Multinationals and the great tax debate: a view from industry

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1. Introduction

This paper was prompted by the paper 'Multinationals and the great tax debate' prepared by John Watson (available via www.lexisurl.com/thegreattaxdebate). For convenience, I shall refer to that as 'The Watson Paper'. I found that a well considered and stimulating paper which provides a useful summary of key issues and sources. The purpose of this paper is to draw out and expand on some of the issues discussed, in particular concerning the nature of the underlying problem, and the existing and proposed tools for addressing it. In particular I consider the issues by reference to the issues and approach outlined by the OECD in its Base Erosion and Profit Shifting ('BEPS') work, which is intended to address similar matters. That leads me in a different direction to that The Watson Paper suggests, but I would see that as exactly the type of constructive development of ideas which John Watson's work was intended to spur.

I place specific focus on issues associated with intangibles and with the digital economy. One key theme of my paper is that intangibles, or at least a significant class of them, are no longer self-standing, passive, mobile, assets which generate pure income profit. Once that is more fully understood, it becomes easier to see what can be done to address anti-avoidance concerns within the existing international system and where any limitations on what can be done may lie. It will also become apparent that there are some areas of the current system–in particular the system of credit for withholding taxes suffered–where the system increasingly struggles to achieve its objective of allocating taxing rights rather than multiplying taxing rights. Addressing problems of double non-taxation, or less than single taxation, associated with intangibles and the digital economy is likely to increase these problems of multiple taxation, unless there is parallel work done to ensure that tax credits follow the taxing right.

The views expressed in this paper are the personal (and still developing) thoughts of the author.

2. What is the nature of the problem?

After putting on one side the issue of tax evasion, and the possibility of dispensing with Corporation Tax on profits altogether, The Watson Paper frames the issue as primarily one of how a corporate tax system can be designed or modified so that it can counteract tax avoidance. I agree with the paper's comments concerning why it is right to retain a system of Corporation Tax on profits and I see the issue of tax evasion as one of compliance and enforcement rather than as one meriting great theoretical debate.

I also accept that tax avoidance is a significant aspect of the target – and it is certainly the key focus of the current UK debate. For the reasons discussed below, I suggest however that the core of the underlying issue may be a more fundamental one. This is that, even if there were no avoidance, there are aspects of the existing rules which may no longer be delivering the outcomes expected and desired. In some cases this can result in significantly less tax being due than might have been expected and intended when the rules were first designed. This mismatch between subjective expectation and the practical effect of current rules creates a perception that avoidance is a much broader problem than it is. That undermines trust in business and trust in the tax system generally.

We thus have a mixture of problems to unpick and solve, with the danger of various spirals of destructive consequences for international trade and business generally, if that is not carefully and accurately done. There is, for example, the danger of reinforcing public distrust if we identify the problem as solely one of tax avoidance and then produce solutions which leave outcomes which are still materially out of line with expectations. There is the danger of unilateral action by national governments resulting in multiple taxation and high barriers to international trade. Or there is the danger of radical action intended to solve a problem of avoidance which creates turmoil and dysfunctional mismatching systems during a period of transition, while perhaps actually enhancing opportunities for avoidance – because it is a lot more difficult to anticipate gaps or mismatches in new systems than to plug gaps in familiar ones.

Finally, although there is an understandable and proper focus on profits unintentionally falling outside the tax net, we do need coherent and complete action to minimise existing or new sources of multiple taxation. Both less than single taxation and more than single taxation can distort competition in the markets affected and are undesirable.

3. The OECD Base Erosion and Profit Shifting (BEPS) review

3.1 Tax competition, harmful tax regimes and tax avoidance

When considering the interaction of international tax regimes we also need to consider the needs and rights of individual governments to design their tax systems in a way which meets the specific needs and priorities of their particular country. Thus it is generally accepted in principle that, provided that internationally agreed boundaries and commitments are respected, then tax policy is a matter for national governments. Within these boundaries it is therefore quite acceptable for governments to tailor their tax systems to meet their national needs and policy choices. That may involve applying different rates of tax or raising different forms or mixes of taxes. Within the Corporation Tax system it may also involve different categories of exemptions or reliefs.

It is important to recognise that these national policy choices are not just about how much tax to raise but are also about where to apply grit or oil in the system to discourage or encourage certain types of activities. A Carbon Tax may for example be raised to try and encourage energy efficiency or use of renewable sources, or relief may be given for pension contributions, whether or not charged to profit & loss account, so as to support pension provision. It is of course acceptable, and fully intended, that companies should respond to this grit and oil. That includes taking the broad tax regime of a country into account when choosing where to carry on business generally or a particular supporting function.

The difficulty in each of the above two areas is in determining where the boundaries lay between what is acceptable tax competition, or acceptable company responses to tax law, and what is a harmful tax regime or tax avoidance. There will of course be cases in each area which are, or seem, clearly on the wrong side of the boundary – for example, where there are visible attempts at alchemy to turn grit into oil or to multiply oil – but in general the boundaries are fairly subjective and difficult to define.

It is noticeable that the OECD in its BEPS Action Plan is somewhat careful in how it phrases its approach to defining the boundaries in these two areas. Thus, in relation to Harmful Tax Practices (Action 5), it puts its focus primarily on issues

of substance and transparency rather than on boundaries concerning tax rate or tax base. Similarly, whereas some arrangements which would generally be perceived as avoidance are directly within its target zone, there is reluctance to use pejorative language concerning businesses concerned.

That may perhaps be because it recognises that the boundaries between what is acceptable or not are not clear –or perhaps because it recognises that such language can itself be destructive. What is clear from statements made by the OECD is that it intends to approach the issue as one of a lack of coherence in international tax regimes which needs to be addressed by improving those regimes, and not as a campaign concerning morality.

3.2 The scope of the BEPS Action Plan

If we leave to one side the areas of the BEPS Action Plan which relate to transparency and disclosure, or mechanics for implementation of BEPS proposals, or mechanics for dispute resolution, the substantive issues addressed are thus focussed mainly on areas of potential incoherence or weakness in international tax rules which can either allow profits to escape tax altogether (as with hybrids) or allow tax rate arbitrages in circumstances which are perceived as potentially misallocating taxable profits. In one way or another, the actions are generally focussed on eliminating or minimising what is phrased as 'double non-taxation or less than single taxation' – particularly where that is associated with practices that artificially separate taxable income from the activities that generate it.[1]

It is notable that the BEPS Action Plan explicitly states that 'while actions to address BEPS will restore both source and residence taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates, *these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income*'[2] (my emphasis).

It is also perhaps notable that the Action Plan, while noting the attention OECD member countries have given, and do give, to eliminating double taxation[3], does not set that as a focus in the current instant. The one arguable exception to that is Action 14 concerning making dispute resolution mechanisms more effective. That is however phrased as concerning actions which ensure certainty and predictability for business – which will not be much comfort if what is delivered is the certainty of double taxation.

3.3 Why are these limitations significant?

The reasons why I focus on these limitations are because:

(a) a significant issue underlying concerns with the current international tax system may not be as much to do with avoidance as with the fact that the system, even where working as intended, may no longer necessarily attribute a significant proportion of taxable profits to the customer jurisdiction – and we should bear in mind that that may become an increasing issue; and

(b) in the alternate (where, for example, withholding taxes are applied to revenues), the current system can often result in double taxation, or just excessive taxation, which represents a competitive barrier to cross border trade – and that that problem is likely to increase.

