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INVESTMENT AND DEVELOPMENT



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EDITORIAL STATEMENT

*Transnational Corporations*¹ is a longstanding policy-oriented refereed research journal on issues related to investment, multinational enterprises and development. It is an official journal of the United Nations, managed by the United Nations Conference on Trade and Development (UNCTAD). As such it has a global reach, a strong development policy imprint, and high potential for impact beyond the scholarly community.

Objectives and central terrain

The journal aims to advance academically rigorous research to inform policy dialogue among and across the business, civil society and policymaking communities. Its central research question – feeding into policymaking at subnational, national and international levels – is how to make international investment and multinational enterprises contribute to sustainable development. It invites contributions that provide state-of-the-art knowledge and understanding of the activities conducted by, and the impact of multinational enterprises and other international investors, considering economic, legal, institutional, social, environmental or cultural aspects. Only contributions that draw clear policy conclusions from the research findings will be considered.

Grand challenges and the need for multiple lenses

The scale and complexities of the “grand challenges” faced by the international community, such as climate change, poverty, inequality, food security, health crises, and migration – as embodied in the United Nations’ Sustainable Development Goals (SDGs) – are enormous. These challenges, combined with the impact of disruptive technologies on business, rapidly evolving trends in international production and global value chains, new emerging-market players and new types of investors and investment, make it imperative that policymakers tap a wide range of research fields. Therefore, the journal welcomes submissions from a variety of disciplines, including international business, innovation, development studies, international law, economics, political science, international finance, political economy and economic geography. However, submissions should be accessible across disciplines (as a non-specialized journal idiosyncratic research should be avoided); interdisciplinary work is especially welcomed. The journal embraces both quantitative and qualitative research methods, and multiple levels of analyses at macro, industry, firm or individual/group level.

Inclusive: multiple contributors, types of contributions and angles

Transnational Corporations aims to provide a bridge between academia and the policymaking community. It publishes academically rigorous, research-underpinned

¹ Previously: The CTC Reporter. In the past, the Programme on Transnational Corporations was carried out by the United Nations Centre on Transnational Corporations (1975–1992) and by the Transnational Corporations and Management Division of the United Nations Department of Economic and Social Development (1992–1993).

and impactful contributions for evidence-based policy-making, including lessons learned from experiences in different societies and economies, both in developed and developing-country contexts. It welcomes contributions from the academic community, policymakers, research institutes, international organisations, and others. Contributions to the advancement and revision of theories, frameworks and methods are welcomed as long as they are relevant for shedding new light on the investigation of investment for development, such as advancing UNCTAD's *Investment Policy Framework for Sustainable Development*.

The journal publishes original research articles, perspective papers, state-of-the art review articles, point-counterpoint essays, research notes and book reviews. All papers are double blind reviewed and, in line with the aims and mission of the journal, each paper is reviewed by academic experts and experts from the policymaking community to ensure high-quality impactful publications that are both academically rigorous and policy relevant. In addition, the journal features synopses of major UN reports on investment, and periodic reviews of upcoming investment-related issues of interest to the policy and research community.

Unique benefits for authors: direct impact on policymaking processes

Through UNCTAD's wider development community and its global network of investment stakeholders, the journal reaches a large audience of academics, business leaders and, above all, policymakers. UNCTAD's role as the focal point in the United Nations system for investment issues guarantees that its contents gain significant visibility and contribute to debates in global conferences and intergovernmental meetings, including the biennial *World Investment Forum* and the *Investment and Enterprise Commission*. The work published in *Transnational Corporations* feeds directly into UNCTAD's various programmes related to investment for development, including its flagship product, the annual *World Investment Report*, and its technical assistance work (investment policies reviews, investment promotion and facilitation and investment treaty negotiations) in over 160 countries and regional organisations. The journal thus provides a unique venue for authors' academic work to contribute to, and impact on, national and international policymaking.

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A half-century of resistance to corporate disclosure

Alex Cobham, Petr Janský and Markus Meinzer*

As the complexity of transnational corporations (TNCs) grew in the post-war period, their effective degree of disclosure diverged from what is standardly expected of single-country firms. Country-by-country reporting is the key proposal to re-establish appropriate TNC disclosure, and ultimately TNC accountability – and as such, has been consistently resisted by many TNCs, professional services firms and some key headquarters countries in the Organisation for Economic Cooperation and Development. This paper charts two main waves of pressure for progress. The first, most visible from the late 1960s to the early 1980s, reflects the claims of the New International Economic Order and the rise of the G77 group of countries, while the second saw international civil society take a leading role. The current phase sees these two impulses combine and may finally deliver meaningful progress. The paper addresses both the political underpinnings and the developing technical component to the claims for deeper TNC disclosure, ultimately shaped into the pursuit of an international standard for public, country-by-country reporting – and the resistance to it. The paper also provides illustrative results based on the existing country-by-country reporting data for banks. It concludes with a discussion of the prospects for country-by-country reporting.

Keywords: Corporate accountability, country-by-country reporting, TNC disclosure, Sustainable Development Goals, tax avoidance, tax havens

1. Introduction

The story of country-by-country reporting (sometimes referred to as CbCR) is the story of the search for equal accountability for transnational corporations (TNCs) and domestic companies – an attempt to set a floor for disclosure requirements for TNCs. Over the last sixty years, two major waves of pressure for progress can be distinguished. The first, most visible from the late 1960s to the early 1980s, reflects the claims of the New International Economic Order (NIEO) and the rise

* Alex Cobham (Alex@taxjustice.net) and Markus Meinzer (Markus@taxjustice.net) are at Tax Justice Network. Petr Janský (jansky.peta@gmail.com) is at the Institute of Economic Studies, Charles University, Prague.

of the G77 group of countries – both related in important ways to Raul Prebisch's intellectual and political leadership, including as the first head of UNCTAD. The second wave, reflecting both global civil society's engagement with the nature of TNCs and the specific development of a tax justice movement, began to grow in the early 2000s and continues to the present day. The use of country-by-country reporting data in an indicator under discussion for the Sustainable Development Goals target on illicit financial flows reflects the two waves combining as G77 and G20 members jointly set the international agenda, with support from civil society. The inclusion of such an indicator in the Sustainable Development Goals would represent important progress; and the range of other initiatives ongoing suggests that the TNC resistance to disclosure may eventually be overcome.

This paper charts the two waves of pressure for progress, addressing both their political underpinnings and the developing technical component to the claims for deeper TNC disclosure, ultimately resolved into the specific aim of an international standard for public, country-by-country reporting.

What emerges most clearly is the dominance of political dynamics over technical issues. While the concepts involved are necessarily highly technical, the debate is not over technical concepts but over the ability of TNCs to resist regulation through the process of evolving an equal accountability regimen by calling on professional services companies to make their case or by lobbying governments directly.

Whereas section 2 discusses the two main drives for progress, their political underpinnings and the developing technical component to the claims for deeper TNC disclosure, section 3 uses the outcomes of the second wave – country-by-country data for banks – to provide some preliminary results, illustrating the opportunities but also the need for a technically robust standard. The final section concludes with a discussion of the prospects for finally achieving public country-by-country reporting from TNCs.

2. CbCR: a half-century of struggle for corporate accountability

Although there are important reasons to be cautious about comparing the revenues of individual governments with the turnover of individual companies, it is nonetheless striking that 69 of the largest 100 economic entities in the world on this basis are TNCs (Global Justice Now, 2016). The level of information each is required to publish about its activities is quite different. Governments have greater responsibility to citizens than do companies to their stakeholders, perhaps, but the discrepancy in data disclosure is marked. We know, for example, the line-by-line breakdown of government revenues. For most multinationals, we do not even know the level of sales in different countries. Or of staff. Or assets. Or profits. Or tax paid. Or all the companies or names under which a multinational operates.

By contrast, the annual accounts of companies that operate in a single jurisdiction contain most of this information – as was the case for all companies at the time when corporate law and accounting norms began to emerge, with the rare exceptions of a handful of enterprises such as the East India Company and the Royal Niger Company, which operated on behalf of imperial powers (Amujo & Cornelius, forthcoming). In many jurisdictions, those annual accounts have long been required to be placed in the public domain.

This reflects a crucial decision in the development of entrepreneurship, by which governments allowed the liability of individuals who run companies to be capped, so that commercial activity was not held back, for example, by the risk that business failure would also mean the loss of a director's family home. Although limited liability companies have existed for centuries, it was only in the early 19th century that the structure became formalised in legislation, which led to it being widely adopted. The effective quid pro quo for this protection was the requirement to publish company accounts, signed off by an approved auditor. Limited liability socialises some of the private risks of business failure; the publication of audited accounts provides the transparency needed to allow external stakeholders and investors to manage their exposure to those risks.

In the 20th century, the growing emergence of business groups operating transnationally necessitated major changes to national regulatory frameworks that had hitherto been purely domestically focused. This shift saw the League of Nations take a leading role in establishing the basis for international tax rules that first governed imperial-era interaction in the multinational tax sphere and were later taken up by the OECD (Picciotto, 2013).

Compared with tax regulations, regulations on transparency were pursued with less rigour for the globalising world. With most multinationals headquartered in and owned from current or former imperial powers, the OECD country governments could be largely confident in their ability to ensure domestic regulatory compliance and access to the data required to levy appropriate tax charges in their own jurisdictions. As we explore below, this confidence began to erode as some states' pursuit of deliberate "tax haven" strategies, and the promotion by professional services firms of schemes to exploit these strategies, changed the compliance decisions of TNCs (Palan, 2003; Tax Justice Network, 2018).

2.1. The G77's fight for corporate disclosure

While the key objective of the NIEO was for developing countries to improve their terms of trade and ensure sovereignty over their natural resources, a significant element of the NIEO was to establish disciplines for the regulation of transnational corporations in their jurisdictions. On this front, the G77 took the lead in the 1970s

(Bair, 2015). Its emergence dating back to the Bandung Conference of 1955 or perhaps the establishment of UNCTAD with Prebisch at the helm in 1964, the NIEO was formally laid out in a United Nations document in 1974 (United Nations General Assembly, 1974).

The seventh principle, of a total of 20, calls for the “regulation and supervision of the activities of transnational corporations by taking measures in the interest of the national economies of the countries where such transnational corporations operate on the basis of the full sovereignty of those countries”. It confirms the extent to which the NIEO saw regulation of TNCs as a priority in its own right and as fundamental to achieving sovereignty and a more equal global distribution. In practical terms, this prioritisation directly informed one of the key practical steps taken in pursuit of the NIEO: the Draft Code of Conduct on TNCs.

After a failed 1972 coup attempt against Chile’s president Salvador Allende, in which US multinationals were widely seen as complicit (e.g. Garcés, 1976; Kornbluh, 2013), Chile requested the establishment of a UN committee for transnational enterprises.¹ A group of Eminent Persons, personally selected by the UN Secretary General, began investigating financial and other affairs of multinational companies. After long negotiations the UN Commission for Transnational Corporations (UNCTC) was founded in 1975. Within this commission, a Group of Experts on International Standards of Accounting and Reporting (GEISAR) was convened to improve the financial transparency of transnational corporations.

Among the experts there was consensus that public reporting requirements should shed more light on the corporate networks and finances of multinational corporations. Accordingly, the GEISAR recommendations issued in 1977 contained the requirement to publish financial reports for each company that a multinational corporation operated, including information on intra-group trade (Ylonen, 2017: 45-46; Rahman 1998: 600, 611), which is particularly vulnerable to tax avoidance. These far-reaching proposals were unanimously adopted by GEISAR and passed on to the UNCTC for ratification. If ratified, these recommendations would have become binding and would have been implemented by the United Nations Economic and Social Council (ECOSOC).

The publication of GEISAR’s recommendations in 1977 drew a reaction from two leading business lobby groups: the International Chamber of Commerce (ICC) and the International Organisation of Employers (IOE). They formed a working group to coordinate opposition and subsequently published a detailed letter ahead of the meeting of the UNCTC, where the recommendations were to be considered and

¹ The following paragraphs draw on Meinzer & Trautvetter (2018).

voted upon (16–27 May 1978). The likelihood of endorsement of the report was high because the Commission operated on the principle of majority voting, and lower-income countries supported the report's endorsement and had an absolute majority in the Commission (Rahman 1998: 601).

In order to block progress, the lobbyists successfully mobilised support from within the negotiation room. The OECD representatives threatened to leave the UNCTC, not to accept nor to implement its recommendations, and to stop financial support if majority voting was not replaced with unanimous decision making. In practice, this might have implied that the Commission's recommendations would have remained without effect, as most multinational companies were headquartered in OECD countries. Ultimately, the OECD countries were successful: the principle of consensus was introduced and the far-reaching recommendations of the GEISAR report were not adopted. Instead, the Commission recommended launching a new Ad hoc Intergovernmental Group of Experts on International Standards of Accounting and Reporting. Power to nominate the experts was yielded to governments, and for the next 15 years, until the dissolution of the UN Commission, no consensus on binding standards was reached because OECD members rejected disclosure proposals from lower-income countries. In some cases, the objections were more narrowly held: “[...] the United States and Japan alone have exercised such de-facto veto in order to block many decisions otherwise agreed upon by all other nations” (Ibid.: 616, 609-611).

In June 1973, shortly after the Group of Eminent Persons had taken up their initial investigation of multinational company affairs, an alternative body was set up. The International Accounting Standards Committee (IASC) was founded as a federation of audit associations from 10 OECD countries and Mexico, which in turn were strongly influenced by the big audit companies. Within the first 13 months of its existence this body produced 26 accounting standards (Rahman 1998: 605; Obenland, 2010: 1), enabling the creation of an alternative set of business-led standards to the UN proposals – without any of the latter's required disclosures.

In March 1980, less than two years after the OECD countries had introduced the consensus principle in the UN Commission, the IASC presented a draft for an accounting standard on segmental reporting (IAS 14). This introduced financial segment reporting by geographic area (i.e. at the regional rather than country level) (Giunti, 2015: 22, 40-41) – aggregating multiple jurisdictions so that national accountability was not supported. The UN process for ambitious accounting standards with public disclosure was closed down as private actors captured the political space and put in place a much weaker standard.

The conflict was never, of course, a technical one over accounting standards, but a political one over the right to regulate and, ultimately, the right to development. The defeat of disclosure was followed by a broader shift in the approach to TNCs.

Bair (2015) has evaluated the evolution of three related efforts to constrain TNCs within the United Nations system: the Code of Conduct drafted by the UNCTC; the Draft Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights, developed and circulated in 2003 by a Sub-Commission of the Human Rights Commission; and the Guiding Principles on Business and Human Rights (the “Ruggie Principles”), which supplanted the Draft Norms and were endorsed by the Human Rights Council in 2011.

Bair compares the basis for corporate obligations in each of the three and concludes (p. 169): “what the distance between the Code of Conduct and the Draft Norms marks is not simply the rehabilitation of the corporation, but also – and more profoundly – a transformation in our view of the state, and its role in development”. Seen in this way, the defeat of the GEISAR process is a pivotal moment in the failure of the NIEO. It reflects the failure to establish an obligation for corporate disclosure by TNCs not only in general, but also specifically as an element in a project “geared toward the realization of what the G77 understood as a collective right to development, vested in the state” (Bair, 2015, p. 161). It might be seen as inevitable, given the relative economic and political power of OECD members and TNCs together, and the absence of broader public or civil society engagement. But that assessment also points the way towards the potential for progress.

The GEISAR process took place during what Hill (2004) refers to as the first of three generations of UN–civil society relations, running from the UN’s creation after World War II to the end of the Cold War. Hill writes that international NGOs (INGOs) were the main civil society actors, and “[w]hat is striking about this period is how little actual engagement there was of INGOs in the work of the UN” (Hill, 2004, paragraph 1). The second generation saw UN engagement by a much broader group: “In marked contrast to the first generation of UN relations with non-governmental actors, the newly-emerged national and regional NGOs sought to engage directly in intergovernmental deliberations and, through advocacy and mobilization work, influence their outcomes” (Hill, 2004, paragraph 3) Hill then speculates that a third generation of UN–civil society relations is emerging: one that has space for like-minded coalitions of governments and civil society organisations. As we explore below, such a like-minded coalition has emerged in a somewhat ad hoc fashion around country-by-country reporting – and with the potential for comprehensive success.

2.2. Civil society and a country-by-country accounting standard

As the social, political and economic tribulations of structural adjustment, coupled with the end of the Cold War, left the G77 and much of the UN system in a quite different position, the mantle of challenging TNCs in order to defend the right to

development was taken up by civil society – albeit not always with the consistent view that such a right should be vested in the State.

The tax justice movement, which coalesced with the formal establishment of the Tax Justice Network in 2003 and has developed globally since then, does take the view that States are key actors and that power relations vis-à-vis TNCs are important to the former's ability to ensure the progressive realisation of rights. At the same time, however, States are themselves duty-bearers that must also be held accountable.

