowadays often takes less the form of traditional ring-fencing and more the form of across the board corporate tax rate reductions on particular types of income (such as income from financial activities or from the provision of intangibles). The BEPS report (OECD, 2013a) calls for proposals to develop 'solutions to counter harmful regimes more effectively, taking into account factors such as transparency and substance'. In furtherance of this goal, the work of the Forum on Harmful Tax Practices (FHTP) will be refocused to develop more effective solutions."

5.2.1 Tax abuse and tax avoidance

It is important to understand what is being addressed here. Much of the debate on international tax focuses on tax avoidance which could be regarded as abusive; that is to say, the distortion of a business's affairs to make use of technical shortcomings in the rules. Simply placing an activity in a jurisdiction with a low tax rate is not abusive in this sense at all. Provided that the activity is genuinely carried on in the low tax jurisdiction, there is none of the "segregation between the location where actual business activities and investment take place and the location where profits are reported for tax purposes", which has been identified as a growing issue by the OECD (see page 21 of the OECD's 2013 report, "*Addressing Base Erosion and Profit Shifting*"). However, the effect is undoubtedly to erode the tax base of the jurisdiction in which profits would have arisen, had not tax considerations dictated that those profits should be realised elsewhere.

5.2.2 A structure designed to minimise tax

Let us take an example. Suppose that a company, "Tradeco", sells goods to consumers in the UK by advertising them on the internet. Tradeco has no UK presence, being resident in and carrying on business from a tax haven; that is to say, a country in which it pays no or very little tax, either because the tax rate there is low or because of a tax break for which Tradeco qualifies. Orders are taken and processed in the tax haven, where the management board of Tradeco makes all the commercial decisions; the administration of the business is carried on there as well. The goods themselves are manufactured and posted to customers by companies "Manco" and "Postco", both resident in countries which tax a small mark up on the costs of their activities. Finance comes from a branch of an overseas company, "Finco", which is set up to ensure that the interest is hardly taxed at all. "IPco", which holds the patent rights on which the manufacture of the product depends, is in another tax haven. All the companies concerned are in the same group. The position is illustrated in figure 1.

5.2.3 How it works

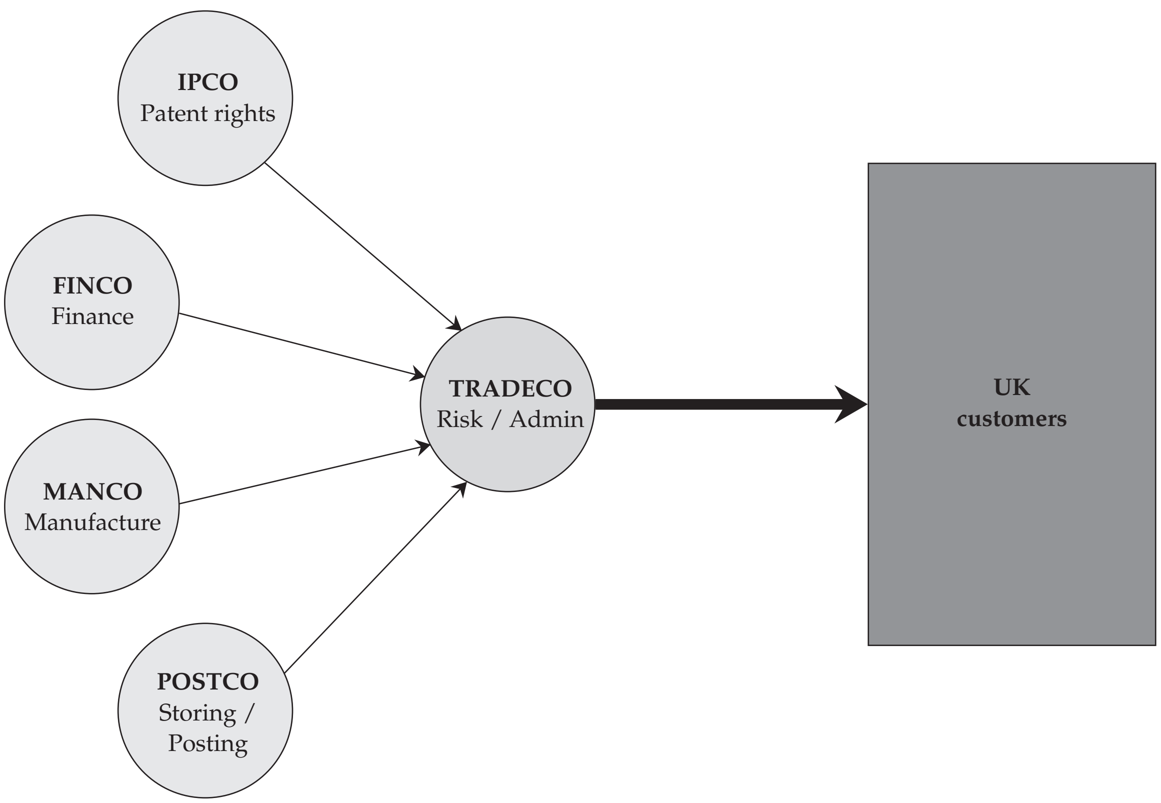
Whatever system of profit allocation you use, it is hard to see that any profit is being earned in the UK, since nothing whatever is being done here. (It would be different, of course, if the rules were changed as was suggested in part 4, so that Tradeco was deemed to have a UK permanent establishment by virtue of its sales to UK consumers. However, we are looking at possible reforms one by one and so will ignore this possibility.)

So as the law currently stands none of the companies should pay UK corporation tax. The aggregate corporation tax charged on group profits by other jurisdictions is tax on the margins made by Postco and Manco, plus very small tax payments from Finco, IPco and from Tradeco itself. That low tax overhead will enable the group to undercut UK domestic competitors. If these competitors move offshore to maintain their competitive position, there will be erosion both of the UK's tax base and also of its GDP.

5.3 The natural limits to the exploitation of preferential regimes

There now, this game of advising on international tax planning sounds disarmingly straightforward, doesn't it? Along comes the client with its new venture, a quick flick through the directories to see where taxes are low, some coloured circles on a piece of paper and there we are:

Figure 1



bingo! Tax is saved by the client, an invoice is issued and, kerching, a fat fee drops into the till, propelling the adviser towards some fast living on a well-appointed yacht in the Caribbean.

Now before you immerse yourself further in that issue of "The Tax Avoider's News", which you have just opened at the situations vacant page, it is worth reading on a little; because even with the rules as they are, there are natural limits to the activities which can be placed in low tax jurisdictions. Those limits depend, of course, on the nature of the product which is to be delivered to the customer and the processes which are necessary to that delivery. Let us look back at the functions indicated in figure 1 and see how susceptible they are to being moved.

5.3.1 Manufacturing/storage/dispatch

Perhaps we should begin with the more physical activities. Here the place where they are carried out is likely to depend on considerations other than tax. Manufacturing requires a competent workforce, proximity to the point of sale, low labour costs and the availability of suitable premises, etc. These are all likely to compete in importance with the local rate of taxation when the group decides in which jurisdictions its factories should be placed.

Because of the futility of avoiding tax on profits which the business never actually makes, discussions on the location of manufacture are unlikely to be delegated to the tax manager. Much the same can be said about the decisions on the location of storage and dispatch. As a general rule, activities involving the local handling of goods come low on the "easy to move" list.

5.3.2 Risk

The placing of risk is far more fertile ground for the tax planner. For a start, risk is highly mobile. In the example at figure 1, all the risk can be kept in Tradeco by providing in its contracts with Manco and Postco that they will provide Tradeco with the goods and services it orders at a price equal to their total costs plus a fixed mark up, and that Tradeco will indemnify them against any liability they incur in the process.