I will explain these points in more detail below. It is perhaps worth noting however that:

(i) Although press or public comment that a Company has £Xm of revenues in the UK and pays little or no Corporation Tax is generally dismissed as a simple misconception of what Corporation Tax is, its resonance does perhaps suggest a perception that the allocation of taxing rights is not always working as it should; and

(ii) The suggested solutions of either a pure or a top-up destination tax (and to a lesser degree a unitary tax system including a sales key) perhaps implicitly reinforce this point. Whereas they are presented as ways of making avoidance more difficult they contain an implicit assumption that, at some level, at least part of the taxing rights properly belongs in the customer jurisdiction.

It is also perhaps understandable why the OECD decided to treat the issue of allocation of taxing rights as outside the direct scope of the BEPS review. Thus whereas the elimination or reduction of 'double non-taxation' would create a bigger pie for countries to share, materially changing the basis on which they share that pie will result in winners and losers – and probably big winners and big losers. That would be problematic enough in itself, but the massive complexity of the issues will make many countries very uncertain as to whether they would be winners or losers. Reaching agreement would be exceptionally difficult.

When such a debate is viewed from a business perspective there may perhaps also be an assumption that, whatever happens, businesses are likely to be material losers. Making the pie bigger would obviously give more scope for inter-governmental agreement and thus there would be a temptation to make the pie bigger at the cost of business so as to secure that. That is even before considering the increased likelihood of double taxation, whether permanently or during any transition period. Achieving a broad consensus which included business, and which didn't damage international trade, would require a solution which reduced tax distortions of markets arising through more than single taxation (whether from existing issues or proposed changes) as well as those arising through less than single (or reduced) taxation.

4. BEPS Action 1 – the Digital Economy

The best entry point for considering why it may not be possible to duck the issue of allocation of taxing rights is perhaps by considering issues surrounding the Digital Economy. This is the one BEPS action area where there is a suggestion that existing tax rules may not give a satisfactory allocation of taxing rights to the jurisdiction of the customer base due to the lack of nexus[4]. It is also notable that the Action requires the consideration of both direct and indirect taxation aspects, suggesting that substituting (customer driven) revenue based indirect tax obligations for direct tax obligations is at least a possibility.

What has become apparent as discussions of this action have commenced is that the digital economy isn't confined to the headline cases who have the provision of digital services as their primary profit making activity but is present across all categories of business. In many or most of these businesses there will be digital aspects which either perform or enable a supporting cost centre activity, or peripheral profit centre activities. Those may be online reservation or sales services, or functionality which enables truck leasing companies to remotely prevent lorries from starting

1 OECD Action Plan on Base Erosion and Profit Shifting p10

2 OECD Action Plan on Base Erosion and Profit Shifting p11

3 OECD Action Plan on Base Erosion and Profit Shifting p9

4 OECD Action Plan on Base Erosion and Profit Shifting p14

if lease payments have not been made –or any other functionality which enables the provision of services or control from a distance (eg.in remote central support centres for particular functions).

This is likely to make it exceptionally difficult to target core digital profit sources without a disproportionate and unjustified impact on lower value or lower margin support services. It also emphasises the point that there is a primary difficulty which is not one of tax avoidance, but rather the efficiency or functionality benefits which digital capabilities provide to normal commercial operations. As both technology, and expertise in using technology, continue to develop this will become a more and more significant issue. One only has to consider the developments in the technology around 3D printers, for example, to realise that we are perhaps not too far away from being able to directly supply goods remotely.

When the current international rules were designed there would almost certainly have been an assumption that it would not be possible to do business in a country without having a substantial presence there which would attract taxable profits and tax. At a fundamental level the world has changed, and is continuing to change, in a way which means that this assumption no longer applies.

Other issues which are becoming clearer as digital economy discussions proceed are, for example:

(a) the difficulties with a straightforward PE or notional PE solution. For example such rules would in principle apply to create PEs in multiple jurisdictions for any business, however small, which offered an online sales functionality. Any notional PE solution would therefore, at a minimum, need to include a substantial revenue threshold below which a PE would not be held to exist. Where there was a notional PE, there would of course still be a need to decide how to determine what profits to attribute to that PE – and that is likely to be a very difficult practical problem; and
(b) the difficulties which can arise in even identifying where a customer downloading information is located if a proxy server is involved. I do not have the industry knowledge to be clear as to how best to step around that type of problem. I struggle to believe, however, that a modern business does not have a reasonable management reporting method for understanding or estimating what sales it makes in given markets – and that should be enough provided rules can be designed in a way which makes any peripheral uncertainty acceptable.

One other factual aspect which has become clear is the interactive nature of the relationship between the provider and the customer in many digital business models. These have the capability of not just identifying and analysing customer segments but of actively responding to customer input as part of an iterative digital process to improve and focus what is provided. More broadly, simple aspects such as customer volume in a particular market or customer lists are important intangibles.

I recognise that, under current principles which distinguish between doing business with a country and doing business in a country, none of these provide particularly compelling indicators of doing business in a country and thus of having a taxable presence. At a more subjective level they do however give a sense of value being provided by a country, or from a country, and this is perhaps consistent with the jaundiced public perception of some of the outcomes that they see. At a simple level people's experience is that they are sitting in a room in the UK say, doing the input work for a purchase which they will receive in the UK – and they do not understand how or why none of the profits are UK profits. This perhaps also accords with the subjective impression many of us have that one impact of the digital economy has to been to move work from the supplier to the customer or user.

I would not claim to be an expert in the narrow area of the pure digital economy. It is therefore quite possible that there is a lot more of relevance to be said which could sway conclusions one way or the other. It does however appear to me that:

(a) there is a substantive and real issue to consider concerning whether customer jurisdictions should have some form of additional taxing rights with respect to remote digital supplies;
(b) there are potentially major difficulties in properly targeting any such provisions so that they give appropriate taxing rights with respect to profits which are primarily derived from digital activities, but do not have a disproportionate and damaging impact where profits are primarily derived from non-digital activities in other jurisdictions; and
(c) there might be expected to be difficulty in determining what profits should be attributed to any PE or notional PE as most costs will probably relate to supporting supplies in general, rather than to supporting supplies to a particular country.

I also emphasise that, while it may be reasonable to consider whether customer jurisdictions should have some form of taxing right with respect to remote digital supplies, I do not believe that this should be full local taxing rights of the type that might be arrived at if there were deemed to be a normal PE. If we made a change then we would be trying to correct the tax allocation for the impact of changes in the technological background which makes it possible for an overseas company to make cross-border supplies without having a local presence, (ie. the fact that the technological barrier which provided a natural divide between 'overseas' and 'local' has been broken), and not go to the other extreme of fully removing overseas taxing rights.

In the pre-digital world the normal model would probably have been for there to be an overseas company performing the production function and then a local company (whether a group member or a third party) performing the sales and distribution function. Arm's length relationships would provide a reasonable and acceptable allocation of profits, and of taxing rights, between the producer jurisdiction and the sales and distribution jurisdiction. What we are trying to correct for is the fact that technology has enabled the transfer of the sales function with respect to in-country sales to the overseas jurisdiction. In time it may enable the transfer of increasing elements of the distribution function to the overseas jurisdiction (indeed to some extent that might be seen as already happening via the separation and hollowing out of local distribution to routine, low value, fulfilment functions).

Ideally the solution we should be aiming for is one which has the practical effect of correcting the allocation of taxing rights for what technology has moved – and not one which goes further and reallocates taxing rights with respect to production functions to the local jurisdiction. Equally, it is important not to ignore and reallocate benefits which accrue from new classes of value creating intangibles and associated activities which have developed as technology has progressed.