The first draft accounting standard for a country-by-country reporting requirement (Murphy, 2003a) set out the basis for making data public to ensure that TNCs would provide effective disclosure about their activities and risks at the country level and that this would also provide the public with the necessary data to hold governments to account for their approaches to TNC taxation. In keeping with the spirit of the GEISAR disclosure proposals, the standard provides for consistent and detailed reporting of TNCs' activities, jurisdiction by jurisdiction.

Although swiftly taken up by civil society transparency advocates, initially focusing on the extractive sector and subsequently spreading to tax avoidance more broadly, the proposals were resisted at the International Accounting Standards Board and at the OECD. As well as advancing technical proposals, however, tax justice advocates sought to change the underlying political narrative, challenging publicly the idea that tax “minimisation” was just “smart business practice”.

News stories on tax avoidance by individual multinationals are so commonplace today that it is easy to forget that the first major story was just ten years ago.² On 6 November 2007, The Guardian ran under the headline: “Revealed: how multinational companies avoid the taxman” on the front page, the results of a six-month investigation of the international banana trade supported by the Tax Justice Network (Lawrence & Griffiths, 2007). The generic nature of the headline would not be appropriate in 2018 and reflects just how little prior coverage of this issue there had been.

The headline also reflects the main dynamic which has persisted since 2007: the view that tax avoidance is perpetrated by multinationals and against the State. Subsequent exposés – for example of Apple, SAB Miller and Starbucks – have typically been met with two responses: that companies have a duty to shareholders to minimise their tax and that each multinational group abides by the law (and taxation) in each country where it operates. By implication this response puts the onus back on States that are responsible for the laws in question.

² The following paragraphs draw on material prepared for a forthcoming chapter in a volume on tax justice and human rights, edited by Nikki Reisch and Philip Alston.

In general, such responses have been met with public scepticism. The shareholder duty element has largely fallen away. First, legal advice obtained by the Tax Justice Network from a top law firm provides a direct challenge to the claim (Farrer & Co, 2013). Second, academic evidence has shown that shareholders do not benefit from lower effective tax rates – in fact, they face higher risks and no higher returns (Brooks, Godfrey, Hillenbrand, & Money, 2016). Third, public awareness of the costs of tax avoidance has risen sharply, so that rather than seeing it as smart business, it is increasingly seen as anti-social business practice (e.g. a survey carried out for the UK tax authority found that 61% of respondents felt that it was never acceptable to use a tax avoidance scheme, most commonly because “it is unfair on others who pay their taxes” (Shah, 2016)).

Recent developments have, for the first time, focused more closely on the role of the State in avoidance: the LuxLeaks revelations have shown how Luxembourg had approved hundreds of secret low- or zero-tax deals proposed by the big four accounting firms of major multinationals, led by PwC; and the European Commission’s State aid investigations have shown the Belgian and Irish States directing substantial efforts to facilitate profit-shifting from fellow member States of the European Union (EU). The Irish case, in which the Commission followed up on a US Senate committee investigation that had revealed a large share of Apple’s profits recorded in an Ireland-based entity ostensibly with no tax jurisdiction, was pivotal to this change in focus.

Finally, the phenomenon of profit-shifting had itself changed over the period – from a marginal activity in the early 1990s to a globally significant one by the late 2000s. As Cobham & Janský (2017) show, the proportion of US TNCs’ profits that were declared in jurisdictions other than where the underlying economic activity took place rose from just 5-10% of global profits in the 1990s to 25-30% by the early 2010s.

After the financial crisis of 2008-09, the combination of fiscal pressures and a growing public willingness to appreciate the risks as well as the benefits associated with TNCs, along with a highly engaged civil society movement, led to country-by-country reporting reaching the agenda of the G8 and G20 groups of countries.³ For the first time, perhaps, the convergence of interests between the public in higher- and lower-income countries became visible – and with it the possibility of an informal alliance between international civil society and the G77.

As early as 2010, and in reaction to the financial crisis, the first rules were approved in the United States as part of the Dodd-Frank Act, requiring listed companies from the extractive industries to publish their tax payments and payments to governments on a country-by-country or project-by-project basis. Although this

³ The following paragraphs draw on Meinzer & Trautvetter (2018).

requirement was broadly matched by the European Parliament in September 2010, the corresponding implementing regulation by the Securities Exchange Commission (SEC) was annulled by the courts in the United States shortly after its adoption in 2012.⁴ In May 2013, the Extractive Industry Transparency Initiative (EITI) reformed its criteria to include more detailed country reports and the EU passed the new accounting directive that included reporting obligations for extractive industries starting in 2016.

Against this background and the specific direction of the G8 and G20, the OECD's 2013 Base Erosion and Profit-Shifting (BEPS) Action Plan (p. 23) stated that the organisation would

[d]evelop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that [TNCs] provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.

On behalf of the G8, the OECD developed a country-by-country reporting standard, which in its final version closely resembled the original proposal by Richard Murphy (Tax Justice Network, 2013: 6), except in two key areas. Instead of requiring consolidation at the country level, and consistency with the global financial accounts, it allowed country-level aggregation of individual subsidiaries (OECD 2015: 32). Cobham, Gray, & Murphy (2017) compare the specific variables required by the various reporting standards with civil society proposals, identifying the various shortcomings of current standards (see Table 1). They also discuss in detail the user case for country-by-country reporting that underpins the civil society case (section 3 illustrates the potential value of public country-by-country reporting data).

Second, instead of creating transparency for investors, consumers, journalists and tax authorities alike, the reporting was reinterpreted as an instrument of transparency for tax authorities alone. An OECD memorandum from October 2013 confirms that the OECD sees the data as disposable for the exclusive use of tax authorities. This reframing implied that the data would be covered by tax secrecy and thus hidden from public view.

⁴ In 2012 the American Petroleum Institute, the US Chamber of Commerce, the Independent Petroleum Association of America and the National Foreign Trade Council filed suit in federal court in the District of Columbia, seeking to strike down the relevant disclosure rules. The suit claimed that mandatory disclosures were unconstitutional violations of companies' First Amendment rights. No individual company associated itself publicly with the action taken.

Table 1. Comparison of data fields in country-by-country reporting standards

	Civil Society Proposal	OECD CbCR	CRD IV	Dodd-Frank	Canada	EITI	EU
Identity	Group name	Group name	Group name	Group name	Payee name	Payee name	Group name
	Countries	Countries	Countries	Countries	Countries	Legal and institutional framework	Countries
	Nature of activities	Nature of activities	Nature of activities	Projects (as in: by contract)	Same data required by project as well as by country	Allocation of contracts and licenses	Projects (as in: by contract)
	Names of constituent companies	Names of constituent companies		Receiving body in government	Subsidiaries, if qualifying reporting entities	Exploration and production	
Activity	Third-party sales	Third-party sales				Social and economic spending	
	Turnover	By the process of addition	Turnover				
	Number of employees FTE	Number of employees FTE	Number of employees				
	Total employee pay						
Intra-group transactions	Tangible assets						
	Intra-group sales	Intra-group sales					
	Intra-group purchases						
	Intra-group royalties received						
	Intra-group royalties paid						
Key financials	Intra-group interest received						
	Intra-group interest paid						
	Profit or loss before tax	Profit or loss before tax	Profit or loss before tax				
	Tax accrued	Tax accrued					
Payments to/from governments	Tax paid	Tax paid	Tax paid	Income taxes paid	Tax paid	Profits taxes	Taxes levied on the income, production or profits of companies
	Any public subsidies received		Any public subsidies received				

Source: Cobham, Gray & Murphy (2017).

Note: CRD IV = Country Reporting Directive IV, EITI = Extractive Industries Transparency Initiative, EU = European Union, FTE = full-time equivalent.

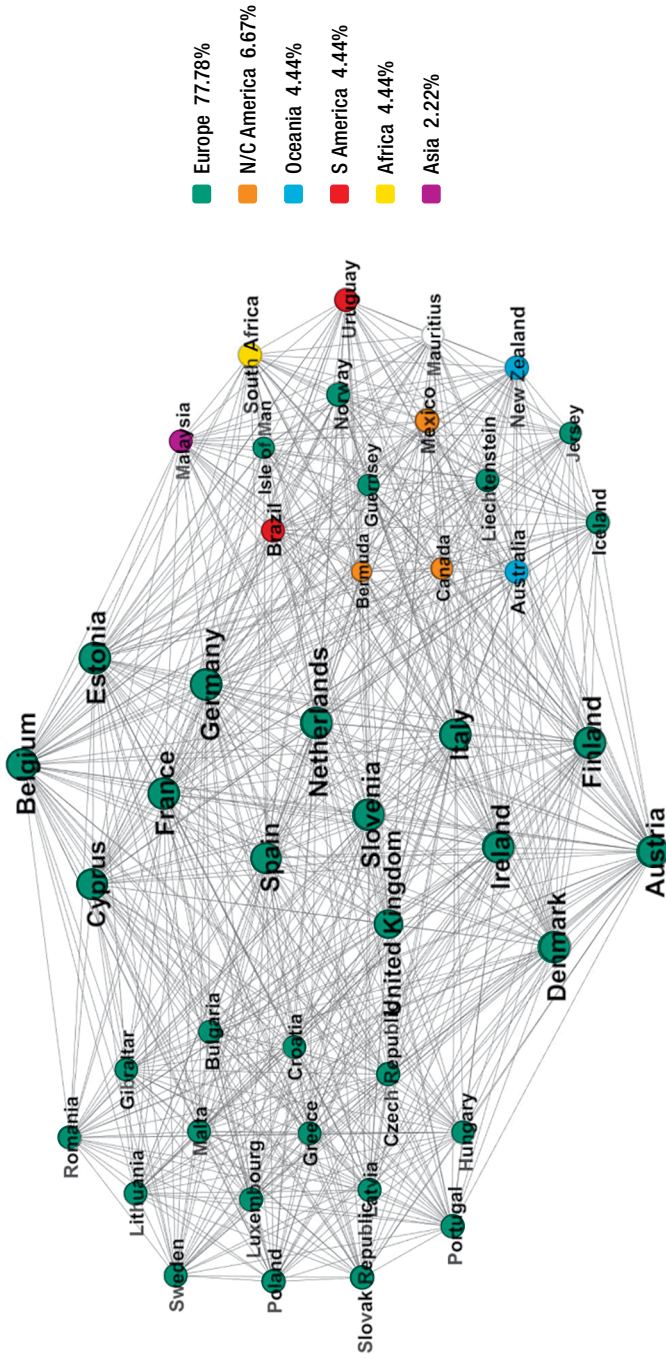
Following the OECD's call for written comments on the first draft of CbCR at the beginning of 2014, 135 submissions were made. Fully 87% of these were from the private sector. Of these, Deloitte and PwC made two submissions each and KPMG made one submission. Apart from two, all private sector submissions rejected public country-by-country reporting. Of the responses, 130 came from developed countries, with the largest proportion from the United States and the United Kingdom (43%), and not one from tax authorities in developing countries (Godfrey 2014: 11). In contrast, in a survey conducted by PwC at the beginning of 2014, of 1,344 CEOs surveyed from 68 countries, 59% were in favour of public reporting. A detailed analysis of the OECD discussion (Corlin Christensen, 2015) confirms that it was focused narrowly on people with technical expertise from the private sector and excluded other interests.

Following the consultations, KPMG Switzerland welcomed the weakened CbCR proposals on 4 April 2014, and in particular, the intention not to make the data public. Just one day before, a KPMG partner from the United Kingdom had been appointed as head of the OECD Transfer Pricing Unit, which has been responsible for CbCR through the OECD BEPS Action Plan since 2013. Also in May 2014, the Business Roundtable, a powerful US business association, wrote to the US Secretary of the Treasury and warned about the consequences of the OECD's actions on BEPS and possible reporting requirements.

At the end of 2014, Pascal Saint-Amans, head of the OECD Centre for Tax Policy and Administration, stated the position plainly: "Now to come back to the country by country reporting, the agreement clearly – and that was a condition to the agreement – is that this information will remain confidential. It's to be used by the tax administration ... it is not designed to be publicly released. Otherwise there would be no agreement ... That's something I know a number of businesses were concerned about. This solution makes unhappy a number of people, particularly the NGOs ..."

According to reports from the negotiations, it was above all the United States and Germany along with the Big Four that insisted the data should not be made public (see Meinzer & Trautvetter, 2018 for more detailed discussion of this point). And with this decision, the data are to be reported directly only to the tax authorities in the country where the multinational company is headquartered, and then exchanged with selected tax authorities under complex, newly created exchange arrangements. The data are subject to strict tax secrecy – and interested countries have to fulfil demanding technical requirements to participate in the exchange. As a consequence, as Figure 1 shows, almost all lower-income countries remain excluded – despite international commitments, such as the UN Sustainable Development Goals, which require global measures to curtail illicit financial flows including corporate tax avoidance, and European obligations such as the Lisbon

Figure 1. Bilateral exchange relationships as of May 2017



Source: Rasmus C. Christensen, by kind permission.
 Note: Size and position by degree (number of exchange relationships), colour by region.

Treaty, which call for all policy areas to be consistent with and to complement international poverty reduction targets.

2.3. Southern leadership and the Sustainable Development Goals

While unbalanced access to OECD CbCR data exacerbated the inequalities in global taxing rights rather than ameliorated them, one lower-income region was taking the challenge into its own hands. Starting in 2012, the African Union/UN Economic Commission for Africa High-Level Panel on Illicit Financial Flows from Africa had begun the work that would deliver a major report in 2015 – and, perhaps more importantly, exerted a clear influence even before then, by ensuring that illicit financial flows were targeted in the Sustainable Development Goals framework.

The High-Level Panel's focus on TNC disclosure, and the specific tool of country-by-country reporting, is clear:

We were encouraged by the emergence of discussions on country-by-country reporting of employees, profits, sales and taxes as a means of ensuring transparency in cross-border transactions. Country-by-country reporting, publicly available, will help to show where substantial activity is taking place and the relative profits generated and taxes paid. In the absence of a universal tax administration, country-by-country reporting will enable tax and law enforcement agencies to gain a full picture of a company's activities and encourage companies to be transparent in their dealings with African countries. (p. 45)

African States should require multinational corporations operating in their countries to provide the transfer pricing units with a comprehensive report showing their disaggregated financial reporting on a country-by-country or subsidiary-by-subsidiary basis. African governments could also consider developing a format for this reporting that would be acceptable to multiple African revenue authorities. (p. 81)

The Panel calls for partner countries to require publicly available disaggregated, country-by-country reporting of financial information for multinational companies incorporated, organized or regulated in their jurisdictions. (p. 85)

The High-Level Panel's predominant focus on tax avoidance by TNCs – largely matched in the report of the UN Secretary-General's High-Level Panel of Eminent Persons on the Post-2015 Development Agenda – has ensured that the issue was carried through to the Sustainable Development Goals (SDGs).⁵

⁵ Specifically, SDG 16 target 4: By 2030, significantly reduce illicit financial and arms flows, strengthen the recovery and return of stolen assets and combat all forms of organized crime.

Thus far, at least, the depth of political support for the G77 and within parts of the UN system at least has ensured that retrospective efforts of lobbyists, and possibly of OECD member states, to remove TNCs from the scope of the target have been unsuccessful. Moreover, one of the two indicators proposed for SDG 16.4 would draw directly on OECD country-by-country reporting data in order to construct a measure of profit misalignment (Cobham & Janský, 2018). The misaligned profit indicator is defined as the value of profits reported by TNCs in countries for which there is no proportionate economic activity of multinational enterprises. A central feature of the indicator is that the underlying country-level misalignment measures provide monitoring and accountability for individual States seeking to reduce the (negative) misalignment suffered – for example, to demonstrate to citizens and domestic businesses that TNCs are being fairly taxed – and for States that benefit from profit-shifting at the expense of others, an accountability mechanism to demonstrate their commitment to global progress.

One potential issue relates to the channel through which the data might enter the UN system. Most straightforward in practical terms at least would be to work with the OECD, as it gathers partially aggregated data from tax authorities. Some States provide headquarters to only one or a few TNCs passing the threshold, and until public reporting is agreed, the question of confidentiality may affect what data can be shared through the OECD. The OECD will publish, from late 2019, country-by-country data, aggregated to the country level to preserve confidentiality. This may well prove sufficiently high quality to allow the construction of the misalignment indicator, depending on the extent of suppressions to protect TNC identities in individual jurisdictions. Alternatively, a delegated UN body could – in tandem with the OECD or separately – obtain additional data directly from member States' tax authorities, with the guarantee of protecting the confidentiality of individual reporting TNCs. Given the cooperation of OECD and/or member States, either approach is broadly feasible. It goes without saying that the best approach to construct such an indicator would be to overcome TNC confidentiality issues to facilitate the disclosure originally envisaged by GEISAR and by civil society proponents of country-by-country reporting. The misaligned profit indicator is defined in a similar way to some of the indicators applied to the data for European financial institutions in section 3.