On that basis, all the risk is taken by Tradeco which, having little to do in a physical sense, can be placed in the most tax advantageous jurisdiction. Moreover, the high level of risk will be reflected by a high proportion of the profits of a successful venture because, with the possible exception of the patent royalties paid to IPco which might be profit related, Tradeco's costs are independent of the amount for which its products are sold.

5.3.3 Intellectual property

It is often easy to arrange for intellectual property rights to be held in companies resident in low tax jurisdictions, by ensuring that those carrying out the relevant research do so on behalf of those companies. Properly organised, this should not require a transfer of existing rights from a high tax jurisdiction and thus the prospect of an unwelcome capital gain, because the rights are never held in such a jurisdiction in the first place.

The fact that intellectual property rights can be so easily placed is the driver behind the "patent box" regime in the UK, which applies a special low tax rate to income from the exploitation of certain UK, EU and EEA patents. That is, of course, a preferential regime, although one can see why the UK government regarded it as necessary; after all, the alternative was to stand by and watch the rights to UK inventions being assembled in tax havens. Perhaps the fact that the purpose of the regime was to make the UK competitive with existing alternative regimes exculpates it from some of the stigma attached to "the race to the bottom".

5.3.4 Finance

Money, of course, is easily moved. The fact that it can be lent to UK borrowers via intermediate companies, which pass interest back to the lenders without withholding tax, means that it can be provided from any jurisdiction to the UK. In figure 1, Finco lends to Tradeco which is resident in a tax haven, so it is unlikely that any issue of withholding tax arises. Of course, if the tax rate on the profits of Finco is higher than the rate on the profits of Tradeco, it might be better for the finance to be provided in return for an issue of shares. However that may be, the message is that interest is one of the income streams which can often be rolled up tax free offshore.

5.3.5 In general

It would be a mistake to take the comments above as universal truths because circumstances differ. In some multinationals there will be room to move risk to avoid tax; in others, there will not. In some cases, the intellectual property rights will be significant. As we saw in part 4, it will often be possible to suck money out of high tax jurisdictions by charging a deductible royalty, but to arrange matters so that the royalty does not attract significant tax elsewhere.

The permutations are endless, but one way or another there are many situations where profits can be generated in tax havens in a manner which defies reallocation. Among the profits most eligible for this treatment are those which flow from risk, from intellectual property and from finance.

5.4 The response to the problem of preferential regimes

The best way to prevent this sort of planning is to abolish preferential tax regimes; alas, though, this is hardly practicable. The villains here are not multinationals using loopholes to misattribute their profits. They are the finance ministries of those countries which are prepared to run in a "race to the bottom" in order to increase their own jurisdiction's slice of the economic pie.

Short of stamping out democracy worldwide, the implications of which are beyond the scope of this paper, there is simply no realistic possibility of all governments renouncing the use of low corporation tax rates and tax breaks for the common good. Indeed, on page 53 of the OECD report, the authors seem conscious of this, calling for proposals to develop "solutions to counter harmful tax regimes more effectively" but then, surprisingly, diverting attention from the real issue by adding the weasel words "taking into account also factors such as transparency and substance".

The possibility of a country, or a group of countries, putting in place systems to limit this type of base erosion was raised in the Mirrlees review and is referred to in the report of the House of Lords Select Committee. How this might best be done is considered below. At the same time, however, perhaps it is worth asking why a country – which is already receiving a fair level of tax from the activities carried on within its borders and the assets held by its residents – would introduce measures to prevent profits and income arising elsewhere from being undertaxed. Why should it care? After all, if the profit allocation rules have been properly applied, surely it already has what it is entitled to?

5.5 Good fiscal citizenship and the "radical alternative"

At paragraph 93 of its report, the House of Lords Select Committee on Economic Affairs said:

> "We agree that fundamental reform of the international tax framework should be pursued in the OECD. As things stand, there are too many opportunities for multinational companies to manipulate their affairs to reduce their global tax payments. Corporate manipulation of the system so as to avoid taxation reduces governments' revenues undermines public trust in the tax system [sic]. We recommend that the Government should continue to play its full part in encouraging the OECD's reform agenda to an early successful conclusion. At the same time the Government – and the Treasury review we propose – should explore the scope for more radical alternative approaches to corporate tax."

Perhaps a country which embraced these sentiments could regard a role in policing the international tax system as something which it ought to undertake, rather like helping to enforce the resolutions of the UN. Of course, this only makes sense if it is the most appropriate jurisdiction to carry out that role. Therefore, once it is accepted that the profits – which would otherwise be untaxed or low taxed in the country in which they arise – should be taxed somewhere else, the question is: "where?" The candidates are:

- the jurisdiction in which the profits would naturally have arisen, but for the object of avoiding tax. This approach seems impractical since it would be very difficult indeed to identify that jurisdiction;
- the jurisdiction of the direct or indirect owners of the company in which the untaxed profits are made. This has already been dismissed as a satisfactory basis for corporation tax generally in part 2 and is rejected here for the same reasons; and
- the jurisdiction of the customer base, which certainly seems to provide a firm rock on which to found liability to taxation. To borrow the words of Professor Rita de la Feria, as quoted at paragraph 103 of the House of Lord Committee report: "Customers are not easy to move and there is nothing that a company can do to move the customer: the customer base is where the customer base is."

Looked at in this way, it is a no brainer. The residence of the customers cannot be manipulated, so it is to destination based tax that we must look if we wish to prevent profits being rolled up under the protection of preferential tax regimes.

5.6 Practical reasons for a destination based tax

The reasons why a jurisdiction might wish to tax profits ultimately funded by sales to its residents, even where those profits are generated elsewhere, are not wholly quixotic.

Quite apart from any tax revenue which might be raised, the threat of such a charge should protect its own tax base by discouraging its businesses from outsourcing activities or profit centres to low tax countries; otherwise, those businesses may come under competitive pressure to do just that. The non-taxation of a company's profits means that it needs a lower pre-tax return to justify its shareholders' investment, giving a commercial edge over fully taxed competitors. Once one group selling to a jurisdiction sets up operations in tax havens, others may find it necessary to do the same in order to maintain a level playing field.

It is necessary to keep this in perspective. A multinational selling throughout the world is unlikely to unwind its planning merely because one jurisdiction levies a destination tax, even if that is the jurisdiction in which those profit centres would naturally occur. Only if a substantial proportion of its sales were to countries taking this approach would the opportunities to obtain a tax advantage through outsourcing to low tax jurisdictions begin to disappear.

5.7 Move the burden to VAT?

A "destination based" tax system raises tax by reference to the jurisdictions in which the customers are situated. The best known destination based tax is VAT. One way to reduce base erosion through profit shifting would be to move the emphasis from corporation tax to VAT by simply changing the rates. Mention has already been made of the rationale for taxing corporate profits; however, whether or not one believes that the case is made, a general shift from a tax on profits to a tax on turnover is unlikely to be politically saleable.

Perhaps then one could go half way. What about a mixed system, under which activities which result in virtual products are excluded from corporation tax and the supply of those products attracts an especially high VAT rate? That is an interesting concept but, as its proponents readily acknowledge, there would be complex boundaries to police and it seems doubtful whether it can be delivered in practice.

5.8 Using the jurisdiction of the client base

So, if we still feel strong enough, the next task must be to consider whether it is practicable to create a tax which is based on the profits generated by particular activities, but which is anchored to the jurisdiction of the client base rather than to where those activities are carried on.

This is considered in part 6. Before that, though, it might be helpful to focus for a moment on one difficulty with which the structure of any new tax would have to cope. How do you deal with long economic chains, where the low tax profits are made in companies which neither carry on business in, nor make sales to, customers in a jurisdiction to which the new destination based regime applies?