In particular that includes intellectual property which is managed and used in an active and dynamic role within the overseas business rather than just representing a passively owned property right. As the Expert Group on Taxation of the Digital Economy, appointed by the European Commission, has commented:

'The digital economy undoubtedly contributes towards job creation, encourages innovation; and stimulates growth within the EU. In the current economic climate, many digital companies are a quite unique success story and the EU wishes to encourage further innovation and economic growth. This makes it important that digital companies are covered by a tax framework that facilitates growth, particularly amongst start-ups and SMEs, so that they are given the opportunity to reach their full potential, while ensuring a fair and equitable taxation for all economic sectors. Taxation should not determine business models or "winners" but be neutral to the business model applied.'[5]

In considering changes to international tax systems we also need to bear in mind that developing and introducing any fundamental change in the principles of those tax systems would be likely to be an incredibly difficult process which would be likely to involve many years of debate, disagreement and turmoil. We are not in the position we were in 80 or 90 years ago when the current rules were developed, where the rules were developed in tandem with the growth of international trade. We now have international trade on a massive and ever increasing scale and we would be trying to implement major change without disrupting that trade. That in itself would almost certainly rule out the most radical proposals for change as impractical. It is like the old joke of someone asking 'how do I get to John O Groats?' and receiving the answer 'Well, I wouldn't start from here'.

The way forward will therefore almost certainly be one based on first trying to make the existing rules more robust and coherent and then considering whether/where this may still leave an unsatisfactory position. This is essentially the approach mapped out by the BEPS review process, with the digital economy being the one area where hesitation is effectively expressed as to whether more coherent and robust versions of the existing rules can do the job. This hesitation suggested a possibility of some variation or addition to existing rules in this area. The implicit assumption however was that this was a well defined area where narrow, targeted, action could be taken.

As the realisation dawns that the digital economy is not a narrow and well defined area but a pervasive and increasing feature of all modern business the realisation also dawns that narrowly targeted changes are unlikely to be possible. As there will be a quite proper reluctance to make precipitate changes which have a much broader impact on business the output of BEPS Action 1 may effectively be another Action Plan rather than an action. There will be a desire to first more fully consider how significant an issue will remain once other BEPS actions are completed. There will also be a desire to properly consider what the impact of any additional changes to address any remaining issue would be on business in general.

There are already some reports to the effect that the OECD now proposes to deal with digital economy aspects as part of the broader actions rather than as a standalone action. That is consistent with the type of iterative process above, with a subsequent review of whether any additional measures are needed and, if so, how they can be designed so as to address the remaining problem but not cause extensive broader damage and difficulty.

I give the outline below of a type of broad framework for peripherally modifying (rather than overturning) the current international system which might perhaps be considered as a mechanism for allocating additional taxing rights to customer jurisdictions if current concerns cannot be satisfactorily addressed via the current BEPS work. Before that I consider some of the issues and directional thoughts in areas which are under review and which directly or indirectly touch on issues resulting from digital functionality. I then revisit some of the reasons why a unitary tax system is certainly no answer to the issues identified, and why core or top-up destination taxes as described in the Watson papers would probably also not hit the spot. I also discuss related areas of existing systems (withholding taxes and the 'deemed profit tax' systems operated by a number of non OECD countries) which form part of the current international landscape, and associated double taxation issues which are increasingly arising and are likely to be exacerbated by some of the OECD work.

I emphasise that whereas the framework I give perhaps provides a workable mechanism for modifying current rules if and where there is seen to be a need to allocate more taxing rights to customer jurisdictions, I do not reach a definite conclusion as to whether or where such a change is appropriate. I see that as something to be best considered at a later stage in the BEPS process, particularly as there are very significant challenges in appropriately targeting any change and setting the boundaries as to where it should or shouldn't apply. I do however believe that there is a need to change the credit rules so that credit can be allocated consistently with the allocation of taxing rights over relevant group profits, rather than all credits being trapped in the immediate counterparty.

5. PE definitions and the 'preparatory and auxiliary' issue

BEPS Action 7 focusses on preventing the artificial avoidance of PE status. This includes consideration of the specific activity exclusions in Article 5 (4) (a) to (d) of the OECD Model Treaty, and the more general exclusions in Article 5 (4) (e) and (f), for carrying on preparatory and auxiliary activities through a fixed place of business in the jurisdiction. This specifically includes consideration of things such as warehousing, which The Watson Paper discusses, and wider issues such as marketing which have been controversial in some instances. The preamble to the Action specifically mentions issues around artificial fragmentation of operations amongst multiple group entities to qualify for exceptions in this context.

In considering these issues it is worth reflecting on a number of aspects of the existing OECD model treaty and associated commentary:

(a) Firstly, as is implicitly conveyed by Article 5(4)(f), the exclusions in Article 5(4)(a)–(d) are for those categories of activities carried on in isolation and not for those activities carried on in combination –Article 5(4)(f) is required for that, and that is subject to the proviso that the overall combination is of a preparatory and auxiliary character. This substantially limits the independent significance of the exclusions in (a) to (d) which are not subject to the 'preparatory and auxiliary' character consideration of (e) and (f);

(b) Secondly, the commentary on Article 5 makes clear that whether or not activities have a preparatory and auxiliary character needs to be considered in context rather than simply being a matter of considering whether the activity fits one of the descriptions on a list of activities which are typically preparatory and auxiliary. Thus paragraph 24 of the commentary says 'The decisive criterion is whether or not the activity of the fixed place of business in itself forms an

5 'Expert Group on Taxation of the Digital Economy –General Issues Working Paper for meeting held on 12 December 2013'

essential and significant part of the activity of the enterprise as a whole.' And

(c) It is of course also relevant that a PE can be created, (under Article 5(5)), by a dependent agent which has, and habitually exercises, an authority to conclude contracts in the name of the enterprise. Whereas the legal relationship of being a group subsidiary is not sufficient (under the OECD model treaty) to make a group company a dependent agent, it can be if the subsidiary is viewed as de facto acting under the instruction or control of the other entity. If you put these two authority and control tests together they might be seen as mutually exclusive (ie. can there be local authority which is exercised under instruction from overseas without de facto authority resting overseas?). That would reinforce the point below concerning the significance of parallel transfer pricing considerations. There is perhaps however a narrow range of circumstances where a group company might be a dependent agent; for example, where it only does business with the one group customer or is otherwise not economically independent (eg. how economically independent are limited risk distributors).

It also needs to be borne in mind, however, that there being a PE will not result in additional direct tax costs unless there are profits allocable to that PE – after deducting the arm's length charges which are (we assume) already being made by any associated company whose profits are already being recognised and taxed in the local jurisdiction. If such a determination that there is a PE, in conjunction with a consideration of what are the properly allocable profits to the PE, just results in an additional filing and compliance burden and not more tax, then that benefits no-one. It is for this reason that, in practical terms, these type of PE discussions will often become a discussion about whether the transfer pricing is right or not rather than a discussion about whether there is a PE or not.

There is then the further issue of fragmentation. I should say at this point that I do not believe that such fragmentation is always, or even normally, artificial rather than a simple commercial preference to have a clear legal separation of what is done locally into a local company. A company is far easier for all parties (ie. accountants, tax authorities, and tax personnel) to understand and deal with than a permanent establishment or branch. As indicated earlier I believe that, even in a pre-digital world, what was done locally would normally have been done in a separate company.

The natural way to consider dealing with fragmentation in the context of the PE criteria would be to take into account activities of connected companies when considering the Article 5 (4) criteria. If that were done on a broad basis then the likelihood is that that would result in far more PEs being considered to exist than is desirable or intended in the context of the concern, ie. PEs where there would or should be no profit allocable after deducting existing arm's length charges. It is possible that more targeted provisions might be appropriate however if that is considered necessary to deal with a fragmentation of Article 5(4) (a)–(d) activities designed to step around testing of whether their character is preparatory and auxiliary.