3. CbCR: transparency for accountability

In this section we explore the practical value of proposed TNC disclosures. This is possible, with some important limitations, using country-by-country data that is published by European financial institutions under the fourth Capital Requirements Directive (CRD IV). As shown in Table 1, the CRD IV disclosures fall well short of the civil society template in terms of the reported variables. In addition, the transposition

of the directive into EU members' national laws allowed for major inconsistencies within and between countries. The results are nonetheless illustrative of the potential value of the data. Our findings are among the first based on CRD IV data, and although necessarily preliminary (a full paper is forthcoming), provide clear indications of the scope available to hold TNCs and States accountable for tax behaviour. Before turning to the data and the preliminary analytical results, we review the related literature. This section is based on Janský (forthcoming).

3.1. Literature

There are three areas of relevant literature: the use of banks' country-by-country reporting data, the use of other country-by-country reporting data and the measurement of the misalignment of real economic activity and profits. The bank data have become available only recently, but there are already a few notable analyses. Richard Murphy, the originator and advocate of the CbCR (Murphy, 2003b), published one of the first empirical analyses using the data, in a report for a group of members of the European Parliament (Murphy, 2015). Murphy (2015) uses data for 26 banks, 17 of which had published the full data and seven of which had published only partial data, to conclude that overstatement of profits in low-tax and offshore jurisdictions appears to be occurring. Jelínková (2016) uses the data for 32 banks (28 of them for both 2014 and 2015) in her student thesis and finds that banks report their profits disproportionately to their activities. She estimates that if profits were apportioned across countries on the basis of employees and turnover, on average about 60% of reported profits would be redistributed. Oxfam has been very active in this area, with a few reports focused on individual countries such as France (Oxfam, 2016) and a recent report (Oxfam, 2017) – for which the Centre for Research on Multinational Corporations SOMO (2017) prepared estimates – focused on the country-by-country reporting data of 20 European banks and their presence in tax havens. In this section we use a larger data set (with more banks, including those most important for the Czech Republic), but employ a methodological approach consistent with Oxfam (2017) to enable direct comparisons.

The introduction of public country-by-country reporting for extractive sector companies listed in the EU and United States (Wójcik, 2015) was significant, if partial, success for the international civil society campaign launched in 2003 (Seabrooke & Wigan, 2015). Johannesen & Larsen (2016) found that country-by-country reporting of tax payments is associated with significant decreases in value of firms in extractive industries, and they associate this effect of disclosure rules with a reduction of rents derived by firms from tax avoidance. Akamah, Hope, & Thomas (2017) find that US multinational companies that operate more extensively in tax havens tend to disclose their foreign operations at a higher level of aggregation.

They argue that the evidence is consistent with managers attempting to avoid strong criticisms of their firms' tax-avoidance practices by making geographic disclosures less transparent.

Some research studies the misalignment between reported profits and economic activity: how much more profit is reported in tax havens in comparison with economic activity undertaken there. The policy consensus (OECD, 2013) on the need to apply corporate taxation where a given value was created is empirically investigated through two sets of estimates. Cobham & Loretz (2014) use company-level balance sheet data retrieved from the Orbis database provided by Bureau van Dijk. Cobham & Janský (2017) estimate the size of the misalignment of economic activity using US data provided by the government Bureau of Economic Analysis. Relatedly, Riedel, Zinn, & Hofmann (2015) find that the tightening of transfer pricing rules raises the reported operating profits of high-tax affiliates, and vice versa for low-tax ones, and reduces the sensitivity of affiliates' pre-tax profits to corporate tax rate changes. They therefore suggest that the regulations are effective in limiting tax-motivated profit-shifting behaviour. In another similar analysis, MSCI (2015) identifies 243 companies (out of 1,093 in the MSCI World Index constituents; health care and IT companies stood out) paying an average rate of 17.7%, versus the 34.0% that would result if these companies were paying taxes in the jurisdictions where they generate revenues, i.e. equivalent to comparing the location of reported profits and sales (the total difference amounts to US\$82 billion per year).

Overall, the literature supports three relevant points: first, that tax avoidance by TNCs represents a material distortion to the world economy, imposing major revenue losses for many countries; second, that the level of TNC disclosure is associated, possibly in multiple ways, with the degree of tax avoidance; and third, that country-by-country reporting can reveal important aspects of that behaviour. It is the final element to which the current analysis contributes.

3.2. Data

Credit institutions and investment firms established in the EU (hereafter "banks") have had to publish sectoral country-by-country reports since 2015. The banks' data are available thanks to disclosures required by the Capital Requirements Regulations 2013. The requirements originate from Article 89 of the Capital Requirements Directive – CRD IV, of which paragraph 1 says:

From 1 January 2015 Member States shall require each institution to disclose annually, specifying, by Member State and by third country in which it has an establishment, the following information on a consolidated basis for the financial year:

- (a) name(s), nature of activities and geographical location;
- (b) turnover;

- (c) number of employees on a full time equivalent basis;
- (d) profit or loss before tax;
- (e) tax on profit or loss;
- (f) public subsidies received.

Since the resulting data are not aggregated across banks by any institution and are often hard to find on banks' webpages, Janský (forthcoming) uses a data set collected by a group of researchers at Charles University in Prague. The paper uses the data as they were on 31 January 2017, but updates continue and the intention is to make the full data set publicly available through Open Data for Tax Justice (<http://datafortaxjustice.net>).

The selection of these banks was created in the following way. We focused on the biggest banks. To see which they are, we use a leading list of Europe's 50 largest banks by assets in 2015 and 2016 (SNL, 2016). In addition, a few relatively large banks that are not on this list, but for which data are available in the data set were included in the analysis to improve the coverage. Although the data are available as a result of the EU regulations, the data also provide information about other European as well as non-European countries' and banks' activities. So rather than having an EU or European focus, we use the data to shed light on the global activities of banks using a sample skewed heavily towards having better EU and European coverage. There are in total 56 banks. The data for all variables seem to be available for 35 banks. For 10 banks, there are no data. For the 11 remaining banks, only some data are available. Given the nature of the data and the underlying research still in progress, the results should be considered preliminary and illustrative only.

3.3. Methodology

Janský (forthcoming) constructs a range of measures of profit misalignment. The most graphically striking are the relative misalignment measures, which show the ratios, aggregated for all banks in the sample, of each country's profit and turnover, and of profit and employment. In this way, a number over one hundred (%) indicates a country with a higher proportion of bank profit than of economic activity. The most extreme cases show profit misalignment far in excess of any proportionate real activity; and to countries that consistently fail to capture an aligned profit share.

The indicator of relative misalignment is the ratio of the shares of a given country's profit and turnover (or employees), multiplied by 100 for a clearer interpretation:

$$\text{Relative misalignment}_{it} = \frac{\text{Share of profit}_{it}}{\text{Share of turnover/employees}_{it}} \times 100 \quad (1)$$

The relative misalignment can have values between zero and, theoretically, infinity. The higher the estimated values of relative misalignment, the higher is the misalignment. If all the profits were aligned perfectly with turnover, the relative misalignment would have values of 100 for all countries. In reality, we expect countries with a concentration of real economic activity to have values of between 0 and 100, and for tax havens to have values higher than 100. This helps to answer questions such as which countries have a higher share of banks' income than turnover. If a country has a value of 200, that implies that twice as much profit is reported there than would correspond to its share of turnover. It can also be interpreted with a percentage sign; in the same example, 100% more profit than turnover was reported in a given country.

3.4. Preliminary results

Figures 2 and 3 show preliminary results for the year 2015. Both graphs show countries only if their income is higher than €1 billion. Figure 2 shows the relative extent of gross profit misalignment, according to equation (1). Figure 3 plots the relative misalignment of profit with the number of employees against the relative misalignment with turnover, with the size of the circle reflecting the absolute value of profit reported in the country.

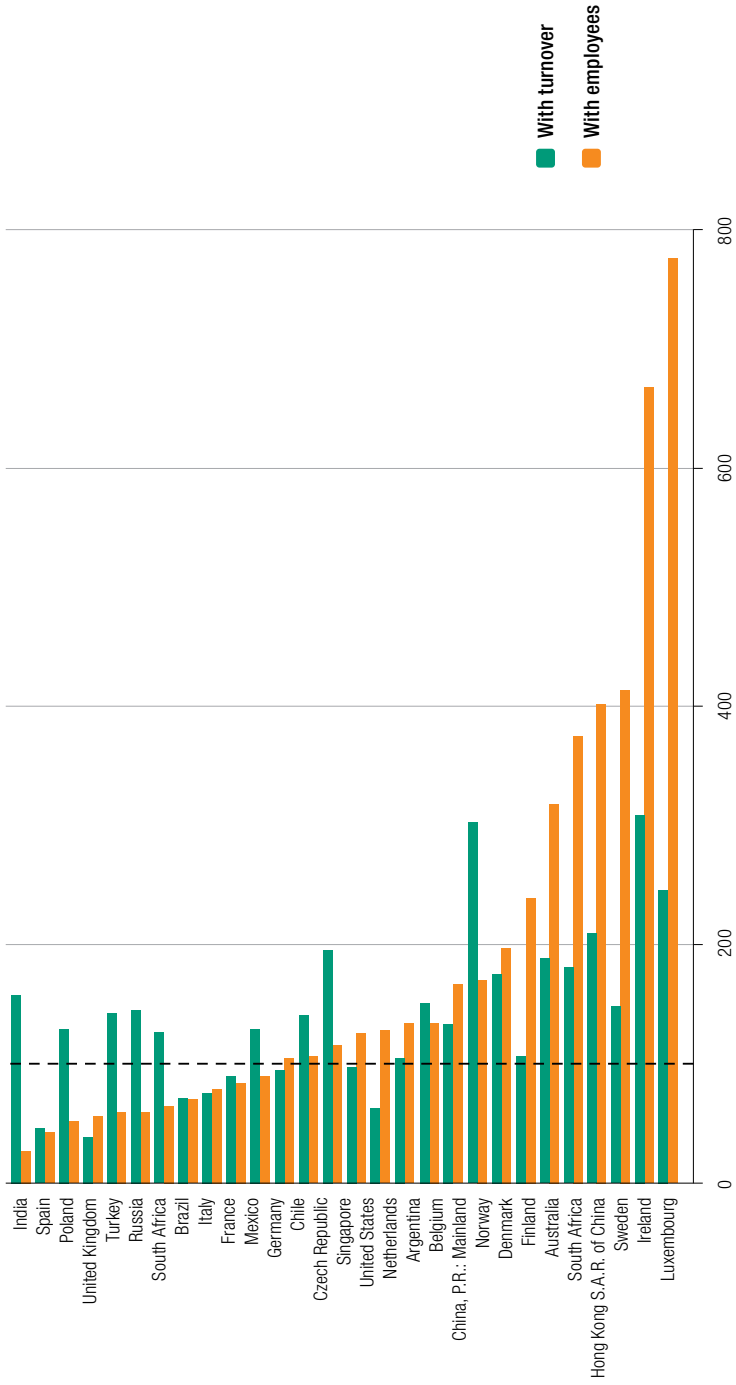
The results in Figures 2 and 3 point to countries being spread along quite a wide spectrum of relative misalignments. Most big economies, including France and Germany, have very low misalignments. Their values are about 100 for both the number of employees and turnover (i.e. TNCs are declaring the same proportion of their global gross profits as the share of their global economic activity in these jurisdictions). Some selected jurisdictions have substantially more income reported than the number of employees or turnover of banks suggested. These jurisdictions include Ireland and Luxembourg, for which there are ample data. There are other tax havens with similar relative misalignment, such as Cayman Islands, Curacao, Jersey, Mauritius and Qatar, but for these there are not many observations and the income reported in them is below the €1 billion.

Ireland and Luxembourg stand out for a number of reasons. They are the two countries with the highest relative misalignments with the number of employees, and first and third highest relative misalignment with turnover. Their misalignments with the number of employees are about 700 for both and with turnover about 250 for Luxembourg and 300 for Ireland. Hong Kong (China), another jurisdiction that is often considered a tax haven, has high levels of reported profits and exhibits high levels of relative misalignment with both the number of employees and turnover. In addition to examining further the role of these tax havens, research should focus on other results that we find hard to explain. Some other countries' results do not allow for a straightforward interpretation and are suitable cases for future research

with the CbCR and other data sources. Examples are those of China (which show high relative misalignment with turnover in particular) and of the United Kingdom and of Spain (which both seem to have substantially less income reported than the number of employees or turnover of banks would suggest).

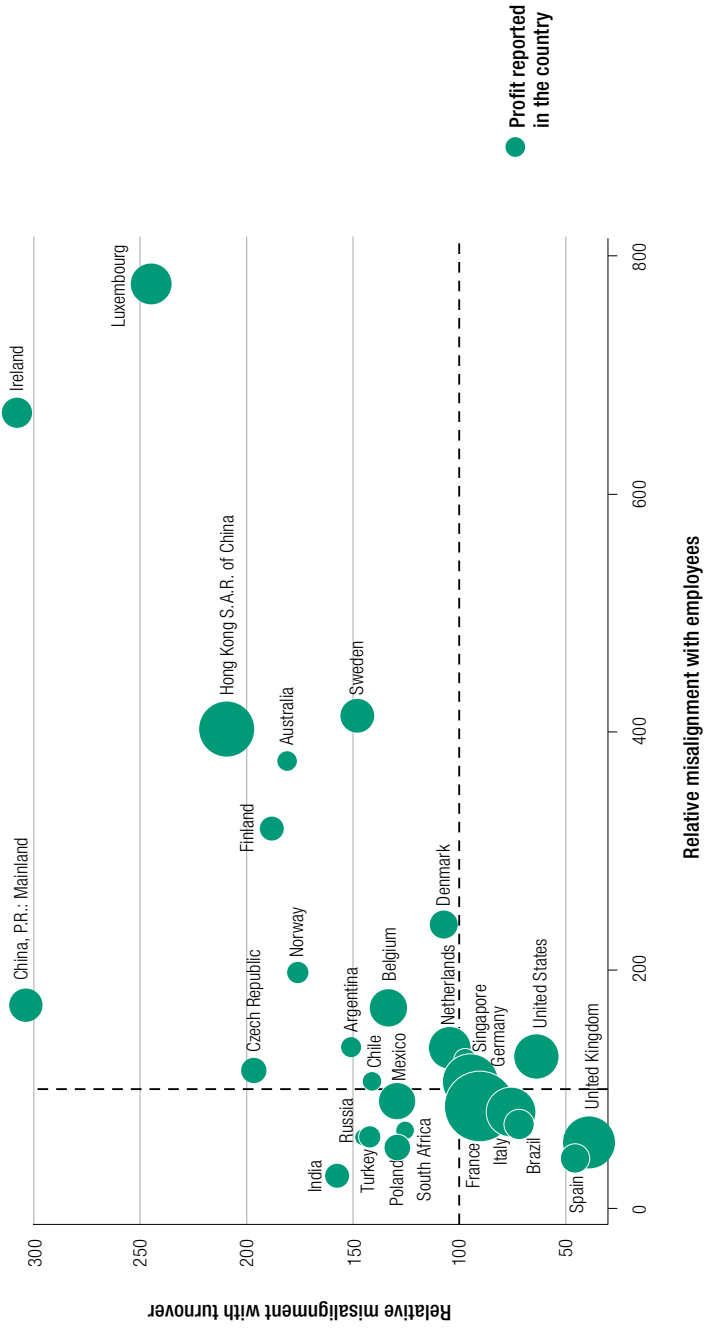
The CRD IV data are not of sufficient quality to support specific claims in relation to tax revenues at risk from profit shifting, as the civil society proposals for country-by-country reporting would allow. But even these data provide clear indications of the pattern and scale of profit misalignment, and of the individual TNCs and jurisdictions that appear to pose the greatest threat to the countries where most of their real economic activity takes place. It is the implied threat of accountability that underpins the long-standing resistance to TNC disclosures, of TNCs themselves, the professional services firms that profit from selling tax avoidance services and a number of key OECD members (both headquarters jurisdictions and profit-shifting hubs).

Figure 2. Relative extent of gross profit misalignment with number of employees and turnover 2015
(Per cent of gross profits)



Source: Jansky (forthcoming).

Figure 3. Relative extent of gross profit misalignment with number of employees and turnover
(Per cent of gross profits)



Source: Jansky (forthcoming).

4. Conclusion: the future of country-by-country reporting

Ending the exceptions that allow TNCs to be simultaneously among the biggest economic actors on the planet and the least transparent would provide a significant step towards accountability – and also towards the ability of States to deliver on the collective right to development, and of the public to hold States to account for doing so. Public country-by-country reporting will not revive the New International Economic Order, but it would shift accountability in a meaningful way for both TNCs and tax havens. The OECD can provide a valuable step forward by facilitating the publication of partially aggregated CbCR, as outlined in Annex C of a recent report (OECD, 2018). But the rejection by powerful member States of full publication prevents the OECD from delivering the level of disclosure necessary to bring TNCs in line with other economic actors.