5.9 The length of the economic chain

It is simple enough where there is a direct sale from a company in a tax haven to consumers in, say, the UK. The company clearly falls within the mischief which is being addressed, so one only needs a mechanism with which to compute and collect the tax. The position is more difficult, however, where the low tax profits are some way back in the economic chain.

Let us illustrate this with a couple of examples.

5.9.1 The simple chain

First, assume that Company Z (which is in a tax haven) sells products by mail order into the UK and that for every £100 of products sold it has a cost of £10.

See Figure 2.

That leaves Company Z with an untaxed profit of £90. If we had a destination based tax, it would pay tax on £90 in the UK at the UK rate.

5.9.2 The more complex chain

Now let us suppose instead that Company Z sells the goods for £95 to wholesaler Company Y, which in turn onsells to Company X. Company Y and Company X are both also in tax havens. It is Company X which sells to the UK consumer.

See Figure 3.

Company Z still makes a profit of £85, but now it has neither a presence nor customers in the UK. If tax on that £85 is to be collected, it must be collected from Company X.

Figure 2

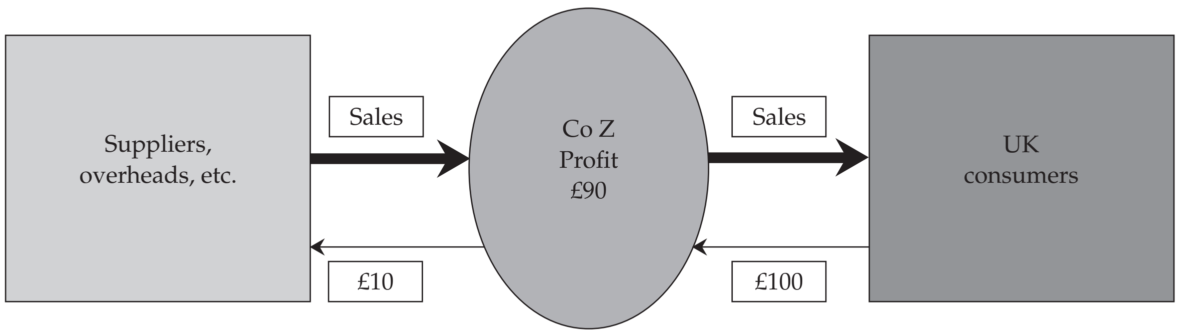
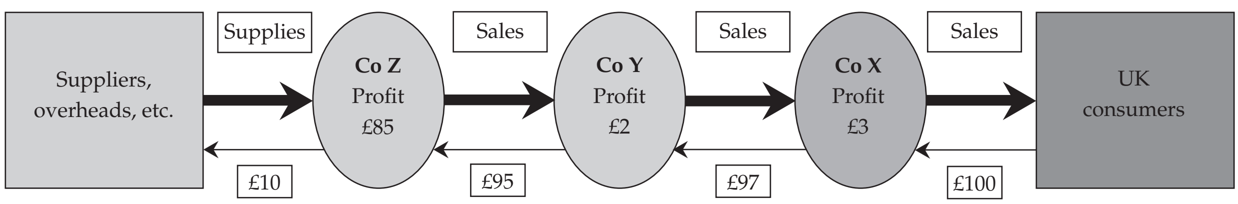


Figure 3



It is therefore essential that any destination based tax contains a mechanism under which profits occurring early in the economic chain can be taxed when sales are made to residents of a jurisdiction which has adopted the tax, even though this may be many steps away.

Although the triple transfer of the product in this illustration may look unusual, bear in mind that the profits rolled up in Company Z might arise from any supply of goods or services which enabled the ultimate product to be produced. For example, Company Z might make its profit on licences of intellectual property, which were necessary to enable Company Y to manufacture the product. Clearly, if the destination tax is to achieve its object, these profits would need to be caught.

5.10 Conclusion

Having identified this difficulty, consideration can now be given to how a destination tax might be constructed.

6 Replacing source based taxation with a destination based tax

6.1 Putting together a destination based tax

Although the intrinsic stability of the customer base may point towards a destination based tax, this gives few clues as to how it should be constructed. All too frequently, its advocates follow generalisations with a comment that "details need to be worked out". Yes, but until we have a workable framework we have nothing. Often, commentators try to compensate for this with some hand-waving reference to adapting VAT principles. Perhaps, then, that is where the start should be made.

6.2 Can a destination based tax be based on VAT?

In its report, the Select Committee of the House of Lords recommended that the Treasury should undertake a detailed study into a "destination based" cash flow tax, which in some respects might be broadly similar to VAT.

This is a concept borrowed from academic writers. Professor Rita de la Feria, of Durham University, advocates the system as follows:

> "What matters then is where your customers are based and companies would pay tax on their profits in a similar way to how the current VAT system operates."

She then goes on to observe:

> "A lot of good practice already exists in relation to VAT, which would help to implement a destination based system, so you wouldn't need to start from scratch."

(See www.dur.ac.uk/news/newsitem/?itemno=18100.)

These quotations encapsulate the proposal quite neatly. Ideas would be borrowed from the world of VAT, a destination based tax on turnover, and used to construct a destination based tax on corporate profits. Put like that, the process does not sound particularly challenging, but the starting point must be to look at the VAT system and to identify those parts which can usefully be recycled.

The first step is to outline the VAT system as it operates where all parties are in the UK, so that there are no cross-border transactions. The second is to consider how this system might be adapted.

6.3 The domestic VAT system

VAT is chargeable on most supplies of goods or services made in the course of economic activity carried on independently. The VAT Directive defines "economic activity" so widely that it encompasses any business or exploitation of property, the requirement that it be carried on "independently" serving to exclude the services rendered by employees to their employers.

Wholly passive ownership does not amount to an economic activity, so the sale of a portfolio holding of shares by someone other than a share dealer is not generally treated as a supply. Even where a supply is made in the course of an economic activity, however, there are exemptions; these cover the provision of most financial services, the provision of medical care and insurance, and other things besides. A supply falling within an exemption does not involve the payment of VAT. A business whose total supplies (either being real supplies or supplies deemed to be made under the legislation) amount to less than a fixed sum is excluded from the legislation unless it decides to opt in. That sum is currently £79,000 in the UK.

The VAT charged in respect of a supply is based on the price received for it and VAT is levied on the full amount of that price. Each country operates the tax independently and charges VAT at its own rate. The rate in the UK is 20% (ignoring reduced and zero rates on special products).

6.3.1 The economic chain in a single jurisdiction

Where the economic chain is in a single jurisdiction, tax is levied on each of the taxable supplies in the chain. Each time such a supply is made, the trader becomes liable to pay the VAT included in the price to the authorities and, if the recipient of the supply is also VAT registered and the supply is attributable to his taxable business, the recipient will become entitled to a rebate of exactly the same amount.

The exchequer neither gains nor loses, save in two circumstances:

- where the recipient of the supply is the ultimate consumer or does not incur the expenditure for the purposes of a VAT registered business. In that case, the person making the supply pays the VAT over but there is no matching recovery; or

- where the recipient is to use the goods or services to make exempt supplies. In those circumstances, it would not be entitled to recover input tax. Since it is highly unlikely that one would wish to replicate the system of exempt supplies when constructing a profits tax, this possibility will be ignored.

The amount of tax on the supply is identified as a separate element in expressing the consideration given for it. This helps the supplier to calculate the VAT due in respect of the supplies it makes; it also assists the recipient to work out how much input tax it is eligible to reclaim. For this reason, a bill of, say, £120 will normally be broken down into £100 plus an additional £20 of VAT.

6.3.2 Input and output tax

To illustrate this, let us suppose that Company A sells goods to the public for an aggregate of £1,200,000, which is expressed on the relevant invoice as £1,000,000 plus VAT of £200,000. That means that out of the total price of £1,200,000, £200,000 will be paid by Company A to the taxing authority as output tax.