There is probably a lot more to be said or thought about in this area. At this point however it seems to me that a lot of the PE and value attribution issues centre around the existing concepts of what is or is not preparatory and auxiliary for a particular business when considered in context. For example, advertising and marketing to help secure contracts, where the profits of the enterprise resulting from those contracts are to a substantial degree uncertain and dependent on issues associated with delivery and performance under those contracts, should probably be viewed as preparatory and auxiliary even if it goes a long way along the track towards securing those contracts. If however it is the securing of the contracts which itself delivers the major contribution to profits, with performance then being a more routine matter, then that does not seem to be in the nature of something which is preparatory and auxiliary. You would however expect similar concepts to be relevant for the services concerned when considering what the arm's length price payable is.

I await the Action 7 conclusions with interest, but we will have to wait until 2015.

6. Background comments concerning intangibles and the substantive transfer pricing workstreams (Actions 8–10)

These actions capture a number of key areas and issues. They are thus worthy of consideration in some detail, but perhaps in conjunction with reflecting on a few background areas which will help consideration of whether the actions can address the entire underlying concerns, or will leave more to do.

It is first worth noting that all three of these BEPS actions refer to the possibility of 'special measures'. What I understand is meant by this is some extension or deviation from the arm's length principle because there are some circumstances where this principle is not seen as sufficient to arrive at the desired allocation of taxing rights. It is of course implicit in this that there must be some more fundamental concepts or principles which should be used to consider where profits and associated taxing rights properly belong, or how they should be shared. The relevant concept suggested in the BEPS discussions is that of 'value creation', but I think it needs testing a bit more whether that is the right concept (and I discuss that further below).

The direction in which misallocation of profits and taxing rights can happen can perhaps be viewed as being along two different axes. On the vertical axis are shareholder/subsidiary misallocations, with the types of issues typically addressed by CFC rules, or thin capitalisation rules, falling within this category. On the horizontal axis are supplier/customer misallocations of the type typically dealt with by more general transfer pricing rules. You might of course take the view that thin capitalisation rules sit between those two boundaries – as loans between sister companies may be in point. I think the better view is to see this as an issue which goes up and then down the vertical axis however as the primary issue concerns the amount of the debt (ie. the intra-group capital structure) rather than the pricing of the debt.

This distinction is important because a good solution needs to correct any misallocation by reallocating to the right place and not by simply creating a further misallocation. This was an important consideration when the UK updated its CFC rules. It was recognised there that the proper target for the CFC rules was the misallocation of profits – which properly belonged to the UK parent to tax – to overseas subsidiary jurisdictions. The target was not, and should not be, misallocations of profits between overseas companies or jurisdictions. It was appreciated that if the UK CFC rules tried to also hit that target then that would make the rules so unmanageably complex and burdensome from a compliance perspective that that in itself would make the UK unattractive as a parent jurisdiction. Furthermore, it would have made it more difficult to properly target the rules on their intended target without also catching normal overseas commercial activities. Finally, and significantly, it would result in the misallocation of profits, which properly belonged to overseas jurisdictions to tax, to the UK parent.

Any solutions coming out of Actions 8 to 10 thus need to be considered in the context of whether they reallocate profits along the right axis or simply create a new form of misallocation. They will also need to be considered in terms of whether, when measured against the more fundamental principles touched on above, they move profits to the right place along that axis. In particular, whether the allocations going to the customer jurisdiction are in accordance with the appropriate fundamental concepts. That sense check is of course one which I am suggesting may need to be made in a broader third party (supplier/customer) context, but the discussions occurring in connection with Actions 8 to 10, and the conclusions arrived at, may help inform that consideration.

6.1 The assumed and actual profile of modern intangible assets

It may first be useful to give some comment and thought concerning intangible assets. They are both the subject matter of Action 8 and, in many ways, fundamental to the digital economy and related modern economy issues which this paper focusses on.

The existing international tax rules might be seen as having yet another implicit assumption, which is that intangible assets are always passive assets. They are thus explicitly or implicitly dealt with as property assets which give rise to income streams which are pure income profit, rather than as active assets whose development, maintenance and exploitation play a dynamic role in a business, and which have significant functions and costs associated with them. Thus issues have generally been approached on the basis that intangibles are mobile property assets, whose place of ownership can be readily determined and readily transferred, and where the tax issues which need to be considered are essentially (and always) similar to those which apply to rental incomes from immovable property, or to interest income from the lending of capital.

It is possible that there was a time when this was the general profile of the intangibles encountered. Thus, if patent royalties were being considered, then there would perhaps be an initial process of investment in research and development followed by a long life of essentially pure income profit from royalties from the patented invention. Similar principles may have applied to copyright royalties from artistic work.

This is no longer the sole, or indeed general, profile of intangible assets. Consider, for example, intangible assets associated with scientific and technological development, including those central to the digital economy, where the rate of technological change is so rapid that the individual intellectual property assets which result may have a relatively short useful life and be subject to constant processes of update and succession.

To take another example, consider the modern phenomena of brands. These are often mistaken as being mere registered logos but that is a long way from the truth. Certainly logos will be designed so as to themselves be attractive, but the value of a brand almost always comes not from the name or logo but from what is associated with it. The strength of a brand comes from developing and maintaining a personality for the brand, and developing and maintaining two way relationships with customers. A brand might thus be seen as a virtual person –and a lot of thought, work and activity goes into developing and maintaining that person as a character over time, with features that a particular target market will find attractive. Those include core features which need to be constant, consistent and reliable over time so as to generate trust and familiarity, but also more fluid features which are flexible and responsive so as to adjust as tastes, technology and markets change.

Once that development in the form of intangibles is recognised their profile and function might now be seen as having similar distinctions and functions to those which apply for tangible assets. Thus there will still be a class of assets which are passive assets with profiles similar to that of a building generating rental income. There are however very significant classes of intangible assets, which may have similar legal features to those passive assets in terms of issues of classification and registration or other forms of protection, but which are essentially part of the plant and machinery or stock of modern businesses. These will typically have significant supporting functions and costs associated with servicing their almost continuous need for maintenance, update and replacement. That support may be located in one place or legal entity, but is perhaps increasingly spread or shared across a variety of legal entities and places. There may or may not be overlap between the location of the legal ownership of the intangible assets concerned and the location of that support, or may be overlap to a greater or lesser degree.

It is also worth noting that, although there may be one or more legally registered intangible assets, eg. a registered trademark, which exist and give continuity over time, there are likely to be many, many, more legally distinct supporting pieces of intangible property (eg. separate items of know-how, or separate designs, patents or copyrights) which are continually created or updated and replaced as part of the process of imbuing the core asset with value, or maintaining and enhancing its value over time.

It should also be taken into account that, as technology continues to develop, that support may increasingly come from the technology itself – ie. technology which has the capability of learning and creating something new itself – rather than needing extensive and frequent human interaction. At that point, the profile may perhaps start to swing back towards something which has more of a passive character, ie. of owning property which has that capability. Or we may start approaching more fundamental philosophical and ethical questions concerning the status of that technology – which are thankfully beyond the scope of this paper!

6.2 BEPS Actions 8 to 10 – Assure that transfer pricing outcomes are in line with value creation: intangibles; risks and capital; other high risk transactions

Although only the first of these BEPS actions is formally to do with intangibles, all three can be conveniently understood and considered against the background of the discussion above concerning the nature of modern intangibles, together with consideration of the digital economy (which depends upon capabilities flowing from intangibles) –and consideration of the issues of value chain fragmentation which underlie both normal commercial operations and tax avoidance concerns.

The most direct link is obviously with Action 8. The core of this is a continuation and wrap up of the pre-existing project to update Chapter VI of the OECD Transfer Pricing Guidelines which deals with special considerations associated with applying the arm's length principle to intangibles. The heart of those discussions could in turn be viewed as a debate concerning the extent to which profits derived from intangibles should be viewed as deriving from passive legal ownership rights (ie. something which can be detached from supporting functions and activities) and to what degree they should be viewed as deriving from the functions and activities which support them.