As a result, three other channels are under exploration. One is the voluntary route. In line with the Ruggie principles, this depends on TNC willingness to go beyond the minimum necessary. There are potential champions here – Vodafone, for example, has committed to publish its OECD standard reporting from 2019, and its fellow members of the ‘B Team’ alliance have indicated some interest. The Global Reporting Initiative (GRI) is in the process of piloting a much more technically robust standard than the OECD’s, designed specifically for public reporting. Voluntary approaches are difficult, as the data would inevitably focus attention on the absolute levels of a given TNC’s profit misalignment – rather than any relative superiority to less transparent rivals. But uptake across a given sector – for example, by the members of the International Council on Mining and Metals, which backs the GRI – would largely overcome this question. The Open Data for Tax Justice hub will by 2019 host a live database of publicly available country-by-country data, nesting various standards to enable analysis. But the brief survey of the history of TNC disclosure here should make clear that voluntary efforts can provide only piecemeal progress, at best, rather than the comprehensive solution ultimately needed.

A second channel is that of unilateral requirement for publication. The UK parliament has already legislated to allow publication, but the government has not yet chosen to impose the requirement. The French parliament had passed a measure mandating publication, before the last government reversed this with an archaic technical manoeuvre. In the absence of multilateral agreement at the OECD, pressure will continue for others, such as the EU, to take the lead – despite the reported reluctance on Germany’s part.

The third channel is for the issue of TNC disclosure to return to the UN system. One possibility here would be for ISAR, the successor to GEISAR, to develop a mandatory public standard. Another would be for the requirement to be embedded within the draft treaty on TNCs and human rights. Perhaps the most obvious

channel, however, given UNCTAD's central role in analysing data on the investment (and more recently, profit-shifting) behaviour of TNCs, would be for that organization to become the repository for country-by-country reporting data, and the guardian of a strong standard to deliver the data to underpin an indicator of profit misalignment for the SDGs.

From its establishment more than 50 years ago, UNCTAD took a leading role in identifying the need for greater regulation of TNCs to ensure a positive contribution to global development. Through the 1970s and 1980s, UNCTAD provided the key international forum to consider new corporate disclosures – until ultimately the lobbying of TNCs and their professional service providers closed down the space. Now, with civil society and Southern countries in alliance in seeking redress to the problem, and the value of country-by-country reporting as a tool, UNCTAD could re-emerge as a leading forum.

A more natural fit might now be the UN technical committee on tax, which has been a focus of recent civil society and G77 efforts to establish a more politically representative and global forum to replace the OECD in international tax discussions. Despite the recent, leading support of India, however, the tax committee currently lacks the resources and the political space to play such a role. Another alternative could perhaps emerge through the OECD Inclusive Forum, through which lower-income countries can join discussions if they commit to the BEPS Action Plan on which OECD member States led during 2013-15. But this could become a more representative space only if OECD members were willing to cede some of their power, which at present seems unlikely.

The experience of the last fifty years confirms that bringing TNC disclosure in line with that of other economic actors will not happen easily – despite its importance to the right to development. The efforts of the G77 and of international civil society are increasingly aligned around the goal of advancing TNC disclosure, through public country-by-country reporting. But the resistance of TNCs, professional services firms and OECD member States has proven durable over the years.

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International tax, regulatory arbitrage and the growth of transnational corporations

Sol Picciotto*

This paper traces the history of international corporate taxation, discusses how transnational corporations (TNCs), through their tax advisers, have helped to shape the system, and suggests that this is important in understanding the development of TNCs. It argues that a key competitive advantage of TNCs is their ability to exploit differences in corporate tax rules, as a form of regulatory arbitrage, which is facilitated by the inadequate coordination of those rules. It focuses on the divergence between the understanding in business, economics and international studies that TNCs are unitary firms and the principle which has increasingly hardened in international tax rules, especially on transfer pricing, that the various affiliates of TNCs in different countries should be treated as if they were independent entities dealing with each other at arm's length. It argues that this facilitates tax avoidance, which is one of the strategies of the exploitation of regulatory differences, or regulatory arbitrage, which has contributed to the growth and oligopolistic dominance of large TNCs. While claiming that they merely obey the laws of each country where they do business, TNCs have taken advantage of their global reach to mould laws and normative practices, and develop structures taking maximum advantage of the loose coordination of global governance regimes.

Keywords: arm's length principle, BEPS, formulary apportionment, transnational corporations, tax avoidance structures

1. Tax and transnational corporations

1.1. The divergence between tax rules and business reality

Tax is at the centre of the relationships between TNCs and States, yet there has been surprisingly little attempt to examine the interaction between TNCs and the international tax system. There has been a stark divergence between the underlying

* Sol Picciotto is Emeritus Professor, Lancaster University; Senior Fellow, International Centre for Tax and Development (ICTD); Visiting Professor, University of Warwick; s.picciotto@lancs.ac.uk. I am grateful to colleagues at the ICTD for their support, and especially to Michael Durst for his insights and comments; the paper was also greatly improved thanks to comments and suggestions from Peter Muchlinski, Jeffrey Owens, and Bruno Casella.

principles of international tax rules, and the academic and policy discourse on TNCs in the fields of international business, political science, economics and even international law. In all these fields, it is axiomatic that TNCs behave as unified firms under central direction. There is certainly plenty of discussion in the international business literature of degrees of decentralization, conglomerates and concentration, group structures (divisionalization, regionalization), the balance between strategic direction and operational management, and other problems of managing complex multinational corporate empires. Yet the unquestioned assumption is that the TNC is a unitary business enterprise and a single political actor. In contrast, international tax rules have become based on the legal fiction that each national tax authority should treat the local affiliates of a TNC as if they were independent entities, dealing “at arm’s length” with the other members of the corporate group.

This paper explores the reasons for, and consequences of, this strange divergence. The issues go beyond international tax: there are similar problems in other areas of economic regulation, such as prudential requirements for banks. At root, they lie in the central tension that States are national while TNCs operate globally. Yet this should not be overstated. Although State power is in principle territorial, a State’s jurisdiction can extend more widely (Picciotto, 1983; Picciotto 2011, pp. 34-50). As is well known, the US, in particular, makes extensive claims to extraterritorial jurisdiction over both US-based TNCs and others wishing to do business in the US. Conversely, although TNCs operate globally, with few exceptions they have an ultimate home State, as the term transnational suggests.

One source of the difficulty for governments in regulating TNCs is the fiction of corporate personality. A company is formally a separate legal person, even if it is a 100%-owned subsidiary of another. However, the law is sufficiently flexible to be able to disregard this fiction through doctrines on “lifting the corporate veil”, “single enterprise” or “organic unity” (Blumberg, 1983; Hadden, 1993). Indeed, a number of countries have adopted tax consolidation regimes at the national level (Ting, 2013). Thus, whether the concept of a separate corporate personality should be accepted or disregarded in any particular context is ultimately a political question.

The adoption of an enterprise approach is easier at the national than at the global level. Traditionally, international law is public law governing the relationships between States, whereas corporations are private legal persons and hence governed by national laws. However, the rapid growth of TNCs, especially since the 1950s, highlighted the tension between the global reach and visibility of TNCs and this dualist hierarchy of national and international law. The increasing size and importance of TNCs made them a prime target for regulation, in both home and host States, exposing them to multiple and sometimes conflicting regulatory requirements, which came to the fore in the 1960s. In a period of lively debate, a variety of proposals were advanced. Perhaps most radically, George Ball, one-time US Under-Secretary of State and United Nations representative, and subsequently

Chairman of Lehman Brothers International, proposed that TNCs should be treated as “citizens of the world” (Ball, 1967, p. 29; see also Ball, 1975). He argued that this was needed to resolve the “inherent conflict of interest between corporate managements that operate in the world economy and governments whose points of view are confined to the narrow national scene” (Ball, 1967, p. 28).

Ball’s suggestion did not gain much traction among TNC leaders. Instead, TNCs have preferred to take the position that they obey the laws of every country where they do business. This of course belies the reality that they are global actors, with the power to shape both national and transnational law. Avoiding designation as global citizens blunted the pressures in the 1970s for them to be subject to international obligations. This dissipated into the formulation of a variety of essentially voluntary codes of conduct.

At the same time, TNCs have been successful, by strategic lobbying, in securing rights and protections entrenched in national law, through international investment agreements (IIAs) and similar treaty networks. Tax treaties are even more effective in this respect than IIAs, in that their provisions normally are incorporated automatically into domestic law, which is not usually the case for IIAs. This creates a special tax regime within national laws for international income, so that the ability of States to change international aspects of their tax laws is constrained by international tax rules. The provisions of IIAs do not generally have this direct legal effect, but they do generally include international arbitration procedures for enforcing the rights of investors. These procedures have been used in a number of tax-related cases, which raises questions about the relationship between the two systems. Similar arbitration procedures are now being introduced in tax treaties, which would provide a double lock binding States to the international tax regime (Picciotto, 2016).

By contrast, the weakness of international tax coordination has meant that national laws for taxing TNCs have remained ineffective, largely because they are generally not based on the business reality that TNCs are unitary enterprises. The remainder of this section outlines how this came about, focusing mainly on the rules on transfer pricing, while showing that the issue is much broader than generally understood by this term.¹ The next section discusses how TNCs have exploited those rules and how this has affected their growth and structures.

¹ A fuller account is provided in Picciotto, 2018.

1.2. The development of tax rules for TNCs

International tax rules originated in the work of the League of Nations in the 1920s (Picciotto, 1992, ch. 1.4; Jogarajan, 2018). This laid the groundwork for the system that grew rapidly in the second half of the last century, built around a network of bilateral treaties, based on a model convention (Picciotto, 2013). The treaties allocate rights between States to tax income and capital, aiming mainly to facilitate international investment by preventing double taxation. Only more recently have the guardians of international tax begun to pay serious attention to how the rules can also ensure that companies pay tax where they have real economic activities.

The first model conventions were formulated through the League of Nations and agreed at a conference in 1928. At that time, international investment flows consisted mainly of portfolio investment through bonds and equity participation. Hence, it was agreed to allocate the primary rights to tax business profits (active income) to the country where the business was located, while the passive returns on investment (interest, dividends) should be taxed mainly in the country of residence of the investor.² This allowed a host country to tax the business profits of the local subsidiary of a TNC, or of a branch if it met the threshold for taxable presence, defined as a “permanent establishment”.

National tax authorities were already aware of the difficulty of determining the appropriate level of profits of the various affiliates of a TNC. The issue was put succinctly to the UK Royal Commission on Income Taxation in 1920 by Sir William Vestey, co-founder of a global food firm with cattle ranches in Argentina and worldwide beef sales:

In a business of this nature you cannot say how much is made in one country and how much is made in another. You kill an animal and the product of that animal is sold in 50 different countries. You cannot say how much is made in England and how much is made abroad.³

The issue was investigated in a study carried out for the Fiscal Committee of the League, coordinated by Mitchell D. Carroll (the US representative), with national reports from 27 countries (League of Nations, 1933). The Carroll report found that, although national tax authorities necessarily began from the accounts of the entities within their jurisdiction, they generally had broad powers to adjust these

² The distinction at the time was between “personal” taxes, such as the general income tax, and “impersonal” taxes, which in many countries were schedular, i.e. distinguished between different kinds of activity, including industrial and commercial business; for more detail see Jogarajan, 2018, ch. 3.

³ UK Royal Commission on Income Tax 1920, Minutes of Evidence and Final Report, CMD 615, p. 452, Question 9460. Having identified the weaknesses of international tax coordination, the Vesteyes became pioneers of international tax avoidance. Attempts to defeat the structures they established to avoid tax resulted in long-running legal battles in the UK in the 1930s (Picciotto, 1992, pp. 100-102; Knightley, 1993), and challenges in the Congress in Argentina in 1934 (Grondona and Knobel, 2017, p. 10).

accounts if the entities were under common ownership or control. This was seen as necessary to prevent “diversion” of income, recognizing that such entities were not independent. Resulting from this report, a provision was incorporated into tax treaties from 1935 to allow national tax authorities to adjust the accounts of related entities to ensure that their profits were in line with those of independent enterprises. Carroll reported that two methods were generally used: “fractional apportionment” of the global profits of the TNC, and “empirical” methods, attributing to the local affiliates a level of profit similar to that earned by comparable local firms (League of Nations, 1933, p. 12). This contradictory principle provided an uncertain foundation since, although the power to adjust accounts was premised on the understanding that related entities are not independent, the criterion for attributing profit was a comparison with similar independent enterprises. Table 1 outlines the successive stages of the attempts to apply this principle.

When it was formulated, the principle aimed to ensure an acceptable allocation of the profits of TNCs, focusing on the level of income declared. At that time, there was no internationally agreed guidance on how it should be applied. In the US, a statutory provision of 1928 gave tax authorities broad power to adjust the accounts of related entities as necessary “clearly to reflect the income”, and this provision has remained the same to this day, with only one amendment in 1986. Other countries enacted similar provisions, notably France in 1933, which has also remained unchanged, despite a recent recommendation to narrow its scope (France, Ministry of Finance, 2013), or used general anti-abuse rules. US regulations in 1935 defined the standard as that of “an uncontrolled taxpayer dealing at arm’s length with another uncontrolled taxpayer”, which has since been referred to as the arm’s length principle (ALP). However, for 40 years US court decisions considered that the allocation of profits should be “fair” or “reasonable”, and the ALP did not require any comparison with actual or hypothetical transactions between independent entities (Avi-Yonah, 1995).

The term “transfer pricing” was not used in the context of international tax until relatively recently. It emerged in the economic and accounting literature to refer to the criteria and strategies for pricing internal transfers between related entities within an integrated TNC group for management purposes. A seminal paper by Hirshleifer (1956) analyzed the strategy for pricing transfers of goods, which would lead profit centres to make decisions yielding the maximum profit for the firm as a whole. A literature survey in 1974 explained that “[t]he rationale for an internal pricing system is motivated by the presumed behavioural advantage of operating autonomous units in a decentralized firm in the absence of externally determined market prices for the internally exchanged commodities” (Abdel-khalik and Lusk, 1974). A study in the early 1980s showed that the policies adopted by TNCs surveyed reflected management strategies, notably the type and degree of integration in the firm (Eccles, 1985). Tax was not mentioned in these studies, except for the possibility

Table 1. From profit allocation to transfer pricing adjustments

	National measures	International activities
<p>1915-1968 Allocation of income of TNCs, based on broad powers to adjust accounts</p>	<ul style="list-style-type: none"> • UK, 1915: can assess related resident and non-resident entities based on percentage of turnover. • US, 1928: can reallocate income of related entities “to prevent evasion of taxes or clearly to reflect the income” (now s. 482 of Tax Code); regulations refer to the “arm’s length principle”. • France, 1933: can adjust accounts of entities under common control to restore “indirectly transferred” profits (now s. 57 of Tax Code). 	<ul style="list-style-type: none"> • League of Nations model treaties, 1928: State can tax business profits of a resident company and of the “permanent establishment” of a non-resident. • Carroll report, 1933: finds States use (i) “empirical methods” (e.g. standard profit margin as percentage of turnover), and (ii) fractional apportionment of TNC’s global profits. • League’s Fiscal Committee, 1935: adopts model provision allowing adjustment of profits if conditions between related parties differ from those which would have been made by independent enterprises.
<p>1968-1988 Focus shifts to adjustment of transaction prices, also applied to joint factors of production (capital, intangibles, risk management), instead of treating them as overhead costs to be shared. Application by US states (e.g. California) of global formulary apportionment creates backlash from non-US TNCs and political furore.</p>	<ul style="list-style-type: none"> • US Transfer Pricing Regulations, 1968: specify comparable uncontrolled price, cost-plus or retail-minus, with “other” methods as fall-back. • OECD Working Party, 1967: rejects US approach, deeming impossible the formulation of general rules for determining an arm’s length price. • Studies for US Treasury, 1973; Congress, 1981; IRS, 1984: show that in practice “comparables” are hard to find, frequent use of other methods. Congress urges Treasury to consider formulary apportionment. 	<ul style="list-style-type: none"> • Debate about power of TNCs, including transfer pricing, e.g. of drugs, results in report of UN Eminent Persons on TNCs, 1974. OECD Council calls for report on transfer pricing. • OECD Committee on Fiscal Affairs Report on Transfer Pricing, 1979: largely recommends approach of the US regulations of 1968.
<p>1988-1994 Emergence of OECD Transfer Pricing Guidelines (TPGs)</p>	<ul style="list-style-type: none"> • US Tax Reform, 1986: adds “commensurate with income” test to s.482. • Treasury White Paper, 1988: proposes a new profit attribution method, creating conflict at the OECD, resulting in a compromise to add the Transnational Net Margin Method (TNMM) and profit-split methods. 	<p>OECD adopts TPGs, 1995: adds the two new approved methods, but rejects formula apportionment and emphasizes case-by-case analysis.</p>

Table 1. From profit allocation to transfer pricing adjustments (Concluded)

	National measures	International activities
<p>1995-2015</p> <p>Entrenchment of the TPGs and the independent entity principle.</p> <p>Regulations based on TPGs adopted worldwide, first by OECD countries, then emerging economies, and finally developing countries.</p>	<ul style="list-style-type: none"> • OECD countries adopt regulations, mostly based on the TPGs, though some (e.g. France, US) retain broad statutory power. Only Brazil (1998) opts for a simplified method applying fixed margins. India's adoption of the TPGs (2001) creates a litigation explosion. • Growth of 'cognitive community' of transfer pricing specialists. • Base Erosion and Profit Shifting (BEPS) Action Plan includes work on transfer pricing, perhaps going beyond the arm's length principle, though rejecting formulary apportionment. 	<ul style="list-style-type: none"> • OECD reviews, 2008-10: further entrench ad hoc approach and focus on transaction pricing and comparables, neglecting profit split. • Continual increase of international conflicts and the time taken to resolve them. • BEPS reports, 2015: still emphasize starting from transactions, though with strengthened powers to recharacterize them, adding further uncertainty and complexity.