Now suppose that in the relevant period, the only expense incurred by Company A is £900,000, expressed as £750,000 plus VAT of £150,000, which it pays to its wholesaler. That £150,000 is payable by the wholesaler to the tax authorities as output tax, but it is matched by £150,000 of input tax reclaimable by Company A. So if we also assume that the wholesaler has spent £480,000 (or £400,000 plus VAT of £80,000) for the purposes of its business in the same period, we have the following situation:

See Figure 4.

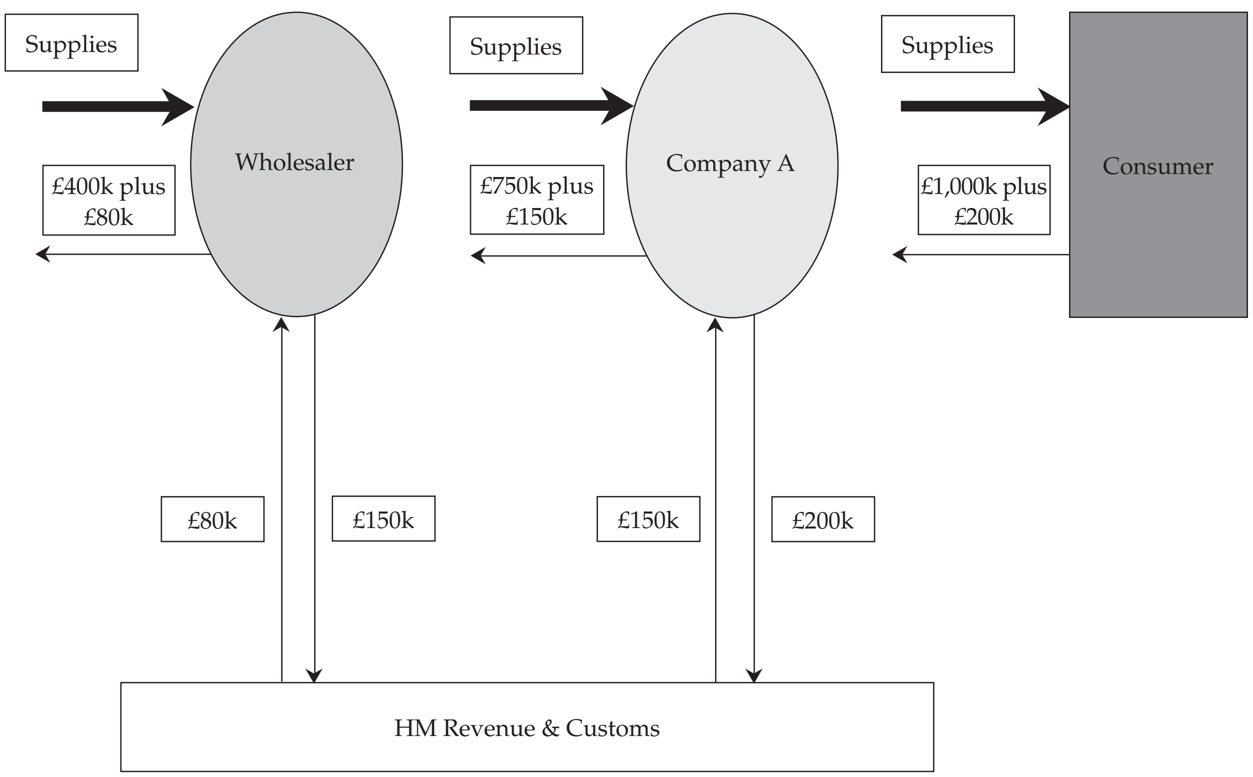
It will be observed that as each company in the chain receives a rebate equal to the VAT paid by its predecessor, the tax collected overall is the £200,000 paid by Company A in respect of the supplies to the consumers. All earlier VAT movements cancel out.

6.3.3 The impact of other expenses

What happens if Company A incurs expenses which do not involve VAT, such as wages, interest costs or amounts paid to businesses with a turnover below the local VAT threshold? The conclusion reached above will still stand. It is true that no input tax is received on these expenses; but there is no corresponding output tax either.

The only VAT which is paid and not reclaimed is still that paid by Company A in respect of its sales to consumers. It

Figure 4: The Principles Of VAT



follows that where, as we are assuming, all parties except the final consumer recover any VAT charged on supplies made to them, the total VAT collected is not sensitive to the expenses incurred by Company A or its predecessors in the economic chain, whether those expenses are the consideration for taxable supplies or whether they are not.

6.4 Adapting VAT in relation to domestic transactions

Now if we are to convert VAT to a destination tax on profits, we will need a system for reducing the overall tax paid to reflect wages and other costs of a type which should be deducted, wherever in the economic chain they may arise. This might be achieved in either of two ways:

- by arranging for a tax repayment, equal to the product of the expense in question and the tax rate, to be paid to one of the companies in the chain; or
- by reducing the tax payable on the sale of the product to the consumer, that being the only occasion when a net payment of tax is made to the authorities.

Each possibility will be considered by reference to labour costs, which will thus stand proxy for all expenses for which a deduction should be available when computing the overall tax.

6.4.1 Repayment upfront

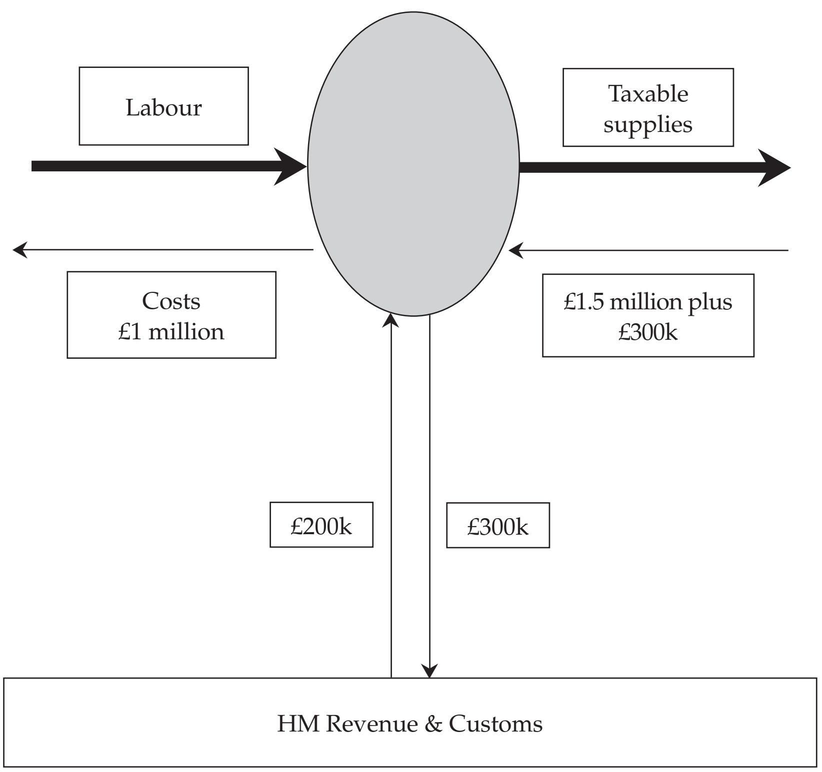
The simplest answer would be for the tax authorities to make repayments in cash whenever labour costs are paid, even though there would be no matching output tax. Suppose, for example, that a company incurs labour costs of £1 million; it then goes on to make taxable supplies of £1.5 million plus an additional £300,000 of tax. Then the company would receive a repayment of £200,000 upfront and would later charge tax on its products in the ordinary way (see figure 5).