You can perhaps drill down from this summary a bit further

to capture elements of that discussion which help explain some of the linkages with BEPS actions 9 and 10:

(a) Firstly, part of the required analysis really hinges on consideration of which of the supporting functions and activities are so fundamental to the maintenance and exploitation of particular intangibles that the performance of those functions would not normally be subcontracted to a third party. There are clear overlaps here with BEPS Action 10 ('Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties'); and

(a) Secondly, a key part of the analysis hinges on consideration of what returns should be attributable to the capital invested in the intangible. Thus, if significant upfront expenditure has been made on developing an intangible then that would be expected to justify a substantial return (indeed, if the category of intangible is towards the passive rather than the active end of the spectrum, then it would be expected to justify the bulk of the return).

Difficult areas arise where substantial investment has been incurred on developing an intangible which is then transferred for a capital sum. The acquirer should similarly be entitled to a return on capital invested; this is where links with BEPS Action 9 ('Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members') may come in.

My comment here of course focuses on the capital allocation aspect of BEPS Action 9, rather than the risk allocation aspect. There are indeed also some aspects to consider which may often be described as risk allocation, but I think it is important to be cautious in phraseology. Thus 'risk' properly considered is perhaps best viewed as concerning possibilities whose likelihood and consequence can be quantified. It is effectively something which is insurable and where BEPS risk can arise because a choice can be made as to where to locate that insurance activity, the capital necessary for it, and the profits (net of insured losses) expected from it. Risk can be contrasted with uncertainty (ie. something which is not predictable in a quantifiable/insurable manner and which, in a business context, is closely connected with the variable return accepted by an entrepreneur).[6]

BEPS risk may of course also arise because it is not normally rational for an entrepreneur to insure every risk that is capable of being insured. If they did then the carving out of profits for the insurers would leave no reasonable expectation of profit for the entrepreneur. This brings further links with Action 10 into play, ie. whereas insuring against a specific risk of loss is generally acceptable; broad ranging insurance which effectively ensures a loss is not.

Why do I divert to make these distinctions? Because a significant part of the debate and concern in relation to the update of Chapter VI of the Transfer Pricing Guidelines (and a subsidiary issue flagged in BEPS Action 10) concerns whether and where the variable return due to the entrepreneur should be left in the hands of a single group company – and where a profit split approach should be adopted to share that variable return. Profit split approaches are exceptionally complex and problematic in practical terms, and it is to be hoped that their application will be limited to those circumstances where there is a genuine sharing of both contribution to, and entrepreneurial control of, the exploitation of an intangible. The concern is that confusion of control issues and risk allocation issues may lead to either or both of excessive use of profit split approaches or a large increase in international disputes (as Tax Authorities will be inclined to argue for or against profit split approaches according to what, with hindsight, best serves their interests rather than there being clear rules to determine what is appropriate).

There are perhaps further links or overlaps between Action 8 and Action 10 when we come to issues such as group synergies, which is discussed in the Intangible Transfer Pricing Guidelines, or the 'hard to value' intangibles which are specifically mentioned in Action 8. There may be links with Action 10 because transactions such as intra-group transfers of what have been described as 'Crown Jewel' types of intangibles are hard to value because of issues which are essentially to do with group synergies and relationships. Thus, although similar types of third party transactions may arise, it is argued that the particular assets concerned are so fundamental to a particular business that they would never be sold separately from that business. This is perhaps one subset of a class of transactions or relationships which do happen in third party transactions but not in comparable circumstances. For example is a fulfilment operation which is effectively a monopoly operation in a particular jurisdiction, because it is so fundamental to the business model of the group, comparable to a third party operation in a competitive market?

These are difficult issues, and I can't say I am sure what an acceptable resolution might look like. I do think an answer needs to be found however which does not make it difficult for groups to consolidate particular activities, assets and functions in particular specialist locations and entities, even where it is unlikely that those activities, assets or functions would be subcontracted or sold to a third party entity.

I draw the following conclusions from that short stroll around Actions 8 to 10:

(1) The work on updating Chapter VI of the OECD Transfer Pricing Guidelines can reasonably be interpreted as recognising that many or most intangibles are now active assets which have substantial supporting functions and costs;

(2) That work, whether alone or in conjunction with other work under Actions 8 to 10, is likely to result in an increased proportion of the profits derived from exploiting intangibles being allocated to the locations where those supporting activities take place and away from the jurisdiction where the primary legal right to the intangible related revenues (eg. royalty streams) arises; and

(3) Actions 8 to 10 seem most likely to result in profits being reallocated from that primary supplier to those entities which form part of the intra-group supply or production chain rather than to the intra-group customer. There may of course be additional reallocations along the vertical axis to parent or subsidiary companies as a result of Action 9 (or CFC or other BEPS review actions). There is however nothing which really touches on the question raised in this paper, and touched on in BEPS Action 1, concerning whether the outcomes for customer jurisdictions are consistent with our more fundamental (and perhaps subjective) expectations concerning where taxing rights belong or how they should be allocated.

This brings me back to the concept of 'value creation' which the OECD has suggested is its guiding light as a fundamental concept which should determine where profits should be allocated in the context of Actions 8 to 10. One difficulty with using this phraseology is that, whether intended or not,

6 Cf. Nate Silver 'The Signal and The Noise' p 29 for the distinction between risk and uncertainty

‘creation’ tends to focus on production. Thus in the story of The Creation peripheral questions around who provided the capital and whether Adam put in a request for Eve tend not to arise. This focus on creation has caused some excitement amongst NGO’s and some concerns in other quarters as playing down the role and value attributable to capital. It also plays down the role of the customer base and collective/interactive market factors.

It needs to be considered whether ‘value creation’ is really capturing all of the aspects which it is intended or appropriate to capture, and whether it is giving the right balance between them. I suspect that it is not and that what is really aimed at is closer to ‘value derivation’ or some other concept which captures that what is relevant is what drives value or profit and where that contribution comes from. I think that, despite the phraseology, BEPS Actions 8 to 10 are heading towards something which does capture the role of property ownership and capital, but perhaps in a way which will leave uncertainty and dispute because of the phraseology used. I do not think that will, or is currently intended to, capture any contribution of the collective customer base or market – and the question is whether or not that is appropriate.

I emphasise again that the outcome of this work (and of the background technological developments it hooks onto) is likely to mean that an increasing proportion of profits from intangibles are attributed to entities in the supporting value chain rather than the entity which directly receives the relevant royalty or other income stream. That has important consequences, which I come back to below, in relation to credit relief for withholding or other taxes suffered on those income flows.

7. Should this lead us towards unitary taxation?

If I compare the commentary I have made above with that given by NGOs arguing for unitary taxation then there is a fair amount of overlap. Consider for example the analysis given by Sol Picciotto in his submission for ‘The BEPS Monitoring Group’ in relation to the OECD Digital Taxation Action.[7]

There are perhaps two major differences:

(a) Sol Picciotto’s paper puts a primary focus on tax driven fragmentation of the value chain which is perceived as tax avoidance whereas in my view that is a narrow aspect of a larger issue; and

(b) I disagree fundamentally with the conclusion that a unitary tax approach is an appropriate response, for reasons which I elaborate on below.

As I believe I have brought out, the ‘action at a distance’ benefits delivered by modern digital technology are real commercial benefits which allow the development and use of remote centres of excellence for a variety of functions in different jurisdictions rather than there being a need for every location to have every function. They also allow such functions, or supporting functions in general, to be carried out remotely in low cost jurisdictions (in pre-tax terms). Although there may be differences of economic or political view as to whether and where the latter aspect is desirable, it seems incontrovertible that both aspects are pure commercial aspects and not tax driven aspects.