Sources: Avi-Yonah, 1995; Durst and Culbertson, 2003; Picciotto, 1992, 2018.

of an internal tax used as a managerial strategy. The focus was on the pricing of goods, and the objective was to set prices that would incentivise managers of production units to remain competitive with outside suppliers, while ensuring that the firm retained the advantages of integration.

Concerns about transfer pricing in the context of international tax emerged in the 1970s, on account of two main drivers. The first came from US initiatives to amend the country's international tax rules, begun under the Kennedy administration. US TNCs had been able to finance their rapid expansion in the post-war period through retained earnings, avoiding controls on capital movements, as well as structuring their foreign operations to minimize tax (see Picciotto, 1992, ch. 5, and section 2.1 in this paper).

The government adopted a dual approach in response. First, rules were proposed to tax the worldwide income of TNCs with US parents, by including the business income of "controlled foreign corporations" (CFCs) in that of their parent, while allowing a credit for foreign taxes paid on such income. This approach treats TNCs as unitary enterprises, disregarding intra-firm transactions, thus rendering the terms of such transactions largely irrelevant for tax purposes. Also, it taxes such consolidated profits at the higher of the host or home country rate, thereby removing the incentive for host countries to reduce their tax rate to attract investment by US TNCs. In response to business pressure, the proposals were watered down when enacted by the Congress in 1962, to cover only the "passive" income of CFCs in low-tax countries.

This put greater weight on the complementary proposals for new regulations on the allocation of income, which were finally enacted by Congress in 1968. These regulations were detailed and prescriptive, aiming to strengthen the ALP and focusing on the pricing of all transactions between related entities, not only physical goods. They specified the use, where possible, of the “comparable uncontrolled price” (CUP) method and otherwise either cost-plus (production costs plus an appropriate profit margin) or retail-minus (the sale price to an unrelated party minus a gross profit margin covering costs and an appropriate profit). However, as a fall-back, other methods for allocating income could be used.

This approach, based on finding “comparables” for transaction prices, was widely criticized. It was rejected as unworkable by the OECD Committee on Fiscal Affairs, based on a report by the UK and the Netherlands (OECD, 1967a). US commentators analysing the implications of the regulations for the allocation of taxable profits began to deploy the concept of transfer pricing, generally used transitively and in a pejorative sense. An insightful article by Peggy Musgrave (1972) considered how best to “assign profits of the international business unit among countries according to some consistent and meaningful index of profit-creating capability” (Musgrave, 1972, p. 399). She concluded that “[t]he more extensive are business interdependencies, the more necessary it becomes to take a unitary view of the enterprise and to attribute profits on a formula apportionment basis” (p. 407). Academic opinion generally supported this view, pointing out that TNCs “enjoy considerable freedom from market constraints in setting transfer prices for intercompany transactions in goods and services”, and that this can be used for “income shifting” to avoid tax, while there are also “many important non-income tax influences on such decisions” (Anon., 1976, p. 1203). Indeed, studies done for the US Treasury (1973), the Congress (1981) and the Internal Revenue Service (IRS) (1984) showed that true comparables were hard or impossible to find, and the IRS in practice made extensive use of other methods (summarized in Picciotto, 1992, p. 198).

As the criticisms in the US of the transactional approach grew, however, the other OECD countries shifted towards accepting it. This was on account of the second factor that fed concerns in the 1970s about transfer pricing in international tax – the political debate about the power of TNCs. Transfer pricing abuse was identified as a technique used by TNCs to undermine national State regulation, including not only tax but other areas such as exchange controls and technology transfer, notably in the pharmaceutical industry (Lall, 1973), with some highly publicized cases such as that of Hoffmann-La Roche (UK Monopolies Commission, 1973). The United Nations set up a Group of Eminent Persons to produce a report on TNCs, and this included recommendations on taxes: to enforce the ALP and to elaborate rules on transfer pricing, preferably by international agreement (UN, 1974). This task was taken on by the OECD’s Committee on Fiscal Affairs.

In parallel, a major international dispute arose over the application by US states, notably California, of their state taxes by applying formulary apportionment to foreign-owned affiliates on a worldwide basis. This created conflict with European and Japanese TNCs, expanding into those states. They were supported by governments at the highest level, resulting in aversion to formulary apportionment of TNC profits (Picciotto, 1992, ch. 9). This reinforced the view of international tax specialists that a more global approach to the question of allocation of TNC profits would be difficult due to political constraints. Hence, they concluded that it should be dealt with pragmatically, as had the Carroll report in 1933.

It was therefore no surprise that the report on transfer pricing produced by the OECD Committee on Fiscal Affairs (OECD, 1979) recommended an approach largely based on the 1968 US regulations and rejected formulary apportionment. There was no consideration of the broader issue of TNC tax avoidance, particularly the abuse of tax treaties through intermediary companies in tax havens. This had separately been referred to the Committee in 1962 by the US, and a working party of US and Danish representatives had reported on measures to counter the use of “base companies”, including provisions such as the US rules on CFCs (OECD, 1967b). No recommendations emerged at that time, and these issues were not mentioned in the report on transfer pricing of 1979. Reports on the use of base and conduit companies were eventually issued in 1986 (see section 2.1).

Continuing concern in the US about the ineffectiveness of the transfer pricing regulations led the Congress to amend section 482 (for the first time since 1928), by adding a requirement that payments for intangibles transferred to foreign affiliates of US TNCs should be “commensurate with [the] income” they generated. It also urged the Treasury to carry out a full review of transfer pricing. Avoiding international controversy, the Treasury set its face against formulary apportionment, but it restricted use of the CUP to exact comparables and proposed a comparable profit method to apply a benchmark rate of return to capital assets or another suitable base (Durst and Culberston, 2003, pp. 71-2). However, this would attribute relatively low profit margins to foreign affiliates of US TNCs, so it led to conflicts at the OECD in the early 1990s.

The OECD Transfer Pricing Guidelines (TPGs), finally produced in 1995, recommended five transfer pricing methods, including a version of the US’s comparable profits method, called the transactional net margin method (TNMM). They also provided for a profit-split method, which could be especially useful where comparable transactions between independent parties could not be identified or where the related-party operations were highly integrated. This would allow apportionment to affiliates in host countries of some of the profits from economies of scale or other synergies. Although clearly involving apportionment, the Guidelines described it as a “transactional” method, and firmly rejected apportionment based on a general formula.

The TPGs emphasize the need for a case-by-case analysis to choose the most appropriate method and determine how to apply it. This retained flexibility for national tax authorities, but it also put tax authorities on a very unequal footing with TNCs' tax planners.

1.3. The arm's length principle: global standards and national sovereignty

The approach thus adopted preserves a nominal sovereignty for each national administration to decide how to adjust the accounts of local affiliates of TNCs, while avoiding overt public debate over the criteria for the allocation of profits. Determining such criteria has always been regarded by technical specialists as too contentious to be done by public or political methods. Hence, transfer pricing has become the preserve of a closed community of technical specialists.

The TPGs require an analysis of the "facts and circumstances" of each case, to identify the functions performed, assets deployed, and risks assumed by each entity, referred to as "functional analysis" (Andrus and Collier 2017: para. 3.26 et seq.). Hence, the transfer pricing methodology must be tailored to each individual taxpayer. Indeed, the main reason given for rejecting "global formulary apportionment" is that it would allocate the global profits "on the basis of a predetermined and mechanistic formula"; this is, however, distinguished from "application of a formula developed by both tax administrations in cooperation with a specific taxpayer or [multinational enterprise] group after careful analysis of the particular facts and circumstances" (OECD, 2017, para. 1.17). This pragmatic approach depoliticizes the issue by converting it from one to be addressed directly in terms of broad principle to a technical one to be dealt with on a case-by-case basis.

This ad hoc approach creates considerable administrative problems, as well as uncertainty, for both taxpayers and administrations. These fall more heavily on tax authorities, due to the disadvantages of information asymmetry. Although the formal legal burden is usually on the taxpayer to justify its accounts, in practice the reverse is the case. If the taxpayer prepares and documents a transfer pricing structure, usually with the help of a specialist team of advisers, the tax authority cannot challenge it without carrying out a detailed analysis. Thus, the beneficiaries have been the growing legion of transfer pricing specialists.

The problems caused by the ALP have been exacerbated by its extension beyond the transfer of physical goods, begun by the US regulations of 1968 and adopted and extended in the 1995 Guidelines. This extension meant that joint factors of production (capital, technology, central services, risk management) should not be treated as overhead costs to be shared, but transfers to be priced by reference to the ALP (Langbein, 1986). These issues continue to confound the application of the ALP (Andrus and Collier, 2017, ch. 6), since they are core centralised functions

in TNCs. TNCs have a central treasury function that closely controls the allocation of funds within the group. Research and development, though taking place throughout the firm, is closely coordinated, and technology and know-how are shared. Risk is ultimately borne by the parent company and its shareholders, who always, in practice, stand behind the liabilities of wholly owned subsidiaries. From the perspective of studies of international business, it makes no sense to treat the responsibility for such activities as being genuinely borne by different legal entities within a TNC corporate group. Yet the entrenchment of the ALP normalized this understanding for tax purposes.

The TPGs are far from legally binding (see Picciotto, 2018), but they have attained a canonical status. Their publication in 1995 led to an increasingly widespread adoption by countries of transfer pricing measures, becoming a veritable torrent from 2010, so that now such rules are in place in almost every country worldwide.⁴ The ripple effect is understandable. Since countries want to be seen to defend their tax bases, but not in ways that might significantly deter foreign investment, the adoption of a global standard seems politically sensible. The announcement of new rules, and especially increased enforcement by any State, would lead TNCs to take steps to ensure that their accounts would stand up to this scrutiny, which is likely to result in a short-term increase in tax revenues for that State. Other countries naturally fear this increase in revenues would be at their expense, so they follow suit. Nevertheless, although it is understandable that OECD countries in the early years after 1995 should have followed the consensus expressed in the TPGs,⁵ it is more difficult to explain the continuing adherence to them, and the policy advice that continues to be given to developing countries that they should follow the OECD approach, despite its evident limitations.

Clearly, TNCs have greatly benefited from the establishment of the ALP as a global standard. It allows them to proclaim their adherence to the rules as good citizens in every country where they do business, while dominating the arenas where those rules are defined and interpreted – nationally and supranationally. Within this overarching structural determinant, the widespread influence of the TPGs seems attributable to three main factors.

⁴ Surveys are regularly published by the Big Four accounting and consultancy firms; a database under development is on file with the author.

⁵ With the notable exception of Brazil, see further Picciotto, 2018.

First is the power generated in a policy community by the formulation of techniques for professional practice.⁶ Especially where a market exists or can be created for such professional practices, enormous investments pour into their refinement and dissemination. Certainly, the field of transfer pricing quickly became an important field of specialization from the 1980s, with an increasing proliferation of specialist courses and publications, and the creation of practice groups in the large global legal and corporate advice firms, as well as the emergence of smaller boutiques offering more specialist techniques such as micro-economic analysis. The epistemic perspectives created in such a field of private practice tend to also pervade the public sector, due to the intermingling of personnel in professional interactions, and career paths through the “revolving door” between the private and public sectors.

The path dependence of policy formation created by these investments in intellectual capital makes it very hard to reform such a field, unless it is disrupted by an exogenous shock. Yet dominant views are strongly protected from such shocks as a result of the increasing gap between the simplistic slogans that dominate public discussion and the technicist terms in which specific policy prescriptions are discussed.⁷ Politicians and others who dominate policy debates in public arenas either have little understanding of the technical details, or gloss over them in their public pronouncements. The difficulty for outsiders to understand the issues is exacerbated by the cloak of secrecy due to the tight confidentiality rules, arcane jargon and increased complexity created by professional practices.

Second, this type of closed policy community can become institutionalized in ways which make it hard for external political pressures to change. Again, transfer pricing is a good example, since its practice became embedded in the OECD, which is the main intergovernmental organization for the formation and diffusion of business and corporate regulatory practices. The OECD has special power in such fields because, although an intergovernmental organization, its work is considered non-political. It operates by developing a consensus around such governance practices, which provide the underpinning for formal international norms, some of which it also formulates. Once its Committee on Fiscal Affairs (CFA) became the driver for developing the formal tax treaty framework in 1956, the OECD became the main institutional focus for managing the tensions generated by that system. The central concern of governmental specialists, going back to the 1930s, has been

⁶ This analysis draws on a variety of social science research efforts on the shaping of markets through professional practices: some based on social studies of science emphasising ‘performativity’ (e.g. MacKenzie, 2006), and others in international political economy on the role of epistemic communities or cognitive capitalism (e.g. Adler and Haas, 1992; Adler and Bernstein, 2005; Dezalay and Garth, 2001), as well as work on the interpretive practices of lawyers (see Picciotto, 2015). The role of ‘cognitive capture’ in the development of the ALP in transfer pricing has also been pointed out by Langbein (2010).

⁷ For a discussion of technicism in global governance, see Picciotto, 2011, pp. 23-24.

to attempt to prevent public disagreement about the allocation of profits of TNCs, by maintaining some consensus on the apparently non-political techniques for dealing with the issue. Whenever political concerns have been awakened about the taxation of TNCs, the task of developing solutions has been passed to the OECD.⁸ This occurred in 1976, 1990 and 2012, and each time the technical specialists responded with further refinements to the ALP.

Third, the formulation of the normative understandings of such professional communities in documents such as the TPGs enables their rapid global diffusion. Thus, the TPGs and any changes adopted to them, once rubber-stamped by the OECD Council, can be effective immediately, unlike changes to a model treaty, which need governmental approval and bilateral negotiation. This is what makes such specialist communities and international soft law central to global governance (Picciotto, 2011).

These factors perhaps help to explain the central paradox of transfer pricing: the almost universal acceptance of the ALP, despite its known and often admitted defects, together with the continuing elaboration of increasingly complex and imprecise methods for its application in practice. The TPGs are far from providing a clear and practical basis for transfer pricing. They result from discussions among the government transfer pricing delegates to Working Party 6 of the OECD, and their style is discursive, that of a report rather than rules or even guidelines for application. Nevertheless, they specify the approach that must be adopted, although leaving considerable leeway for choosing among the five approved methods and how they should be applied. In practice, enforcement has been restrained, especially in poor countries reliant on inward investment, by two factors: the enormous resources needed and the concern not to damage inward investment.

On account of their subjective nature, the introduction of transfer pricing rules based on the TPGs and their increased enforcement, especially in the past 10 years, has led to an increase in international tax conflicts (the majority about transfer pricing), and in the time taken to resolve these disputes (Picciotto, 2016).

⁸ The CFA operates through Working Parties of member State representatives, the most important being WP 1 on tax treaties and WP 6 on transfer pricing. The OECD officials providing support are often seconded from or former members of national tax authorities, but some come from the private sector, or more often go there after a stint at the OECD. Notably, the international law firm Baker McKenzie recruited the top two OECD officials responsible for transfer pricing to its international tax department in 2011, one who had gone from the same firm to the OECD in 2005, and was earlier in the US Treasury. In 2018, the official who had been divisional head for tax treaties and transfer pricing (for only two years) left, and quickly joined a top Washington DC law firm, and it was reported that his successor is a former head of global tax at Amazon.

2. Exploitation of the rules by TNCs and reform attempts

The failure to adopt a coordinated international approach to TNC taxation encouraged TNCs to refine their exploitation of the independent entity principle. This resulted in the creation of complex structures, so that the largest TNC corporate groups have hundreds of affiliates. Analysis by UNCTAD shows that although only 1% of TNCs have over 100 affiliates, these TNCs account for over 60% of value added by TNCs, and that the largest 100 TNCs have some 55,000 affiliates between them (UNCTAD, 2016, pp. 134-5).