The net tax paid by the company is now £100,000, a sum which represents 20% of its profits. Because the £300,000 of output tax reflects the full price at which it sells its product, there is no risk of the relieved labour cost being taxed at a later stage of the economic chain.

The difficulty with all this is that it involves the Treasury paying out tax with no corresponding receipt. This would clearly hit national tax collection. It would also open the door to repayment frauds. So, not this option, then.

Could one improve the position by doing away with cash repayments, instead giving credit by way of offset against other tax payable by the company, for example, payroll tax?

Figure 5: Repayment upfront



This may be less likely to result in repayment fraud, but the economic position is the same as with cash repayments. The fact that there is no payment of cash is not much of a consolation to a government that was hoping to use the payroll tax to build a battleship.

6.4.2 Deferred credit

The alternative is to delay giving the credit in respect of labour costs until a sale is made to a consumer, the first time the government receives tax without having to make a corresponding repayment. This would mitigate the cash flow implications, but it does involve carrying the credit forward down the economic chain. This would be an uncomfortable fit with the invoicing system as used for VAT, although it might possibly be accommodated by adding an extra line to the invoice.

This is not a particularly satisfactory system and would prevent the new regime delivering the main economic advantage normally associated with a flow of funds tax - ie the fact that, because tax is repaid when money is invested and paid when the investment is realised, the cash flow of tax payments would have no value if the return on the investment merely tracked interest rates. Accordingly, there is only a real tax burden if the return exceeds those rates.

Despite these problems, however, deferred credit is probably the best option available.

6.5 Adapting VAT in relation to cross-border transactions

Matters become much more difficult when supplies are made cross-border. Here, the main challenge for those designing a destination based profit tax is how to deal with profits which arise before the economic chain enters a jurisdiction which applies the tax.

There is an analogous position in the context of VAT, where goods or services are imported or supplied into the EU from non-member states. In this situation, VAT is charged on the goods or services, but is immediately treated as input tax. Accordingly, if the importer recovers all its input VAT, there is no net cost at all.

It is hard to see how this mechanism could be adopted for a tax on profits because it neither provides for repayment, nor provides a mechanism under which that part of the imported goods or services which reflects past labour costs can be identified for relief in the future. How could one distinguish between, on the one hand, past profits in the economic chain for which no credit should be given, and, on the other, the expenditure on wages, etc. which is supposed to give rise to a credit? Where there was a long economic chain before sales were made to a recipient in a participating country, the information required to make that distinction simply would not be available.

Thus we seem to be left with a choice between:

- totally excluding profits arising before the chain entered a participating country. This would be inconsistent with the principles of a destination tax; or
- including the whole value of supplies from non-participating countries in the eventual tax charge, whether or not that value reflects labour costs, etc. This would be very hard on producing countries and would distort world trade.

For these reasons, it is hard to see how the principles of VAT could be adapted to create a destination based profits tax.

6.6 A destination based tax as discussed in the Mirrlees report

The possibility of a destination based tax, levied when the sale to a final consumer is made, is put forward in the chapter on corporation tax in the Mirrlees report. There, it is envisaged that the tax would operate on a cash flow basis, so that it would be charged on cash receipts with a deduction or repayment of tax for each cash outflow. The cash flows would include those relating to finance, as well as those relating to transactions in other assets.

6.6.1 Embellishing the cash flow tax

From Meade onwards, economists have been attracted by a cash flow tax because it only taxes economic rents, ie returns above normal interest rates. The Mirrlees report proposes to embellish the basic cash flow tax in two ways:

- by excluding exports and taxing imports. That, of course, borrows from VAT where, to keep EU businesses competitive to foreign customers, exports to countries outside the EU do not bear VAT. Imports, on the other hand, have to be taxed to put them on a par with locally produced products; and
- by allowing a deduction for the cost of labour.

We have already encountered problems in giving a deduction for the cost of labour and, indeed, they are acknowledged in the Mirrlees report. It also identifies a number of other difficulties. The most obvious of these is the reduction in the tax base.

6.6.2 The cost of excluding exports

If exports are to be excluded from the charge, a large part of the corporation tax base will disappear. Many of the country's largest groups are exporters and they would no longer be contributing anything from that activity. Indeed, if a deduction is to be given for their labour costs, the UK government will probably be subsidising their activities.

Are we really going to say that Rolls-Royce, which has annual sales of £5.7 billion, of which 75% are exports and which employs thousands of employees in Derby and Bristol, should cease to pay tax on its profits or even on the export component of them? Surely not.

It is one thing to protect exports from the impact of VAT. VAT is a consumption tax and there is no consumption in the EU. It is quite another thing to remove profits generated on British land by British employees from the scope of British taxation of profits.

Actually, the threat to the tax base does not end there. Any flow of funds tax gives a 100% deduction when money is spent. That acceleration of reliefs reduces the value of the tax yield – and would mark a move away from the current trend of progressively restricting capital allowances in order to fund reductions in rate.

A government would have to be very sure that the tax on imports was going to compensate for these factors before it moved towards the Mirrlees model.

6.6.3 Other difficulties

The transition from a profits tax to a cash flow tax would also be difficult. If the cash flow tax were to take financial movements into account, the repayment of a loan would involve a tax deduction and the drawdown of borrowing should give rise to a charge. If, however, the loan had been drawn down before the change, it would not have been taxed initially. Complex transitional provisions lasting for many years would be needed to ensure a fair result here.

It is possible that some of these difficulties could be surmounted, although how remains unclear. One area, though, seems particularly difficult to deal with. That is the boundary between the countries which adopt a destination basis for corporate taxation and the countries which retain the source system.

6.7 The interaction between source and destination systems

Any new tax will, at least at first, only be introduced in a relatively small number of jurisdictions. This means it has to co-exist with the source based corporation tax which continues elsewhere. What happens, then, when the country from which goods or services are supplied and the country in which the customers are resident take opposite approaches?

Where a company resident in a country which taxes on a source basis sells to customers in a country which taxes on a destination basis, that company would be liable for tax on its profits in both countries. Liability arises in the first country because the activity giving rise to its profits is carried on there; and in the second country because of its customer base. That is not too difficult to deal with. Credit could be given for the tax collected by reference to source in the first country against tax collected by reference to destination in the second; a mechanism for that could easily be included in the new regime.

But what happens when the order is reversed, so that the profits are generated in a country which taxes by reference to destination but the customer is resident in a country which taxes by reference to source? Then there is no tax at either end. To ensure that the profits are taxed somewhere, the new system would have to include some sort of back-up source taxation.

The complexities of this, bearing in mind that we may be talking about an economic chain of several companies, seem hard to surmount. If anyone else would like to have a go, good luck to them. For the moment, however, the wise course seems to be to put discretion before valour and choose another path.

That path, a destination based top up tax, is explained in the next part.

7 Top up tax

Having explored the difficulties which would arise if a number of countries abandoned source based corporation tax in favour of a destination based system, it seems that something different is called for.

7.1 The top up tax proposal

It is therefore proposed to use a destination based tax as a "top up" mechanism, collecting tax from companies which sell to consumers resident in participating countries, but only where the source based tax charged on profits from the operations leading to those sales is too low. This will be referred to as "top up tax".