There are numerous reasons why I disagree with the unitary tax conclusion as either a theoretically appropriate approach or as a sensible practical approach. These reasons draw on many of the points made in The Watson Paper but also extend them:

7.1 Market distortion

The first and primary theoretical point concerns issues of tax related distortions of markets which a unitary tax approach automatically leads to by imposing a different tax cost according to whether a transaction is carried out by a third party or a connected party. A pure third party domestic provider will be taxed based on the price they charge whereas a related party will be taxed on whatever higher or lower amount is driven by a formula. That tax distortion will inevitably drive insourcing and outsourcing decisions. The components of the formula may of course also result in tax driven action to help achieve whatever is the preferred tax outcome, if that can be achieved at acceptable pre-tax cost.

I suspect that the counter to this that would be made by supporters of unitary tax is that the various functions of a multinational are so integrated that there are no true comparables to be drawn between cross-border supplies within a multinational and third party supplies. There is thus already, and unavoidably, market distortion and we need to allocate profits of a multinational in a way which reflects their integrated reality and not by reference to notional comparison with supplies which are fundamentally different.

In my view this confuses a number of different matters and questions. The first question is whether or not, in principle, an arm’s length approach is to be preferred if it can be made to work. For the reason given above I think it is – and I do not think the ‘integration’ argument addresses that as a matter of principle. It is really irrelevant as a matter of principle whether transnational corporations, or any other corporations, operate as integrated firms under central direction.

The second question is whether, as a matter of practise, that fact of integration, if true, makes it impossible to achieve fair comparables. There is something here which gropes towards one of the current challenges concerning what I (and others) have described as ‘crown jewel’ type functions, but again I do not see the issue there is a being one of integration per se. The issue is rather one of separation. It is irrelevant whether or not a function is currently an integrated part of a larger business; the relevant question is whether by its nature it could readily be separated and outsourced. If it could then fair comparables should in principle be available and capable of use without too much difficulty.

The challenge is where a function is so core to a particular business that it could not be separated and outsourced without fundamentally changing or putting at risk that business. That will however apply to a relatively narrow range of functions rather than being the generality. It is also something which the BEPS process is attempting to address, and seems capable of addressing, without discarding the primary arm’s length principle for the generality of non-problematic functions. In some cases that might be addressed by adjusting the relevant comparable (eg. to take account of monopoly type characteristics); in other more restricted cases it may be addressed by increased use of profit-share type approaches.

There is of course a final factual question, which is whether it is indeed true that there has been a step change which means that all modern multinational businesses now operate as integrated firms under central direction. Throughout my 25 years in business I have seen an oscillation between management models which might loosely be described as centralised and those which might be loosely described as regionalised. I have seen nothing to suggest that the needle has become uniformly and permanently stuck on the ‘centralised’ model.

7 BEPS Monitoring Group ‘Response to OECD Request for Input Regarding Tax Challenges of the Digital Economy’

7.2 Political sovereignty issues

Fundamental requirements for a unitary methodology to work as a common and consistent global methodology (ie. one that doesn't result in multiple taxation or less than single taxation) are firstly a broad ranging international agreement of a common global tax base, and secondly agreed formulas to use for allocating this tax base between countries.

One only has to write that paragraph to be clear that it is never going to happen in the foreseeable future. Countries are not going to agree to a wholesale abdication of their sovereign rights and responsibilities to set the general corporate tax base, and its component specifics, according to their national profile and needs. Nor should they; it is a fundamental area of control and responsibility for democratic (or other) governments.

7.3 Accounting issues

A fundamental for a common tax base is a common global accounting base. There is not currently one and there is no prospect of one in the foreseeable future.

7.4 Tax audit issues

A unitary system means that what tax is due in one country will depend on accounting and factual information concerning many different countries. The accuracy of the tax calculation for a particular jurisdiction is thus dependent on the accuracy of the calculation for the entire unitary region. As a practical matter that would make it impossible for tax authorities to satisfactorily audit tax returns. That is likely to make an internationally agreed unitary tax system applying across multiple jurisdictions which are not administratively integrated highly unattractive to tax authorities.

7.5 Summary comment on unitary options

I think I need go no further. Unitary tax options are convenient and attractive as a means of attacking the current international systems, but they are at heart 'stop the world I want to get off' suggestions which do not stand up to minimal prodding. Their practicality requires utopian assumptions and would produce dystopian results.

8. What about destination based tax systems?

There are two variations of destination based tax system to be considered here. One is a wholesale switch to a destination tax system as the primary system, and the other is the use of a destination tax top up system as suggested in the Watson Paper.

The first question is why? The Watson Paper suggests minimising the scope for avoidance as a key driver and yet, as I have suggested, avoidance is merely one aspect of a larger issue of technological change, which has perhaps left the international allocation of taxing rights out of kilter with expectations. If that is right then the real problem to address is not avoidance as such but rather what needs to be done to realign the international allocation of taxing rights so that they are once again more consistent with fundamental expectations and needs.

8.1 Will a destination based tax give an acceptable allocation of taxing rights?

As discussed earlier in this paper, there is no clear objective answer as to how to determine what those fundamental expectations and needs are concerning the allocation of taxing rights, but the consensus probably circles around a need for some consistency with a concept that taxing rights should be allocated in accordance with the location of the key drivers of the profit or value concerned. There are however different variations of emphasis around that concept; for example, whether that is a narrow concept of value creation or something broader, or whether particular emphasis should be put on infrastructure dependent or other drivers which themselves result from, or are dependent on, tax-based funding. What we are grasping for however is some underlying concept of where the profits and taxing rights 'belong'.

The reason for my focus on this underlying aspect is because I think a wholesale destination based tax falls down at this first hurdle by relocating the taxing rights to what in general will seem like the wrong place. Thus, even if practical in the form proposed, it would at best solve an avoidance problem by creating a much larger problem of misallocated taxing rights.

To test that assertion, consider the case of a cross-border service business which had substantially all of its cost base and infrastructure in the UK but made the major proportion of its sales overseas. A destination based system would thus have most of its revenues identified with overseas customer destinations and taxed in those customer jurisdictions but most of its costs and support for those sales in the UK. The UK would thus get little or no tax take (indeed on one interpretation it may even have to fund a refund associated with the net cost base in the UK). This cannot be a desirable or acceptable outcome.

The key problem here is that a wholesale destination tax reallocates *all* of the taxing rights to the customer jurisdiction whereas what we are struggling with in a modern digitalised economy is the perception that *some* additional taxing rights should perhaps belong with the customer jurisdiction. Once people consider the type of example above, where all or a large proportion of the production work is done outside the customer jurisdiction, very few would feel that the right answer is for the customer jurisdiction to have all the taxing rights. A destination tax top up system thus has the merit that it leaves the primary position unchanged but 'tops up' in favour of the customer jurisdiction in certain circumstances.

One potential difficulty with the top-up system is that it tops up where there is avoidance and not by reference to any fundamental concept that more taxing rights belong in the customer jurisdiction. That gives rise to the normal difficulties of defining what is or isn't avoidance, and what exclusions should apply. Watson focuses on 'preferential regimes' or simply low tax regimes but then considers there to be a need for exclusions such as certain low tax regimes of developing countries. This runs up against the normal counter however that there is nothing objectionable as such in a country choosing to levy a low general corporate tax rate on business genuinely carried on there; the problem is where there are profits allocated to a country which do not genuinely belong there. There is thus no clearly defined target and, because the proposal (in contrast to the UK's updated CFC rules) feeds off no underlying concept of where profits properly belong, it seems unlikely that the proposal could be appropriately targeted.

The second problem is thus the same one that applies with misdirected CFC rules that their application will often result in taxing rights being allocated to a different 'wrong' place (ie. the customer jurisdiction) rather than to the right place.