2.1. The evolution of avoidance structures

Basic tax avoidance techniques consisted of creating “base companies” in low-tax jurisdictions or tax havens, to own assets such as intellectual property rights or act as financial or servicing hubs. The deduction of royalties, interest and fees reduces the taxable business profits of operating affiliates, and those payments are channelled through conduit entities in countries with suitable tax treaties (to reduce withholding tax at source) to be retained tax-free by the base company (see Figure 1).

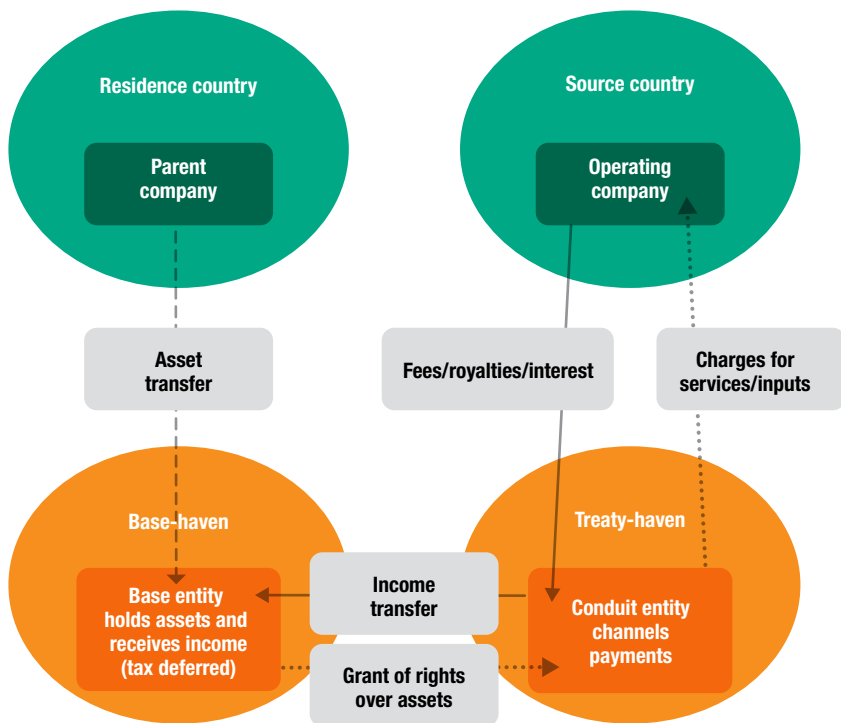
Such “stepping stone” structures were described in reports from the OECD’s Committee on Fiscal Affairs on base and conduit companies in 1986 (as mentioned in section 1.2). These reports provided suggestions for counter-measures in national law and in treaties, including CFC rules, which led to some OECD countries adopting similar measures. However, these measures were limited and ineffective, the results of business lobbying on key elements such as the definition of “passive” income,⁹ and of competition to attract corporate headquarters.¹⁰

It is noteworthy that these devices make relatively little use of manipulating the prices of transfers of physical goods, although this can be problematic, especially where the goods embody specialized technology. The central techniques involve relocating the ownership of intangible assets as well as responsibility for financial or service activities. These are obviously easily attributable to an entity located anywhere, so they are sometimes referred to as “mobile”, although a better term would be “virtual” since such entities may have few or no employees. Thus, the

⁹ A key provision in the US law has been the “active finance” exemption, which has been the target of fierce lobbying by US firms, especially General Electric (Gerth and Sloan, 2011).

¹⁰ The US rules were weakened in the 1990s by “check-the-box” regulations, which allowed subsidiaries to be treated as “disregarded” for tax purposes and became totally ineffective after 2006 when Congress enacted a “look-through” rule (US Senate, 2013, pp. 6-7). The UK largely abandoned its CFC regime in 2012, one of several moves in joining in tax competition with countries such as Ireland and the Netherlands.

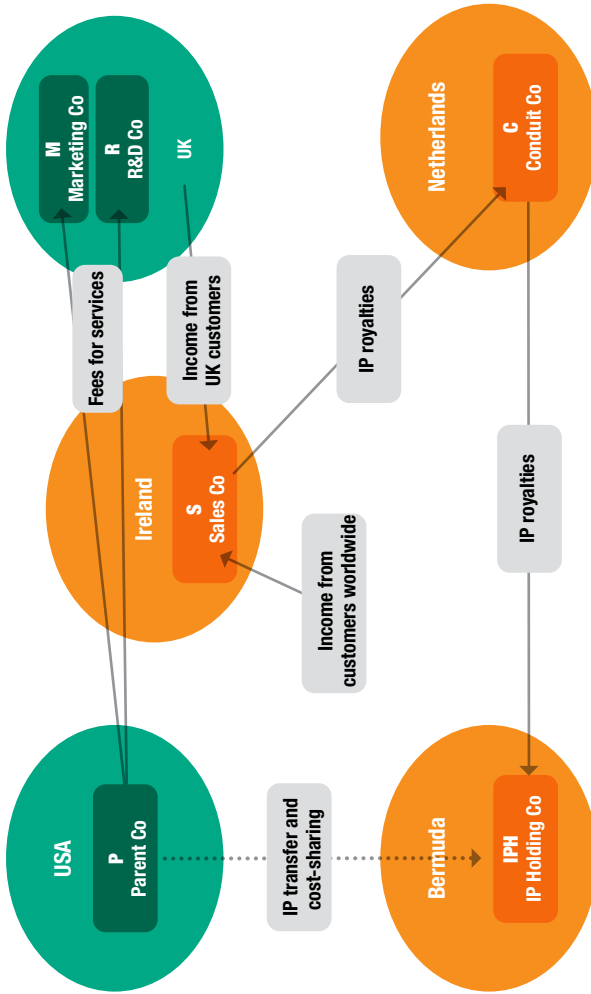
Figure 1. Basic ‘stepping stone’ tax avoidance structure



use of “offshore hubs” became a key element in the structures of the largest TNCs (UNCTAD, 2016).

Following the 1995 Guidelines, the design of TNC structures aimed at tax avoidance became even more complex. The Guidelines emphasized the need for a “functional analysis” of TNC groups, and the attribution of profits on the basis of the functions performed by each entity. Hence, tax advisers devised structures that fragmented TNCs’ business among different functions, so that key functions that add high value could be attributed to entities whose profits would be lightly taxed. This became simpler as improvements in communications, and then digitalization, made it easier to manage global value chains. Affiliates whose profits are subject to high tax rates are treated as performing “low-risk” production, distribution or even research functions, and are attributed “routine” rates of profit, usually applying a “one-sided” transfer pricing method (cost-plus, resale-minus, or the TNMM). A standard type of structure is illustrated in simplified form in Figure 2.

Figure 2. Stripped risk structures and the double Irish-Dutch sandwich



The US parent (P) transfers rights to intellectual property (IP) to a company formed in Ireland but controlled from and therefore treated under Irish law as resident in Bermuda (IPH). IPH has a cost-contribution contract with P to help finance further development of the IP from its future income, to justify the original sale of the IP under US transfer pricing rules. Another company (S) both formed and controlled in Ireland receives large income flows from sales generated worldwide (e.g. from advertising). However, the net profits of S are low, because it pays large royalties for the IP rights. These are channeled through a conduit company C in the Netherlands, which deducts a small handling charge and pays the bulk of the IP royalty income to IPH; no withholding taxes are levied by the Netherlands, as IPH is treated as Irish, while Ireland treats it as resident in Bermuda. Although customers in countries such as the UK deal with another local affiliate company M, it is treated as providing only marketing or other customer support services; the actual sales contracts are concluded with the Irish sales company. In addition to M, P also has other affiliates in the UK (and elsewhere) performing various functions (marketing, customer support, research and development (R&D), even production), but they are treated as low-risk contractors and remunerated with a routine level of profit by P, with such fees reducing its taxable profits in its home country.

Such strategies were further facilitated by competition between countries to offer tax inducements to attract the supposedly high-value activities, e.g. Belgium for shareholding companies, the Netherlands for holding intellectual property rights, Luxembourg for finance, and Switzerland for commodities dealing and distribution management.

2.2. Reform initiatives: the BEPS project

Concern expressed especially by France and Germany about international tax avoidance and evasion led to an initiative in 1996 by the G7 leaders, who referred the problem to the OECD tax experts. The resulting report, *Harmful Tax Competition* (OECD, 1998) resulted only in a voluntary Code, monitored through peer review, and an initiative to improve bilateral exchange of information for tax purposes (Avi-Yonah, 2009).

A decade later, the fiscal pressures resulting from the financial crisis of 2007-8 renewed these concerns, with a sharper spotlight on tax avoidance by TNCs, due to reports from civil society organizations and increasing media attention. Parliamentary inquiries proliferated (e.g. Bocquet and Dupont-Aignan, 2013; US Senate, 2013, 2014; UK Parliament, 2013), and influential academic studies analysed the problem of “stateless” or “homeless” income (Kleinbard, 2011; Wells and Lowell, 2011). The G20 leaders gave political support to an action plan on base erosion and profit shifting (BEPS), again initiated by the OECD’s tax experts (Picciotto et al., 2017).

The G20 called for reforms to international tax rules to ensure that TNCs could be taxed “where economic activities occur and value is created” (G20, 2013). This implied a shift towards treating TNCs as unitary firms, and it was reinforced by the G20’s request for “a common template for companies to report to tax administrations on their worldwide allocation of profits and tax”. The OECD’s tax experts initially assimilated this into the existing work on improving transfer pricing documentation, until it became clear that such country-by-country reports had a very different purpose: to provide each concerned tax authority with an overview of the firm as a whole.

Agreement on the form of this template was a major achievement of the BEPS project. It establishes, for the first time, a global system to provide information, listing all the affiliates of TNC corporate groups with turnover greater than €850 million, and quantifying their assets, employees, profits, and taxes paid in each country. A rigorous peer review procedure has been established to monitor implementation, and the system will provide a key tool for assessing whether and how far tax rules succeed in aligning profits and tax with the location of activities and value creation. Since the reports, at least for now, are to be available only to the

relevant tax authorities, this assessment would guide only them, although plans are afoot to publish aggregated data. The availability of these reports, which may be extended to a wider range of TNCs and perhaps be made public when the system is reviewed in 2020, may prove transformative in the practice of TNC taxation.

However, much of the BEPS Action Plan outcomes resulted in a patch-up of existing rules.¹¹ In particular, although the BEPS project resulted in extensive revision and expansion of the TPGs, this made them more complex and, in many respects, more obscure and difficult to apply. The starting point for transfer pricing audits is still the fictitious agreements between associated enterprises, even if unrelated parties would not have entered into such transactions. Although the revised TPGs now give tax authorities powers to disregard those transactions, to do so they must conduct a factual analysis to determine whether the actual conduct of the parties diverged from the formal contractual arrangements, and they must show that they were commercially irrational. The most authoritative account yet published, co-authored by a leading private practitioner and a former OECD Secretariat official responsible for the work on transfer pricing during most of the BEPS project, is understated but highly critical. It shows how, due to disagreements among participants in the BEPS project, the TPGs have become even more obscure, and concludes that the result has been to make the transfer pricing process “far more complex”, mostly due to the “level of factual detail” now required for the functional analysis (Andrus and Collier, 2017, especially paras. 7.70-71).

2.3. Continuing efforts

The BEPS project is far from finished, as work continues on its most important and most difficult action point, the tax consequences of the digitalization of the economy, as well as monitoring the implementation of the agreed measures. Participation in this continuing work was opened up by the G20 to all States, creating an Inclusive Framework for BEPS, now with 116 members. This consolidates the OECD's domination of technical standard-setting and creates a de facto global tax body.

The implications of digitalization had been considered over a decade earlier by the OECD, when the concern was e-commerce. The resulting reports (OECD, 2005) concluded that information and communication technologies and the internet

¹¹See Picciotto et al., 2017. The report on BEPS Actions 8-10 (OECD, 2015) included revisions to chapters I, II, VI, VII, and VIII of the TPGs, which were incorporated into the version issued in 2017, which is now over 600 pages long. All the final reports on the BEPS Action Plan are available at <http://www.oecd.org/ctp/beps-2015-final-reports.htm>.

would have profound effects on business models, but they did not require major changes to international tax rules, particularly the guidance on transfer pricing. This provided encouragement for digitalization to be further deployed to facilitate tax avoidance structures.

A decade later the issue was made Action 1 of the BEPS project. The 2015 report presented an analysis which stressed that digitalization was affecting the whole economy, so that its tax consequences could not adequately be dealt with by measures aimed at a demarcated digital sector. It made no recommendations, but only identified some interim measures which States might consider adopting, consistent with their international obligations. The OECD asked for, and was given, a further five years to produce a final report, but this work quickly became more urgent as several States moved to adopt measures and the European Commission put forward proposals for coordinated EU action. An interim report in March 2018 again argued that ring-fenced measures are not appropriate, stressed the progress made to adapt indirect taxes on sales to e-commerce, and analysed unilateral measures taken by States (OECD, 2018). A final report is expected before 2020.

This work has reopened consideration of the two basic concepts underlying international tax rules: the threshold for taxable presence, and the criteria for allocating the tax base. Proposals made on both these issues are far-reaching, and adequate solutions would require significant and comprehensive reforms. Yet, by the same token, reaching agreement on such a solution is a daunting task, especially as it requires consensus among a large number of States, for which tax remains central to their formal sovereignty. It is hard to see how this could come about unless the largest TNCs themselves accept that they have a responsibility as global citizens to contribute to a constructive solution.

2.4. Alternative approaches

Throughout the history of international taxation, it has been understood that the most effective approach to the allocation of taxable income of TNCs is to treat them in accordance with the business reality that they are unitary firms. Three methods have been put forward that adopt such an approach (for further details, see Picciotto, 2017, ch. 2). Each has advantages and disadvantages, but any of the three would provide a sounder foundation than the current dominant approach.

One is residence-based worldwide taxation. This would apply home country tax directly on a current basis to the consolidated worldwide profits of a corporate group, but with a full credit for foreign taxes paid. This would in effect treat all foreign affiliates on a full-inclusion basis as CFCs. This was the approach proposed in the US, introduced in much weakened form in 1962, and which some commentators continue to advocate (e.g. Fleming et al., 2014). Indeed, strengthening CFC rules

was one item in the BEPS Action Plan, supported by the US, but States could agree only on very modest recommendations. However, the US tax reform of 2017 largely abandoned its CFC regime, moving to a primarily territorial system, but with targeted measures against erosion of the home country tax base. Other States have also moved away from this approach, though some still retain it (for example, Brazil). It also faces significant practical difficulties, particularly in specifying the home country, which makes it easier to avoid by moving corporate headquarters to low-tax jurisdictions.

A second, which was actively debated in the US from mid-2016 to late 2017, is the destination-based cash flow tax. This would in effect be a unitary approach, since internal transfers within a corporate group are ignored: the tax base is defined in terms of sales to third parties, and it is apportioned among the countries of destination of those sales. However, the reasons for this proposal seem to have been peculiar to the US (the US has no federal value added tax, and this would be economically similar to such a tax), and despite influential support the idea now seems to have been largely abandoned (Shaviro, 2018).

The most comprehensive approach would be unitary taxation with formulary apportionment. As mentioned above, “fractional apportionment” was applied by some States from the beginning and is still permitted under many tax treaties, although firmly rejected by the OECD Guidelines. It has also long been used within some federal systems, notably in the US, and is now proposed for regional adoption within the EU, in the form of a common consolidated corporate tax base. The superior conceptual basis for this approach is widely accepted. The main objection is the political difficulty of reaching agreement among States on its key components: the definition of the tax base and the formula for allocation.

In turn, major obstacles to such a political agreement are clearly the economic power of TNCs and their role as transnational actors. The public concerns about their international tax practices that emerged following the financial crisis has caused them reputational damage, which prompted politicians to proclaim the need for international solutions. This has resulted in a tightening of rules around the world, which is likely to greatly increase the costs of both tax compliance and tax planning. It remains to be seen whether these factors will prompt TNCs to lend active support to a search for a comprehensive approach based on unitary taxation.

3. Conclusions: integrating tax into the understanding of TNCs

It seems clear that the continual claims of TNCs that they simply obey the laws in every country where they do business are disingenuous. As global actors, they are highly effective at lobbying both at the national level, and even more so in

international fora, to obtain rules that they consider suitable. From this perspective, they have been highly successful at securing a framework for international tax that provides strong protections against “double taxation” while leaving considerable leeway and loopholes that can be exploited for tax avoidance. Thus, they devote considerable resources, both to helping to formulate the rules and to devising strategies to shape the interpretation and application of those rules.

More specifically, the international tax avoidance strategies outlined here give many of the largest TNCs considerable competitive advantage over purely national firms, as well as the large universe of TNCs that are small or less willing to devote resources to international tax planning. These strategies have the effect of ensuring low effective tax rates on retained earnings, which provide large pools of cash under the control of senior managers and executives. These resources can be used for further expansion, often through acquisitions, which reinforce the oligopolistic positions of these giant firms. They are also used for share buybacks, which have contributed to the “financialization” of the large corporation. This has been beneficial to the top executives whose remuneration has been substantially dependent on the share price, but damaging to productivity and employment (Lazonick, 2012-13, 2014).