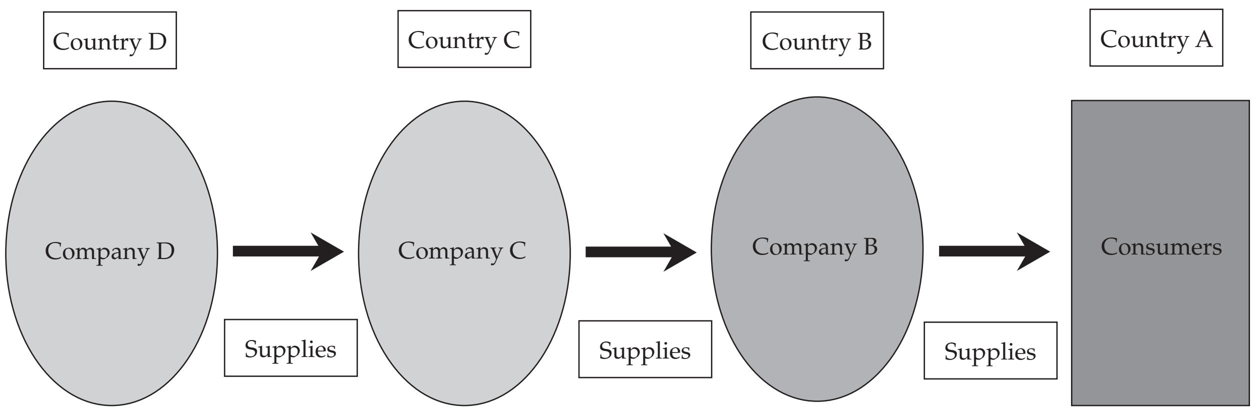
The concept borrows from the UK's controlled foreign companies provisions where, by attributing subsidiary profits to the parent company and then giving credit for tax already suffered on those profits at the level of the subsidiary, any shortfall in the tax paid by the subsidiary is made up at the parent company level.

In the case of top up tax, the additional tax would not be assessed on a parent company, but rather on the company supplying goods or services to consumers resident in a participating country. If the regime is designed in this way, there is no need to interfere with the local tax affairs of companies in non-participating countries. These stay as they are. There is simply a top up when sales are made to consumers at the end of the economic chain.

It may be helpful to illustrate this with a diagram (see figure 6).

Here goods are supplied successively down the chain from Company D to Company C to Company B, before being sold to consumers resident in Country A. Each company is resident in the country denoted by the same letter and each pays some tax on its profits there. Country A has introduced top up tax.

Figure 6: Top up tax: the economic chain



The idea is that:

- because Company B is selling to consumers resident in Country A, Company B should pay top up tax to Country A; and
- top up tax would make up for low tax rates earlier in the chain, ie for the fact that Company D has only paid a low level of tax to Country D, that Company C has only paid a low level of tax to Country C, or indeed that Company B has only paid a low level of tax under the source system to Country B.

That explanation could form the basis of a Victorian company prospectus; it sets out the general idea but without revealing how it is to be implemented. This will be dealt with as the structure is developed in due course.

7.2 A taste of top up tax

Meanwhile, to set the scene, a few of the more obvious questions will be answered as an hors d'oeuvre. What those answers mean, and why it is believed that those answers are right, is discussed subsequently. With that caveat then, here is a basic Q&A:

Will the tax only be charged on large companies and groups? Yes, a country will only charge top up tax where sales by a group to consumers resident in that country exceed a substantial threshold.

Does there have to be some common ownership of Company B and the companies further up the chain (eg Company D) before Company B can be liable for top up tax in relation to the profits of those companies? Yes, there would have to be an ownership link (or, in avoidance cases, a deemed ownership link).

Will the top up tax only supplement the source based tax already charged on profits from activities which contribute to sales to consumers? Yes.

Is top up tax charged in the country of the consumer, even though the company selling to that consumer has no presence there? Yes.

Will any activities be excluded? Yes, there will be exclusions to protect developing countries and to prevent additional tax being paid in respect of certain bona fide overseas operations.

How will the tax base be computed? It will be based on accounting profits; if there are to be variations from international standards, they must be the same for all participating countries.

What rate would be charged? The rate is expected to be rather less than the corporation tax rate applying in the country charging the tax.

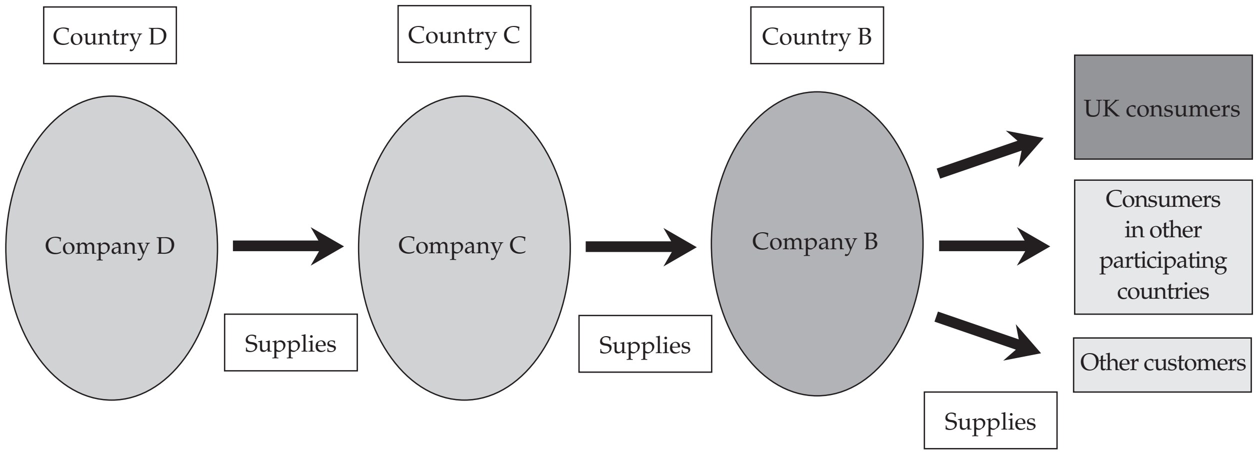
7.3 The structure of top up tax

Now, having given a preview of the denouement, let us build up the structure of top up tax bit by bit. Rather than continuing to refer to the jurisdiction applying the tax as Country A, however, it will be assumed that this is the UK; it will also be assumed that a number of other countries (but not all other countries) adopt top up tax as well.

On that basis, figure 6 could be developed (see figure 7).

In the analysis which follows, references to Company D, Company C and Company B are to those companies as shown in figure 7. All that being said, the time has come to turn to the issues driving the structure of the tax.

Figure 7: Top up tax: the UK's economic chain



Here, those profits of Company D, Company C and Company B attributable to:

- **sales by Company B to UK consumers**, may result in Company B paying UK top up tax;
- **sales by Company B to consumers resident in other participating countries**, may result in Company B paying top up tax in those countries; and
- **sales by Company B to other customers**, may give rise to top up tax being paid by a company further down the chain if Company B is a relevant company by reference to that company's sales to consumers resident in a participating country.

7.4 The threshold

Since top up tax is complicated, complying with it will be expensive. Accordingly, the application of the tax should be restricted to those cases where the supplies made to consumers in the relevant country exceed a substantial threshold.

Let us suppose that the threshold set by the UK is £100 million per annum. Company B will need to prepare a top up tax computation and submit it to the tax authorities of the UK, if its turnover from sales to consumers resident in the UK exceeds that figure. Here, turnover will be computed on an accruals basis, in accordance with international accounting standards. It will include both revenue receipts and capital proceeds.

If Company B's turnover from sales to UK consumers in a particular year does not exceed £100 million, Company B will not need to submit a UK top up tax computation. In determining whether this is the case, however:

- sales from companies in the same group would be aggregated; and
- a targeted anti-avoidance rule would counter any fragmentation of sales designed to ensure that the threshold was not exceeded.

Once it has been determined that Company B has to submit a UK top up tax return, the next step is to identify the profits which form the basis of its liability.

7.5 Relevant companies

It will be appreciated that the accumulation of low taxed profits may not take place in Company B, but rather in Company C or Company D, or even in another company higher up in the economic chain and thus even further away from the sales by Company B to UK consumers.