8.2 Does a destination based tax achieve the objective of being a tax on profits?

The presumption of the Watson Paper, and of this paper, is that we are still aiming to tax profits, and not introduce an additional tax on sales or some other aspect of business. To

achieve that however the system chosen needs to give relief for attributable costs. That is not a simple matter in the modern world where there are long, or diffuse, value chains with supporting functions carried on in different specialised service centres.

The current system deals with that via transfer pricing rules which, despite the complexity and current BEPS reviews, are well established and understood rules which generally work fairly well. A full blown destination tax either has to maintain transfer pricing rules and simply change the place of taxation (which I understand is not the intention), or rely on relief being given for costs in a different place from where the income is taxed – and presumably some form of compensating transfer between governments or other adjusting mechanism.

As discussed in the Watson Paper the proposal for a full blown destination tax is more in the nature of a proposal to tax cashflows, rather than tax profits. The Watson Paper gives extensive and valid reasons as to why such an option is unlikely to be practical or acceptable, ranging from adverse timing or absolute impacts on government cash flows, to practical issues of transition or interaction with remaining source based systems. What is clear, however, is that a full-blown destination tax is not intended to operate as a tax on profits – and there is no obvious practical way for a destination tax to operate as a tax on profits unless (as for the top-up proposal) it were to retain the current source system and simply flip where taxing rights rested. A full blown destination tax system would seem to solve no existing problems and create many new ones – and I don't think anyone is suggesting such an option.

8.3 Practical problems of a top-up system

As set out in 8.1, I have some fundamental concerns in relation to a top-up system since I am not clear what it would target or why. As a result, I suspect that such a system would frequently, or perhaps generally, misallocate taxing rights. I also have general practical concerns with the proposal.

Firstly, I see it as a huge practical problem for taxpayers and tax authorities to try and chase profits along the supply chain as suggested in the Watson Paper. As touched on above, the modern supply chain is likely to include a number of regional or global specialist functional centres which support a broad range of jurisdictions rather than services being discretely identifiable with supplies to a particular jurisdiction. Any need to try and trace through the supply chain would thus require not just the normal allocations and charges required for transfer pricing purposes but a huge layer of additional – and fairly arbitrary – allocations to specific jurisdictions.

Secondly, the proposal would, prima facie, seem to require wholesale amendment of Double Tax Treaties in order to permit taxation in circumstances where there was no permanent establishment. This would be the case not just with respect to the direct counterparty but also with respect to any jurisdiction involved in the supply chain. It is of course true that the BEPS project may also result in requirements for treaty change (most probably via some form of multilateral instrument), but that will concern general principles of international taxation which have been subject to general agreement. It is difficult to conceive of countries signing up to something which more specifically paints them as tax havens or gives carte blanche to other jurisdictions to impose top up tax tariffs on supplies made by businesses in those jurisdictions.

It might of course be argued that the top-up tax could be phrased in parallel terms to CFC tax as being 'an amount equivalent to the top up amount' rather than as being a top-up tax on the specific trade and thus try and benefit from similar defences which HMRC successfully used in the *Brimcom* CFC case. To me, it seems somewhat surprising that those arguments succeeded in that context, but at least in that case there was the investment relationship which could be pointed to (and taxing rights with respect to dividends and gains). Here it would be absolutely transparent what the tax was with respect to – and that that breached the treaty agreement.

There would, of course, also be EU obligations to consider where EU counterparties and/or parent entities were concerned. I would be surprised if those did not also prevent a charge being imposed where the foreign businesses affected were genuinely established in their member states.

9. The role of withholding taxes

9.1 Allocation of taxing rights

In principle withholding tax and credit systems are intended to provide an allocation of taxing rights between the two counterparty jurisdictions to a transaction. Thus, if you are dealing with a pure income royalty stream, a tax rate of 25% in the jurisdiction where the relevant IP is owned, and a withholding tax rate of 10% in the customer jurisdiction, then 10% of the tax due is received by the paying jurisdiction, and the remaining 15% by the recipient jurisdiction.

Withholding tax regimes have the additional attraction for the source jurisdiction of being simple and effective mechanisms for collecting tax on an 'outsourced' basis without the need for significant computation or infrastructure. This makes such systems very attractive for developing countries which have limited supporting tax administrative infrastructure. In countries where there are still foreign exchange controls, there is the added attraction for the source jurisdiction, that classification or other taxpayer disputes concerning liability are probably rare. This is because a taxpayer who argues will not get paid until any dispute is resolved.

9.2 Disadvantages of withholding tax systems

A primary disadvantage of withholding tax systems is that they will not achieve their objective of allocating taxing rights where the income source concerned is not a pure income profit source, particularly if it is a long way from being one. The most obvious example of this is where direct or indirect lending from a bank is concerned. The bank will finance a high proportion of its lending with borrowing of its own and will correspondingly have an interest expense which reduces its profit from a particular loan. If that gave it, say, a £1m net profit on gross interest income of £10m then that profit would be wiped out by a 10% withholding tax. It is for this reason that bank loans will normally have gross up provisions so that any withholding tax is effectively borne by the borrower rather than the lender.

Similar issues arise with respect to intangibles or other income streams. At one level this can arise because the source jurisdiction applies withholding taxes to revenues for services or to reimbursements, whether because there is not a tax treaty in place to override domestic requirements to that effect or because they take a very broad view as to what constitutes a royalty for the purpose of a treaty which is in place. At another level this may arise because, as discussed in 6.1 above, many or most modern intangibles do not give rise to pure income profit.

To put some numbers to this if, from a group perspective, a margin of only 40% say is made on the income stream then

a 10% withholding tax on revenues will translate to a 25% tax rates on profits, ie. all or substantially all of the tax due on the profit will go to the source jurisdiction rather than there being an allocation of taxing rights. If margins are lower that may even result in foreign supplies being taxed at much higher rates than equivalent domestic supplies and thus impose a barrier to international trade. If you go one step further and take into account that existing, or BEPS extended, transfer pricing may allocate taxing rights over that 40% group profit amongst a number of different group entities, but that current foreign tax credit rules will only give a right to credit withholding tax to the direct recipient of the payment subject to withholding tax, it is clear that effective double taxation of the same profits arises.

To be clear there are two distinct issues here:

(a) Whether the practical operation of existing withholding tax systems is achieving whatever is the intended allocation of taxing rights between jurisdictions or is allocating all rights to the source jurisdiction-and perhaps favouring domestic business; and

(b) Whether the structure and principles which underlie current international systems for giving credit for such withholding tax are not working effectively –because they assume simple and closed bilateral relationships rather than the longer multilateral supply chains which are more typical in the modern world.

Only the latter issue would need to be addressed by changes in international tax law. The former issue is a matter of practise and case by case treaty discussion.

I am also not saying that the operational practise, and individual treaty agreements, which give rise to the issues in (a) definitely need to be changed. It may well be for example, that as a matter of development policy, the given allocation of taxing rights, including any high effective rate which gives effective protection of domestic industries, are considered justifiable. What I am saying is that there should be a conscious recognition of the impact of what is being done and of the basis for any decision that that is the right approach. The facts may often mean that the approach is not 'sharing' taxing rights but is allocating them all to one party.

In the specific context under discussion in this paper – of whether and how to allocate additional taxing rights to customer jurisdictions with respect to digital or similar activities – it is of course also the case that a withholding mechanism is not likely to be a practical solution. There are probably too many customers, and small individual ones at that, for it to be practical for them to have withholding obligations. What I am saying is that these withholding tax and credit mechanisms illustrate that it is in principle possible to use a revenue key to try and allocate one end of the taxing rights chain for a profits tax, provided that you use a reasonable revenue based rate and provided that the other end of the chain is a profits based calculation.