The example of international tax also raises broader questions for the understanding of both the dynamics behind the growth of TNCs and the forms they have taken. As regards the reasons for their growth, the theories of “internalization” pointed to the balance between the problems posed by managing large firms with worldwide operations and the economic advantages derived from economies of scope and scale, and business synergies. It seems, however, as pointed out by Grazia Letto-Gillies (2012, ch. 14), that the exploitation and management of regulatory differences have also been an important factor in the growth of TNCs, especially since the 1980s. Strategies for international tax avoidance are an important type of such regulatory arbitrage. As explained in this paper, these strategies go far beyond the manipulation of transfer prices.

For some firms, tax avoidance and regulatory arbitrage have become major elements in their growth dynamic. As the tax rules on allocation of income became focused on the pricing of transactions, the business literature began to consider tax minimization as one of the factors in setting transfer pricing policies, while noting that what can be considered an arm’s length price is a grey area (e.g. Barrett, 1977). Increasingly, tax considerations became an important factor in determining transfer pricing, rather than the concerns of optimising the firms’ business strategy and performance. Now researchers construct complex models to try to take all factors into account (e.g. de Matta and Miller, 2015; Gao and Zhao, 2015). This assumes that managers of profit centres are judged on post-tax returns, which would encourage them to build tax avoidance as well as operational factors into

their decision-making. Alternatively, of course, firms can separate managerial incentive structures from their central tax planning strategies.¹²

A leader in adopting an aggressive tax planning strategy was General Electric (GE) in the last decade of the twentieth century.¹³ Under a former US Treasury official, appointed in 1988, GE built an international tax department of close to 1000 specialists, many of them former government officials (Kocienewski, 2011; Sloan and Gerth, 2011). Closely tied to the creation of GE Capital as its financing arm, GE's tax strategy was integrated with its business decision-making, and combined lobbying for suitable tax rules with devising structures to minimize its taxes worldwide (Gerth and Sloan, 2011). This clearly played a key part in fuelling a range of acquisitions which built GE, under CEOs Jack Welch and then Jeff Immelt, into a global conglomerate. GE even claimed to combine performance with corporate responsibility, at least by avoiding major scandals such as occurred at Enron and Walmart. This was perhaps attributable to the skills of its legal department which, under Ben Heineman in the same period as Samuels, grew even larger than the tax department, with over 1200 lawyers in over 100 countries (Gordon, 2017: 1754). One leading commentator argues that this suggests that in-house lawyers may be more effective in shielding a firm from reputational damage than as guardians of responsible corporate behaviour (Gordon, 2017: 1760).

After a decade of erratic performance, the wheels finally came off this finance-driven growth when GE Capital was hit by the financial crisis (Colvin, 2018), leading to a decision to divest it. GE outsourced its tax planning functions by transferring some two-thirds of its tax team to PwC (Schwanke, 2017), joining what is claimed to be one of the world's largest corporate tax networks of 41,000 specialists in 157 countries (PwC, 2017). This does not necessarily signal a major shift in GE's tax planning strategy, but rather attests to the ability of PwC and the other Big 4 accounting and consultancy firms to offer such services to TNCs more generally.

Thus, in addition to contributing to the global power of the largest TNCs, tax considerations have also affected the structures they have adopted. Tax avoidance was one element of the emergence of the system of offshore finance and secrecy since the late 1950s that was closely tied to the post-war expansion of TNCs, and it was later a key factor in financialization (Hampton and Abbott, 1999; Picciotto, 2011, ch. 7). Tax and financial engineering are clearly central to the strategic management of large TNCs. More recently, the encouragement provided by the

¹²This topic seems under-researched, I am not aware of any recent surveys of management practices comparable to that of Eccles (1980); the issue is discussed in the UN Manual (UN 2017, section A4).

¹³Although GE was exceptional, others also restructured their operations around tax minimization strategies of different kinds, often devised by, or in conjunction with, one of the Big Four, e.g. Caterpillar (US Senate, 2014).

ALP for functional fragmentation seems to have contributed to the increased importance of the management of global value chains. These factors have driven the restructuring not only of individual TNCs, but whole industries. For example, tax and regulatory avoidance and evasion were key strategies for Marc Rich in building Glencore, which together with other trading firms such as Trafigura and Vitol, became dominant in the extractive industries.

At the centre of today's debate about the need for international tax reform are the large internet-based companies. Their growth and dominance can be attributed not just to technological leadership, but to their ability to use tax avoidance strategies to generate lightly taxed revenues to finance their expansion. This has involved creating new business models disrupting a range of sectors including travel and tourism, retail, taxi services and entertainment (Casella and Formenti, 2018). A significant factor in their growth is clearly their ability to avoid not only tax in host countries, but also other regulation such as licensing requirements and employment laws.

Analysis of these changes clearly requires the integration of a greater understanding of international tax into the study of TNCs.

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Act of creation: the OECD/G20 test of “Value Creation” as a basis for taxing rights and its relevance to developing countries

Michael Lennard*

This paper examines the use of the “value creation” concept that plays a central role in current OECD/G20 and European Union taxation work as a way of determining the taxation rights of countries, especially in the increasingly digitalised economy. It examines the likelihood of a consensus on whether it is an appropriate test, particularly with a view to the interests of developing countries. It also notes the need for such countries to ensure that their “policy space” in corporate taxation that is based on the place of consumption is not unduly limited by these developments.

Keywords: BEPS, Base Erosion and Profit Shifting, developing countries, digital economy, multinationals, policy space, taxation of multinationals, tax treaties, transfer pricing, value creation

*“Anyone who writes on a complex subject must learn that he cannot aim one arrow at two targets.” —Arthur Koestler, *The Act of Creation**

1. Introduction

A central idea justifying the recent OECD/G20 Base Erosion and Profit Shifting (BEPS) project, designed to tackle tax avoidance and evasion by multinational enterprises (MNEs) in particular, has been to “ensure that profits are taxed where economic activities take place and value is created”. Among other appearances, it has been at the foundation of the OECD Action Plan initiating the BEPS Project,¹

* Chief, International Tax Cooperation Unit, financing for Sustainable Development Office, United Nations. This paper was written while on sabbatical at the Oxford University Centre for Business Taxation. The comments of Professor Michael Devereux of the Centre on an earlier version of this paper are especially acknowledged; however, the paper reflects only the personal views of the author.

¹ OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing. <http://dx.doi.org/10.1787/9789264202719-en>.

the BEPS Final Report on Actions 8-10 dealing with transfer pricing (profit-shifting) issues² and, most recently, the 2018 Interim Report on Tax Challenges Arising from Digitalization (“the Interim Report”).³ It has also been taken up in the work of the European Union (EU) on taxation of the digitalised economy.⁴

The question of what the term “value creation” means is only now being investigated as closely as its importance warrants, however. Such an investigation is important to understanding the reach and impact of BEPS, but also, most immediately, in considering the possibilities for resolving differences over how to tax the increasingly digitalized economy. It is especially pressing, given that the OECD is seeking a consensus on this issue by 2020.⁵ The meaning of the term, and the level of shared understanding on the point, affect the likelihood of a consensus and the depth of any consensus that is reached. From the perspective of developing countries, important issues are whether the term sufficiently accommodates countries with differing situations and priorities, and how likely it is that the outcomes will have the common sense of ownership that is needed if countries are to adhere to them in practice.

These issues are especially important because there has been recognition as part of the 2015 BEPS Report on this issue that – as summarised by the 2018 Interim Report – “it would be difficult, if not impossible, to ‘ring-fence’ the digital economy from the rest of the economy for tax purposes because of the increasingly pervasive nature of digitalisation. Instead, it considered digitalisation as a transformative process affecting all sectors brought by advances in [information and communication technology]”.⁶

The work on BEPS thus has not focussed only on the Facebooks, Spotifys, Googles and the like of this world but rather on the increasingly digitalized economy more generally (an approach which has some merits in terms of practicality and realism). Thus, any norms emerging out of the work will affect taxation more broadly, not just the most digitalized businesses. As business models and consumer behaviours evolve, such norms will, for good or ill, likely be in place for a long time. This is all the

² OECD (2015), *Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264241244-en>; e.g. p. 3: “Weaknesses in the current rules create opportunities for base erosion and profit shifting (BEPS), requiring bold moves by policy makers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created.”

³ OECD (2018), *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264293083-en>.

⁴ European Union (2018), “Fair Taxation of the Digital Economy”, 21 March 2018, https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en.

⁵ Interim Report, p. 20.

⁶ Interim Report, p. 18.

more reason why the norm-setting process should be scrutinised, including how it is likely to affect developing countries. This note seeks to give just such scrutiny to the current processes and interim outcomes.

Section 2 of the note addresses the OECD/ G20 Base Erosion and Profit Shifting Project and the new focus it has brought to the “value creation” concept, especially by referencing the Interim Report and its potential significance for developing countries. Section 3 examines similar but distinct European Union initiatives. Section 4 considers India’s “equalisation level” as a response to the digitalized economy, and the different concepts of “value creation” its history demonstrates, while Section 5 looks more generally at the tension between the needs for both practical solutions and the certainty of guidance. Section 6 considers the relationship of the value creation concept to the “consumption” side of the market – where a firm “captures” the demand in the market even when it has not (on the “supply side”) actively created that demand. Section 7 addresses the treatment of so-called “interim measures” in the BEPS context, and looks to their wider significance, including for the chances of a consensus outcome. Finally, Section 8 looks at the prospect for a consensus on the OECD / G20 digitalised taxation work, and whether and in what form such a consensus would be suitable for developing country official. It makes suggestions for outcomes that might best preserve appropriate “policy space” especially for developing countries.

2. The BEPS context

2.1. Some areas of agreement

To understand the term “value creation” as used in current tax debates, we should first consider the context of its use in the BEPS Action Plan.⁷ It seems intended to be a term that could be understood broadly and would speak to the political imperative that was such a driver for the BEPS Project. As the Action Plan itself said: “Political expectations are very high in most countries and the results and impact of the BEPS work must be in line with these political expectations”.⁸

The term “value creation” in this sense is employed particularly in connection with the use of tax havens, where activities exist but no value is considered to be created. Not just transparency, but also substance requirements, were seen as key to tackling so-called harmful tax practices, and the term “value creation” reflects this

⁷ OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264202719-en>.

⁸ *Idem.*, p. 26.

perception.⁹ The term was seen as addressing the use of legal structures regarded as lacking economic substance, such as the use of “shell companies that have little or no substance in terms of office space, tangible assets and employees”.¹⁰ In this sense, the term “value creation” is the tip of the BEPS arrow against “practices that artificially segregate taxable income from the activities that generate it”, as the Action Plan puts it.¹¹

2.2. Transfer pricing and value creation

The BEPS Action Plan noted the concept’s relevance to the BEPS transfer pricing work:¹²

In the area of transfer pricing, the rules should be improved in order to put more emphasis on value creation in highly integrated groups, tackling the use of intangibles, risks, capital and other high-risk transactions to shift profits.

The specific value creation issues identified for transfer pricing include “adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital”.¹³ The clear intent, as elaborated in the 2015 Final Report on transfer pricing aspects of the BEPS,¹⁴ was to exclude from the calculation mere ownership of intangibles¹⁵ as well as formal acceptance of risks which really constitutes only funding, without other activities.¹⁶

2.3. The digitalized economy and value creation

The issue of taxation of the digitalized economy draws some of these other BEPS threads together and shows why we need to probe the term’s perceived meaning more closely. The Action Plan originating the still unfinished work related to the digitalised economy noted that¹⁷

⁹ See for example, p. 18 on Action 5: “Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime.”

¹⁰ Action Plan, pp. 13-14.

¹¹ Action Plan, p. 10.

¹² *Idem.*, p. 14.

¹³ *Idem.*, p. 20.

¹⁴ OECD (2015), *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264241244-en>.

¹⁵ *Idem.*, p. 10.

¹⁶ *Idem.*, p. 11.

¹⁷ *Idem.*, p. 110.

The spread of the digital economy also poses challenges for international taxation. The digital economy is characterised by an unparalleled reliance on intangible assets, the massive use of data (notably personal data), the widespread adoption of multi-sided business models capturing value from externalities generated by free products, and the difficulty of determining the jurisdiction in which value creation occurs. This raises fundamental questions as to how enterprises in the digital economy add value and make their profits, and how the digital economy relates to the concepts of source and residence or the characterisation of income for tax purposes. It is important to examine closely how enterprises of the digital economy add value and make their profits in order to determine whether and to what extent it may be necessary to adapt the current rules in order to take into account the specific features of that industry and to prevent BEPS.

2.4. Some areas of disagreement?

There are particularly important areas of disagreement on what value creation means for a digitalized economy, as noted in part by the Interim Report itself. Speaking of the features it identified in digitalized business (scale without mass, increased reliance on intangibles, and the importance of data and user participation) the Report says:

Among members of the Inclusive Framework, the existence of these three frequently observed characteristics of digitalised businesses is generally acknowledged but there is no consensus on their relevance and importance to the location of value creation and the identity of the value creator. There is general agreement that cross-jurisdictional scale without mass and the increased reliance on intangible assets can be highly relevant to the value creation of digitalised businesses, however, there is also agreement that these factors are not exclusive or unique to digitalised businesses.

While there is general agreement that data and user participation are common characteristics of digitalised businesses, there are differences of opinion on whether and the extent to which data and user participation represent a contribution to value creation by the enterprise.

This passage is important, as in recognising differences in the roles of data and user participation in value creation it assumes consensus that taxation in a digitalized environment should be based on value creation *by the enterprise*. Thus, the only debate would appear to be whether the user data that can be monetized or the user participation that adds value – such as by participation in a network, e.g. bringing in friends – is in fact value creation by the enterprise. There is probably far less agreement that the fundamental issue is what value the enterprise creates

than might appear from this passage, and far less agreement on what that means in any case.

2.5. Relationship to substance over form?

Although the BEPS outcomes generally avoid using the phrase “substance over form” other than when referring to domestic law rules, the concept imbues the BEPS work and its understanding of where value is created, as noted in the Transfer Pricing Report: “[A] realignment of taxation and relevant substance is needed to restore the intended effects and benefits of international standards, which may not have kept pace with changing business models and technological developments”.¹⁸ The promise is that better alignment with business models will ensure the taxation of MNEs where substantial activities occur.

The implied promise is that better alignment will also allow proper taxation of new business models. One risk of the current emphasis on “value creation” as the foundation stone for this new taxation edifice is that if there is no consensus on what it means, then any consensus based on the term will be seen through different lenses, with the consequent possibilities of an uncertain investment environment and double taxation or even double non-taxation.

3. The European Union and value creation

The EU’s response to the digitalized economy throws further light on some of these issues. The EU has also adopted the term “value creation” in its work on taxation of the digitalised economy, noting in particular that¹⁹

... profits are not necessarily taxed in the country of the user (and viewer of the advert), but rather in the country where the advertising algorithms has [sic] been developed, for example. This means that the user contribution to the profits is not taken into account when the company is taxed.

This appears a quite narrow focus, but the EU proposal of 21 March 2018 for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence²⁰ notes more broadly that “[t]he application of the current corporate tax rules to the digital economy has led to a misalignment between the place where the profits are taxed and the place where value is created”.

¹⁸Idem., p. 13.

¹⁹European Commission (2018), “Fair Taxation of the Digital Economy”, https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en.

²⁰Available at https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_significant_digital_presence_21032018_en.pdf.

It seems that the EU approach of looking for a “significant digital presence” extends beyond merely looking at the supply side, and this is perhaps why some smaller European countries, with an eye to potential suppliers as residents now or in the future (e.g. Sweden with Spotify) have taken a traditional approach in apparent opposition. A statement on 1 June 2018 by the Ministers of Finance of Sweden, Finland and Denmark says²¹

We believe there are no reasons to deviate from internationally established principles regarding the allocation of taxing rights for the digital economy. The digital economy as well as the traditional economy should be taxed where value is created. Therefore, there should be a thorough analysis whether and to what extent, users in some specific digital business models contribute by creating value for the business and whether this should be somehow reflected in taxation.

This seems to imply that their collective view on what might be regarded as value *capture* through meeting the market should not in itself be regarded as “value *creation*”. The only relevant examination of the consumption side is in terms of whether the consumers have provided data that adds value.

The test proposed in the EU draft directive²² of a “significant digital presence” is very broad. It is based on a threshold of provision of “digital services” (itself a very broadly defined term)²³ of a certain value into a Member State, the number of users in a Member State or the number of business contracts in a Member State. This is all consistent with jurisdiction that is based on a certain level of engagement in the economy or, as the OECD Model puts it, “participating in the economic life of that State to such an extent that it comes within the taxing jurisdiction of that other State”.²⁴ However, such an approach does not use geography and time-based approaches such as traditional permanent establishment tests as the sole basis for demonstrating this participation. The EU’s “significant digital presence” test also seems inconsistent with an approach based on any very narrow conception of value creation.