To construct a coherent top up tax, it is necessary to:

- find a way of identifying the companies whose profits may be taken into account in computing the tax generated by sales to consumers in a particular country ("relevant companies"); and
- to find a way to allocate the profits of each relevant company between the part which is attributable to those sales (the "relevant profits") and the part which is not.

7.5.1 Managing disclosure of profits

For the system to work, each relevant company (other than Company B itself) must provide Company B with extensive information about its profits. Since the disclosure of profit levels is highly sensitive commercially, such disclosure can only be required between companies in the same group as Company B or with some other form of common ownership. Accordingly, the basic rule must be that the relevant companies whose profits may need to be taken into account in Company B's UK top up tax computation are companies in the same group.

This approach also makes the information flow manageable, since the central management of the group should be able to extract information from group companies at will. This convenience does, however, come at the cost of excluding independent suppliers. Is this a problem?

7.5.2 Managing avoidance

In deciding how much this matters, one needs to consider the nature of the avoidance being combated. This depends on who originates it.

If the avoider is Company B or companies in its group, the main risk of leakage under the present system is that profits are channelled to related companies in low tax jurisdictions. There is little risk of profits being channelled to unrelated companies. A company would not adopt tax planning which involved paying intellectual property royalties to, or allowing a large mark up to, a vehicle in a tax haven unless the undertaxed profits would ultimately benefit the company, its group or its owners. No one throws money away merely to avoid tax on it. Provided that the "group" definition is widened to catch companies linked through any significant common ownership, most avoidance by Company B and its owners should be caught.

Now move the lens away from Company B and the picture is different. Suppose that Company X, which is resident in a low tax jurisdiction, has the opportunity to make huge profits on electronic goods for which a mail order market exists in the UK.

- If Company X sells directly to UK consumers, it will have to pay top up tax on those profits.
- If Company X sells to another group member which then sells on to the UK, its profits will still be caught because it will be a relevant company in relation to those UK sales.
- If, however, Company X sells to Company Y, a wholly independent company resident in a non-participating country, which then sells on to the UK consumers, Company X's own profit will escape top up tax as Company X is not connected with Company Y.

Bingo! All Company X needs to do, then, is find an independent company in a non-participating country which will onsell the goods to the UK, in return for the opportunity to make a small return. This is shown in figure 8.

Without more, the low taxed profit of £95m accumulating in Company X will escape UK top up tax because:

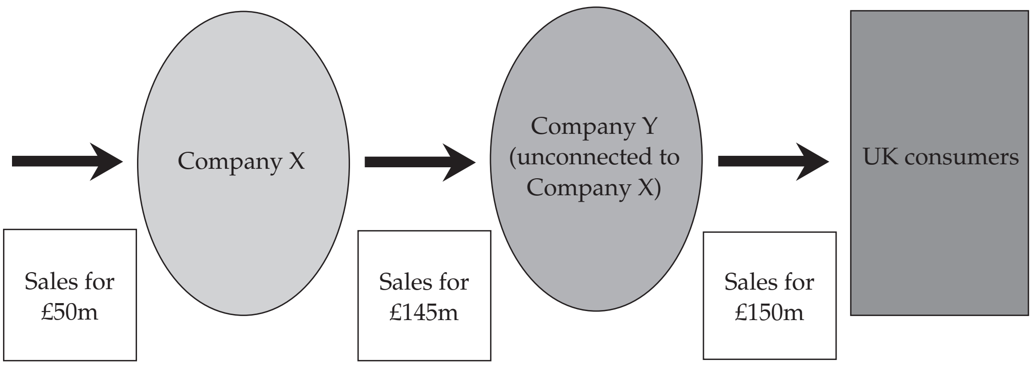
- Company X makes no sales to consumers, or indeed sales to the UK, and so is not liable for the tax; and
- the profits of Company X will not be brought into Company Y's UK top up tax computation as Company X will not be a relevant company.

7.5.3 Targeted tax avoidance rule

The best answer to this sort of planning seems to be a targeted tax avoidance rule, perhaps on the lines that, where a company has been included in an economic chain and would not have been included but for top up tax, it will be treated as being in the same group as the company which would otherwise have made its supplies.

In other words Company X and Company Y would be treated as being in the same group, so that Company X becomes a relevant company in relation to Company Y's supplies to UK residents.

Figure 8: Top up tax: tax avoidance through a non-participating country



7.6 Relevant profits of Company B

Now let us revert to the structure in figure 7, where Company B's customers include UK resident consumers but Company B has other customers as well.

Only the amount of Company B's own profits which are attributable to its own sales to UK customers will be relevant to its liability to pay top up tax. Accordingly, in preparing Company B's top up tax computation, the profits of Company B will have to be apportioned between relevant profits (ie profits on activities which contribute to its own UK sales) and other profits.

How this is best done will depend upon the dynamics of the business. Since we are talking of very large companies which will be debating the position with national tax authorities, the best answer seems to be a general attribution in accordance with contribution, rather than anything more prescriptive; in straightforward cases, however, allocation by turnover might provide a prima facie rule. In the, end the result will need to be agreed on a case by case basis.

7.7 Relevant profits where there is more than one relevant company

Where there is more than one relevant company, the task is more complex. Here, one has to establish the extent to which the profits realised by each of them (including Company B) contribute to the sales made by Company B into the UK.

How is this to be done? Should we approach it through the current OECD guidelines or would some form of profit sharing basis be better? In fact, there would probably be a two-step process:

1. Apply the OECD guidelines to ensure that each relevant company is allocated its correct share of the group profit. Where companies included in the group are commercially independent, because they have been included in the group under one of the anti-avoidance rules, the pricing of the transactions between the company and the rest of the group will speak for itself.
2. Once the profit of each company has been adjusted to reflect the arm's length principle, allocate the profits of each company between the part which contributes to Company B's sales to UK consumers and the part which does not. That is done as described in the preceding section.

7.8 Excluded activities

The idea of the top up tax is to catch group profits (the term group is, of course, used in the extended sense discussed above) attributable to the ultimate sales to residents of the relevant country and to top up the tax on those profits to an acceptable rate. That will remove some or all of the benefits of any low tax rate along the economic chain.

However, there will be circumstances where that is undesirable. Why, if a developing country levies a low rate of tax on agriculture to encourage its farming industry, should the advantages of that flow into the treasuries of rich consumer countries, rather than into the pockets of the farmers themselves? Clearly that would not do at all.

If we assume that equivalent farming produce can be obtained from a number of different countries, the fact that Company B has to pay top up tax on produce acquired from a particular country means that it can afford to pay less for produce sourced there. If, on the other hand Company B had to pay no top up tax, then the absence of any tax cost earlier in the economic chain would accrue to the producers. This is a problem which has already been encountered in other contexts and there are two well recognised techniques for dealing with it.

7.8.1 Limitation of scope

The first is to limit the activities within the ambit of the legislation. Until 2013, the UK limited the activities whose profits fell within its controlled foreign companies legislation by applying exclusions. Now it achieves much the same object by limiting the scope of the legislation itself. Either way, the overall effect is to cut down the profits affected by the legislation.

In the context of a top up tax, one might imagine exclusions for mineral extraction, farming and manufacturing – and, perhaps, labour intensive activities such as call centres as well. Alternatively, the scope of the legislation could be limited to the types of tax avoidance discussed in part 5 above. That is a more sweeping approach, and deciding whether it is preferable will depend on political decisions as to what should be in or out.

7.8.2 Tax sparing

Specific exclusions can also be conferred through a technique known as "tax sparing", which involves a pretence that the "privileged" profits have borne a particular level of tax. This system is used as part of the credit mechanisms adopted in double tax treaties.