If you decide to deem that there is a digital or similar PE it seems quite practical in principle to require tax to be paid based on a set percentage of revenues in the customer jurisdiction and then give credit for that tax against profits taxes due in the jurisdiction of residence.

9.3 Solving the credit problem

As outlined above an existing, and probably increasing, problem with a withholding tax and credit system is that credit is only available in the jurisdiction of residence of the recipient of the gross income – but that much of the profit may flow through and be taxed, without credit offset, in jurisdictions where supporting services are carried on. The same problem would apply if there were revenue based PE taxes levied as described above.

In principle, this doesn't seem too difficult a problem to solve. All that is needed is a right to flow on the benefit of an appropriate proportion of the credit to the supporting group entities who are recognising a proportion of the associated group profit. At a simple level this might be done using a revenue key to allocate through a proportion of the credit, ie. with the gross intra-group supporting charges from a particular jurisdiction as the numerator and the gross revenues of the primary company as the denominator. That would almost certainly have to be done on a pooled basis, ie. pooling all credits for the purpose of the calculation rather than trying to do a jurisdiction by jurisdiction allocation of credits, but there seems nothing wrong with that in principle.

10. What we can learn from deemed profit tax systems?

There are a number of jurisdictions (for example in the Middle East and also China) who use 'deemed profit tax' systems as a simplified basis for charging tax on certain local permanent establishments of foreign companies. This avoids the need for profit computations, and for local attempts to audit them, where, for example, a very high proportion of the associated expenses would be overseas and difficult from a practical perspective to evidence and audit locally.

The tax essentially operates as a withholding tax on revenues, but is based on an assumed profit margin for the given industry or activity. For example, if it is seen as reasonable to assume a profit margin of 40% of revenues for a given industry, and if the local tax rate is 25% then a, revenue based, withholding tax of 10% (ie. 40% x 25%) will be applied as a proxy for the local profits tax.

In these examples the deemed profit tax is used as a proxy in order to allocate 100% of the taxing rights with respect to PE profits to the local jurisdiction. There seems no reason however why similar principles could not be used to find a rough revenue based proxy which is intended to share taxing rights in whatever percentage is desired. If there were the same facts as above but the objective were to share the taxing rights 75/25 between the supplier jurisdiction and the customer jurisdiction for example, then a revenue based tax of 2.5% of revenues might be payable in the customer jurisdiction (ie. 40% x 25% x 25%) and creditable in the supplier (and via, onward credit supplier chain) jurisdictions.

It is of course not suggested that we should aim for international agreement of the profit margin which it is appropriate to assume for any and every business model which can be thought of. The points which it is intended to bring out are that:

(a) It is important to emphasise the fact that withholding taxes are intended to serve as a proxy for an allocation of taxing rights on profits and not as sales taxes. Their rates therefore need to be linked to reasonable profit expectations. The same principle will apply for any similar new revenue based tax which is intended to serve as such a proxy for an allocation of taxing rights on profits; and

(b) The thought process exemplified by deemed profit tax systems gives a good framework for discussing what rates are appropriate to that purpose of allocating taxing rights. That can be adapted to take into account whatever factors are considered appropriate between treaty partners or other bodies concerned. For example, what allocation is intended

between the parties and what adjustments should be made for the fact that the party with the revenue based tax gets a fairly secure stream of taxes whereas the other party is carrying the tax risk of profit variation (both at an operating level and as a result of attributable financing or other attributable overhead costs).

11. A possible model for a modern revenue based system for customer jurisdictions

If it were to be considered appropriate for there to be a broader range of circumstances in which customer jurisdictions should share in taxing rights over profits then a possible model might be as follows:

(a) A deemed 'partial PE' giving rise to an obligation to pay a revenue based tax similar to a withholding tax (but via a filing rather than withholding mechanism) which is creditable against profit taxes in the home jurisdiction;

(b) To avoid this filing obligation arising on too broad a basis and impeding start up or other small scale international business it is suggested that a de minimus threshold should apply, similar to a VAT registration threshold, and that this should be quite a high threshold; and

(c) Rates applicable should be set at a level which is intended to allocate taxing rights in whatever is an appropriate proportion and not relocate them all to the customer jurisdiction. Deemed profit tax principles may provide a useful heuristic mechanism for considering what rate is appropriate. It may well be that that is a fairly low rate if fundamental concepts of what drives the profit generation suggests that (in accordance with current thinking) inputs from supplier jurisdictions are more significant than drivers in the customer jurisdiction.

I am also suggesting that, so as to mitigate existing and increasing problems of double taxation where a revenue based proxy is used for a profit tax, it is essential to update standard tax credit models so that an appropriate proportion of tax credits can be passed through to companies which sit in the supply chain of the direct supplier company. As outlined above, a simple revenue based key may also provide a suitable mechanism for this.

12. Conclusions

As I have set out in the preceding sections of this paper, I believe that the concerns which exist with respect to the current international tax systems are best addressed within those existing systems rather than by an attempt to replace those systems with a radically new system for either taxing profits or allocating taxing rights over profits.

The reason which the Watson paper suggests for considering more radical change is the problem of tax avoidance. As I have set out I think that that is a misdiagnosis of the core problem, and that the real problem may be that, due to technologically driven changes in business models and fact patterns, the current system may no longer be delivering the allocation of taxing rights between supplier and customer jurisdictions which was originally expected and intended. That may increasingly be creating outcomes which do not accord with subjective expectations of where taxing rights should belong and which therefore create an exaggerated perception of the scale and nature of tax avoidance.

The key technological driver which has resulted in that change is the digital and associated capacities to provide external and intra-group services from a distance. That is closely related to the ever growing significance of intangibles. I suggest that increasingly the nature of those intangibles is as active assets rather than passive assets –and that the tax system has not yet caught up with that profile. I suggest that the provision of services, and even goods, from a distance will continue to increase as both technology, and our understanding of how we can exploit it, continues to develop.

I do not mean to play down the problem of avoidance as being a real issue. Those issues need to be addressed, and I believe the BEPS process provides a good structure for doing that. As a result of that process it should become clearer whether broadly satisfactory outcomes are likely to be produced once there is greater coherence within the existing systems or whether there are problems which are to do with the allocation of taxing rights, in particular allocations to customer jurisdictions, rather than being to do with disappearing taxing rights.

If there is a conclusion that additional taxing rights should be allocated to customer jurisdictions then I have suggested a revenue based mechanism for doing that which I think should be capable of providing some fine tuning of the existing systems to allocate more rights to customer jurisdictions. Because that is fine tuning rather than fundamental overhaul it should be capable of introduction without the type of disruption and turmoil which more wholesale change to a unitary tax approach or a destination tax would do. It would also be capable of providing a more appropriate allocation result and fewer new opportunities for avoidance. Perhaps the biggest challenge for the mechanics I propose would not be the issue of the mechanism but the challenge of defining where it should or should not be used. There are no obvious definitional boundaries to draw.

I suggest that the technological and intangible related change I refer to above is not only presenting challenges of missing taxation or misallocated taxation but also problems of double taxation where withholding tax regimes apply – because the credits for the withholding taxes do not follow the taxing rights over the profits through the supply chain. That problem will continue to increase under the current system and would be further exacerbated by the introduction of a further revenue based proxy tax of the type I describe. It needs to be addressed.

In conclusion, there are many challenges ahead for governments and tax authorities in arriving at updated tax systems which can meet the needs of the modern world in a way which supports governments' fiscal needs and thus provide the infrastructure which business ultimately depends on. There are significant dangers that that could be done in a way which causes major damage to international trade, whether because of badly targeted changes or because of unilateral government action which has a damaging protectionist effect. There is a way forward however.

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