Where a treaty gives credit for local tax borne by a branch of a company against the tax paid in the country of residence, the company ends up suffering the higher of the two rates so that the advantage of a low local rate of taxation is lost. Where the double tax treaty adopts tax sparing mechanisms, on the lines indicated at part C of the OECD Commentary on article 23 of the OECD Model Convention, this is remedied by treating certain profits as if they had already borne a higher local rate than they actually have. (Note, though, that tax sparing does not appear in the OECD Model Convention itself and the commentary indicates that the technique should be used with care.)

These, or other similar mechanisms, would need to be used to limit top up tax to its intended target.

7.9 Tax base and tax rate

The purist might argue that top up tax should be applied at the rate at which corporation tax is charged in the country which is applying the tax and that the relevant profits should be computed in accordance with the rules governing that corporation tax system. On that basis, and subject to any exemption for excluded activities, the total tax paid in respect of the relevant profits of the relevant companies would be equal to the tax which would have been paid had those profits arisen from activities being carried on in that country and been taxed there on a source basis.

In the case of the UK, the tax would be topped up to 23% and the effect would be to wholly remove the tax advantage of carrying out any of the activities relevant to UK consumer sales overseas. Although this perfectly achieves the theoretical objects of top up tax, it gives rise to certain difficulties in practice.

7.9.1 Complex tax compliance

Let us start with the way in which profits are computed. It would certainly be possible to require the relevant companies to produce tax accounts in accordance with the rules imposed in the country in which the tax is to be charged, an approach borrowed from controlled foreign companies legislation.

However, the precision of this approach is bought at the cost of much inconvenience, because each relevant company has to prepare tax computations by reference to two different sets of rules. One set of accounts is required for the computation of source based tax on its own jurisdiction; the other would be needed to compute the top up tax liability of Company B.

The position gets worse where a group makes substantial sales to customers in a number of different participating countries. There, each relevant country would need a different set of accounts for each top up tax computation, and yet another set for its own tax authorities. This multiplication of compliance must clearly be avoided, so profits must be measured for top up tax by reference to international accounting standards. If there is to be any departure from these standards, it must apply in all participating countries.

7.9.2 Calculating rates

The need to take a measure of profit which is different from the corporation tax rate in participating countries has implications for the rate at which top up tax should be charged.

If the UK were to charge it at 23%, a UK domestic group could find it had a top up tax liability reflecting the amount by which accounting profits exceed profits as measured for UK corporation tax. To avoid that and generally to prevent top up tax from applying where profits are made in participating countries, it is suggested that the rate of top up tax should be a little lower than the lowest of the corporation tax rates in those countries. That should give a cushion to avoid unnecessary charges arising.

It is worth adding that this is a better approach than simply excluding profits which arise in participating countries because low taxation can arise as a consequence of gaps in systems with a high headline rate of charge and is not restricted to countries commonly thought of as tax havens.

7.10 Creditable tax

References have been made, slightly glibly, to giving credit for tax which has been borne by relevant companies on the relevant profits. That of course would include local corporation tax and also withholding taxes suffered on income received by the company in question. It is also possible that the profits will suffer tax in the hands of others.

For example, Company B which is, say, resident in the Cayman Islands, may be a subsidiary of a UK parent which suffers tax on its profits under the UK's controlled foreign companies legislation. That tax would also have to be included as if it had been paid by Company B itself.

Provided that relevant companies are limited as proposed above, this should not be too much of a problem. The group treasurer should be aware of the tax charged and if the group contains unconnected companies because of the application of anti-avoidance provisions, it may not be too onerous to require the relevant information to be collected. There is, however, a timing issue here. If top up tax is to be computed after all other taxes have been taken into account, the timeframe for submitting a computation must make provision for that. It is, of course, not unusual for a single computation to include both taxes and other taxes which are creditable against them. Here, however, one might have quite a large group of companies, including independents. A little extra time, therefore, would probably be sensible.

7.11 Conclusion

The above is merely a framework on which a top up tax might be based and it leaves plenty of blanks to be filled in. In particular, decisions would have to be made as to:

- the level of thresholds;
- how wide the definition of "group" should be when identifying relevant companies. As explained, there must be some common ownership; but is 50% common ownership the right figure, or should it be 40% or 25%?;
- how to frame the exemption for excluded activities;
- whether there should be any universal variation from the international accounting standards tax rules in computing relevant profits; and

- the appropriate tax rate, and whether or not participating companies countries should use the same rate.

No doubt, there are many other issues besides which would emerge as the detail of the tax was put in place. Still, even at this stage it is worth testing the proposals by asking a number of questions.

Would the tax catch groups in low tax jurisdictions selling into the UK without a permanent establishment here? Yes, it should do that.

What about the UK group which siphons off profits to an IP company in a tax haven? Yes, provided the IP company forms part of the same group as the company selling to UK consumers, it should be a relevant company in relation to those sales.

What about the UK group which uses the manipulation of risk to create low taxed profits offshore? Yes, provided the company making the profit forms part of the same group as the company selling to UK consumers, it should be a relevant company in relation to those sales.

Could the tax be brought in by a group of countries, although others stood aside? Yes, because its nature is to "top up" the tax charge, there is no need for it to dovetail with the tax systems of non-participating countries.

Will the tax push business offshore? No, it is anchored to sales to the consumer which cannot be moved.

No doubt there are other questions which need to be asked and perhaps they will reveal insuperable obstacles. It does seem, however, that the possibility of a top up tax is well worth pursuing.

8 Conclusions

A report like this is a little like a rugby scrum. Ideas are kicked about and mauled and are then pushed out for others to develop. It is traditional to end with a series of recommendations and conclusions, even if the recommendations are merely that certain ideas should be pursued further.

In this case the recommendations and conclusions are that:

- the existing transfer pricing system should be left as it is, with the current OECD guidelines being preferred to a general move to unitary tax. However, tax authorities should not hesitate to use a profit split where it is the most appropriate method;
- the opportunities for avoidance could be reduced by unifying tax rates;
- although the concept of "permanent establishment" could be extended to cover warehousing and dispatch depots, it would be difficult to go further;
- the placing of artificial limits on the deduction for interest would be complex and that artificial limits on the deduction for IP royalties may be only partly effective;
- it is difficult to see how a destination based tax on profits can be substituted for source based taxation unless the new regime is universal; and
- the possibility of a destination based top up tax is well worth considering further.

Rather than end there, however, two general points should be made.

The first is that in reading the various papers, be they minutes of committees or expert analysis, it is important to bear in mind the pressures on those who contributed to them. There is currently a great deal of public interest in how multinationals pay their tax and it is much easier to come to the conclusion that "something must be done" than to determine exactly what that something is. Inevitably, in these circumstances, ideas get bandied about before they have been properly thought through. It is important that, where this happens, these ideas are recognised as being "off the cuff" and not taken as a blueprint for government action until they have been properly considered.

The second point is more serious. The suggestion that taxpayers should be blackmailed into paying more than is legally due by some form of "naming and shaming" should not be countenanced. That is not just because the information provided to the "court of public opinion" is too easily misunderstood; more importantly, it is because the system is not so badly broken that it is worth undermining the relationship between the citizen and the government in order to change it.

Perhaps the last words should be those of Matt Brittin, the UK-based Google Vice President for Sales and Operations:

> "We comply with the law in the UK. It would be very hard for us to pay more tax here based on the way we are required to structure by the system. Tax is not a matter of personal choice, but a matter of following the law and the rules, which is what we do. It is complicated internationally, but we follow the law in every country in which we operate. The fundamental issue for us is that our economic activity, which generates the algorithms that make a lot of products work, comes from engineering that is all coming from California. That is why we pay tax where the profits are generated, which is how the tax system operates."

When you compare the engineers in California with the garlic growers of France (mentioned in part 4), it is hard to resist the conclusion that if we must have destination based tax, it should be of the top up variety.

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