In addition, some services, such as video and audio streaming services, are taken out of the directive as not generating taxable revenues. It may be that these are considered better dealt with by a value added tax (VAT). Conceptually, however, it is hard to justify their removal, consistent with the broad definition of digital services. More globally (quite apart from any peculiarities of the EU), it should be left to

²¹ “Global cooperation is key to address tax challenges from digitalization”, <https://www.government.se/statements/2018/06/global-cooperation-is-key-to-address-tax-challenges-from-digitalization/>.

²² Article 4(3).

²³ Article 3(5).

²⁴ OECD Model, p. 154.

countries to decide whether and to what extent VAT or income taxes or both are applied to particular services.

The specific exclusion of “the making available of a digital interface where the sole or main purpose of making the interface available is for the entity making it available to supply digital content to users or to supply communication services to users or to supply payment services to users” may also be a recognition that streaming services can include interactive elements and may indicate data about the preferences of recipients that would be useful to potential advertisers. There is probably no clean break between interactive and non-interactive services, even if it is a useful distinction, and any borderline is likely to become even more blurred over time, thereby demonstrating the essential falseness of the distinction.

4. India’s Equalisation Levy Report

The Sweden, Denmark and Finland statement reflects one reading of value creation. The other view is essentially that the value chains, value networks and value shops²⁵ of the type referred to in the BEPS Interim Report are geared up not just to create demand but also to respond to it and *capture* value. The detailed report of an Indian government committee on the equalization levy,²⁶ delivered in February 2016, is instructive in this respect. The report is said to be consistent with “the need to ensure that profits are taxed where economic activities deriving the profits are performed and their value is created.”²⁷ It examines both the demand and supply sides of the market, however, and opines that²⁸

The market price as well the volume of sales, in turn, results from the interaction of demand and supply within a market, and are contributed by factors on both demand side and supply side. The supply side factors are related to production and marketing, whereas the primary demand side factor that influences the price of a good or service and the profitability of the enterprise supplying them, is the paying capacity of consumers.

The paying capacity of consumers is a function of the state of that economy, including availability of public goods, law and order, market facilitation, infrastructure as well as redistribution of resources (subsidies) to the consumers directly or indirectly, using public resources. The profits

²⁵Interim Report, pp. 36-41.

²⁶Indian Ministry of Finance (2016), “Proposal for Equalization Levy on Specified Transactions” (Report of the Committee on Taxation of E-Commerce, February 2016). Available at <https://www.incometaxindia.gov.in/news/report-of-committee-on-taxation-of-e-commerce-feb-2016.pdf>.

²⁷Idem., p. 26.

²⁸Idem., pp. 26-27.

arise only when an economic good produced by supplier is paid for by a consumer during the sale transaction. The performance of sale, thus has two limbs – the buyer and the seller and their interaction leads to creation of value and profits. By stabilizing, promoting, preserving and augmenting the paying capacity of the consumers, the Government and the public resources belonging to that economy play a vital role in contributing to the profits generated by enterprises having a significant economic presence in that jurisdiction, and the resultant value of the enterprise.

The report thus seems to have no difficulty in reading the demand side into the value creation calculation. Although this report preceded the BEPS Interim Report, it does suggest less agreement on what value creation means than appears on the face of the latter report.

It next addresses in a footnote the trend in US states towards “significant economic presence” tests and away from “physical presence” tests, a development and approach confirmed by the US Supreme Court Decision of 2018 in *Wayfair*.²⁹

5. Pragmatism versus Purity in Allocating Taxing Rights?

Drawing together some of these threads, one author has noted, that³⁰

Allocating taxation in accordance with value creation is meant to match tax jurisdiction with some “real” location of a corporation’s activity. But this does not make the meaning of value creation clear. Value creation might refer, for example, to one or more of the following factors: employee location, sales location, location of production capacity, location of management or location where capital is raised. What value creation is not is clearer: income should not be allocated to a jurisdiction where a corporation has only a paper presence.

The same author recognizes³¹ that any such discussion of value creation needs to involve consideration of “location savings”, a concept of value creation that is especially dear to the hearts of developing countries, including emerging countries

²⁹South Dakota v. Wayfair, Inc., 585 U.S. (2018): “When the day-to-day functions of marketing and distribution in the modern economy are considered, it becomes evident that Quill’s physical presence rule is artificial, not just ‘at its edges’ (504 U.S. at 315), but in its entirety. Modern e-commerce does not align analytically with a test that relies on the sort of physical presence defined in Quill. And the Court should not maintain a rule that ignores substantial virtual connections to the State”, pp. 3 and 14–15. Available at https://www.supremecourt.gov/opinions/17pdf/17-494_j4el.pdf.

³⁰Morse, S.C. (2018), “International/OECD – Value Creation: A Standard in Search of a Process”, Bulletin for International Taxation (72) 4/5, p. 196.

³¹Ibid.

such as India and China.³² It includes factors such as the lower costs of labour and real estate in most developing countries, which are seen as contributing an often unrecognised value to the multinational that should now be accounted for in transfer pricing analysis.³³ Many proponents of the “value creation” approach based on corporate activities would argue, however, that because such savings are not created by the multinational, but merely captured, they should not be considered in the taxation calculus.

The fact that several factors may be relevant to value creation inevitably means that “each nation has an incentive to establish and encourage ‘value creation’ meanings that will favour that nation, such as customer base for a market country, allocation of risk to capital for a financial centre or location savings for a developing country with inexpensive labour or other factors of production”.³⁴

6. Value creation and the supply and consumption sides

6.1. Echoes of other battles

In many respects any discussion of what constitutes value creation echoes complex discussions about the source of income. With so many factors, located in different places, potentially contributing to the creation of wealth, it has always been a difficult – perhaps impossible – task to find a coherent and widely accepted agreement on the meaning of “source”.³⁵ In discussions of this topic there are also resonances of the discussion of the pros and cons of “formulary apportionment” and its practicality or otherwise as a way of dividing internationally the profits of multinationals.³⁶ A common feature of such discussions is that the consumption side figures in the debate as well as the supply side. It is clear that any consensus solutions in relation to either source or formulas for apportionment, if they are even possible, would need to address to a greater or lesser extent the market and sales.

³² See, for example, Part D (Country Practices) of the UN Practical Manual on Transfer Pricing, especially Part D.2 (China) and Part D.3 (India).

³³ See, e.g. Deloitte (2015), “Location-Specific Advantages”. Available at <https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-beps-changes-transfer-pricing-location-specific-advantages.pdf>.

³⁴ Morse, S. C. (2018) “International/OECD – Value Creation: A Standard in Search of a Process”, *Bulletin for International Taxation*, 2018 (Vol. 72) 4/5, p. 202.

³⁵ See, for example, Vogel K. (2005), “‘State of Residence’ may as well be ‘State of Source’ – There is no contradiction”, *Bulletin – Tax Treaty Monitor* (October), p. 420; Tadmore N. (2007), “Source Taxation of Cross-Border Intellectual Supplies – Concepts, History and Evolution into the Digital Age”, *Bulletin for International Taxation* (January), p. 2; Devereux, M. and J. Vella (2014), “Are We Heading towards a Corporate Tax System Fit for the 21st Century?”, *Fiscal Studies* (35) 449-475, pp. 453-454.

³⁶ See, for example, Clausing K. and R. Avi-Yonah (2007), “Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment”, *Brookings Institution*. Available at https://www.brookings.edu/wp-content/uploads/2016/06/200706clausing_aviyonah.pdf.

6.2. The relevance of sales

The perceived benefits or disadvantages of looking at sales as a proxy for market engagement and a basis of taxation vary, because of differences in developing countries in both objective situation (such as market size) and development policy (including the balance between the investment climate and revenue generation). On the revenue generation side of the equation, Durst has noted that³⁷

- (i) In an era of digital commerce it may be difficult to identify the destination of sales of various goods and services with sufficient reliability to support sales-based apportionment.
- (ii) Sales-based apportionment might generate undesirable results for some countries, especially developing countries in which much income is generated by capital- or labour-intensive activities, ranging from mineral extraction to providing outsourced business services.

Nonetheless, the market is a relatively immobile factor³⁸ and retail sales may be more difficult to manipulate than business-to-business sales,³⁹ especially between associated entities. Furthermore, some developing countries may see a sales-weighted formula as a useful way of attracting investment from mobile factors, including the jobs that will be created and the skills that will be introduced. This appears to be behind the gravitation of most US states away from a balanced (payroll, assets and sales) formula that is supposed (however inaccurately) to represent “the way MNEs generate profits”⁴⁰ to a purely sales-based or sales-dominant formula.⁴¹

³⁷Durst M. (2015), “The Tax Policy Outlook for Developing Countries: Reflections on International Formulary Apportionment”, ICTD Working Paper 32, p. 12. Available at SSRN: <https://ssrn.com/abstract=2587860>.

³⁸Devereux M. and J. Vella (2014), “Are We Heading towards a Corporate Tax System Fit for the 21st Century?”, *Fiscal Studies* (35) 449-475, pp. 470-471.

³⁹Avi-Yonah, R. S., and I. Benshalom (2011): “Formulary Apportionment — myths and prospects”, *World Tax Journal*, 3(3), 371–399, p. 391.

⁴⁰Avi-Yonah, R. S., and I. Benshalom (2011): “Formulary Apportionment — myths and prospects”, *World Tax Journal*, 3(3), 371–399, p. 381.

⁴¹Clausing K. (2016), “The U.S. State Experience under Formulary Apportionment: Are There Lessons for International Taxation?”, *National Tax Journal* 69(2): 353-386 at 356.

The emergence of sales as the dominant factor in the US states is largely an expression of tax competition,⁴² and to the extent such tax competition is unneeded – that the investor would invest without it – it harms development. It may not lead to increased investment or employment to any noticeable extent,⁴³ but developing countries should have the policy space to consider taxation on the basis of relatively immobile factors so as to encourage investment on the basis of more mobile factors.

Finally, there is increasing interest in the possibility of destination-based corporation taxes, again relying upon the third-party consumer as a relatively immobile factor that cannot be readily manipulated.⁴⁴ Whatever the outcomes of this debate, consideration of corporate taxation on the basis of engagement with a market should, more than ever, not be closed down as a policy choice, whether it be an income tax or a destination-based cash-flow tax or other tax.

More broadly, the relevance or otherwise of mobility of factors deserves more consideration in the BEPS work on taxation of the digitalised economy, especially given the highly pragmatic nature of seeking to agree rules on the international allocation of taxing rights.

The most productive way forward for such consensus as may be possible on international taxation of the digitalised economy seems to be to avoid addressing the underlying jurisdiction of countries – the extent of their tax sovereignty – and instead have countries agree by treaty to stay their hands by not exercising all the domestic law rights they have in cases where a treaty applies. That is, the treaty overrides, to the extent of the inconsistency.

This mechanism has risks and costs, but the treaty as a whole is presumed to bring sufficient benefits (especially in terms of an attractive investment climate for developing countries and protection against double taxation for residents) to justify the costs, at least over the longer term, even if it not possible to closely track the balance between the two.

⁴²Durst M. (2015), "The Tax Policy Outlook for Developing Countries: Reflections on International Formulary Apportionment", ICTD Working Paper 32, p. 11. Available at SSRN: <https://ssrn.com/abstract=2587860>.

⁴³Clausing K. (2016), "The U.S. State Experience under Formulary Apportionment: Are There Lessons for International Taxation?", *National Tax Journal* 69(2): 353-386, pp. 381-382, cf. Martin Hearson (2013), "Some Academic Thoughts on International Tax Reform" (December 13), blog. Available at <https://martinhearsen.wordpress.com/tag/formulary-apportionment/>.

⁴⁴See for example, Devereux M. and J. Vella (2014), "Are We Heading towards a Corporate Tax System Fit for the 21st Century?", *Fiscal Studies* (35) 449-475, pp. 470-471; Auerbach, A. J., M. P. Devereux, M. Keen and J. Vella (2017), "International Tax Planning under the Destination-Based Cash Flow Tax", *National Tax Journal*, December, 70 (4), p. 783; Avi-Yonah R. and K. Clausing (2017), "Problems with Destination based Corporate Taxes and the Ryan Blueprint", *Columbia Journal of Tax Law*, 8, p. 229.

6.3. The OECD Technical Advice Group Report (2003)

We have seen that the emphasis in the BEPS work on the business models of corporates focuses very much on the supply side. In practice, there is, and will remain, a significant focus on the consumption side in deciding whether there has been sufficient engagement of the right kind by corporates in an economy to justify a country’s taxation of profits made in its market. Sometimes this justification has been made on the basis that the government has created the infrastructure necessary for a business to take advantage of the market, as some members of an OECD Technical Advice Group (TAG) reported in 2003.⁴⁵ The summary of the TAG debate on this point is important in suggesting the lack of consensus even among a body composed almost entirely of representatives of developed countries, corporates or advisors:⁴⁶

The members of the TAG disagreed, however, on an important related issue: i.e. whether a supplier which is not physically present in a country may be considered to be using that country’s legal and economic infrastructure and, if that is the case, whether and to what extent, such use of a country’s legal and economic infrastructure should be considered to be one factor which, under the supply-based view, would allow that country to claim source taxing rights on a share of the enterprise’s profits.

For some members, source taxation is justified in such a case because the business profits of the foreign enterprise derive partly from the enterprise’s use of important locational advantages provided by that country’s infrastructure which make the business operations profitable. These may include, but are not limited to, means of transportation (such as roads), public safety, a legal system that ensure the protection of property rights and a financial infrastructure.

Other members, however, disagreed. For them, business profits derive from the carrying on, by the enterprise, of business activities and a country is only justified to consider that profits originate from its territory if the enterprise carries on activities thereon. They do not regard an enterprise which may have access to a country’s market as necessarily “using” that country’s infrastructure and, even if that were the case, they consider that such mere use of a country’s general infrastructure would be too incidental to the business profit-making process to consider that a significant part of the profits are attributable to that country.

⁴⁵OECD, “Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-commerce?: Report of the OECD Technical Advisory Group (TAG) on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits” (2003). Available at <http://www.oecd.org/ctp/treaties/35869032.pdf>.

⁴⁶See Annex 1 of the TAG Report for the participation.

That disagreement prevented the TAG from articulating a single comprehensive conceptual base for evaluating the current rules for taxing business profits and the alternatives to these rules. One such alternative would be nexus rules that would allow a country to tax a foreign enterprise if the enterprise made use of that country's infrastructure even if it did not carry on activities (at least in the traditional sense) in that country. Members disagreed on whether economic principles could support such nexus rules.

A far greater number of countries participated in the Inclusive Framework than in the TAG, and there was high participation by developing countries. Thus, it would be surprising if a higher level of agreement could be found now or in 2020 than in 2003, especially if the issue is articulated in the OECD work on the digital economy as clearly as it was in the TAG report.

6.4. Should taxation based on point of consumption be left to a VAT?

The view of those in the TAG opposing taxation based on engagement in a market is in line with the emphasis in the Interim Report on business activities as the foundation of taxing jurisdiction. Recently, Schön has also argued against considering the consumption side in addressing the income tax of the digitalised economy:⁴⁷

Proponents of a change of the international tax rules like to emphasize that the real world premises of the long-standing compromise between residence countries and source countries have been eroded by globalization and digitization. While this is true, one should never forget the simultaneous global rise of general consumption taxes, in particular VAT, since that international compromise on business taxation was forged in the 1920s. ... VAT/GST has been established since World War II as a huge revenue raiser for market countries; among the prominent economies in the world, only the United States has so far withstood the siren songs of this general consumption tax. One can draw the conclusion that, unlike in the 1920s, there now exists a broad and highly successful tax regime tapping the "consumption side" of the market. Against this background, anybody who pleads for taxation of inbound digital services has to show that the emergence of VAT/GST doesn't sufficiently perform this role.

It is true that VAT/GST has to struggle with practical issues of their own as regards the taxation of the digital economy, but nobody doubts the

⁴⁷Schön W. (2018), "Ten Questions about Why and How to Tax the Digitalized Economy", *Bulletin for International Taxation* April/May, 278-292, p. 286.

prominent role of VAT and GST as a source of revenue for destination countries.

Such a debate might be had, but the VAT is indeed a different tax with different incidence, and value added taxes and taxes based on income (or as some would prefer, cash flow) can sensibly co-exist in relation to the same products.

Further, if the civic concern about multinationals paying insufficient taxes where they profit from economic engagement is to be addressed, an additional tax on consumers is likely to be not only an unpopular response, but one that is seen as confirming the power of multinationals in shaping the policy-making process to favour their interests. Of course, a multinational may choose to pass on any extra corporate taxes it bears to the consumer, but it will have to take the risks of such an action and cannot blame the structure of the tax or its incidence for others.

Similar arguments for not taxing royalties and fees for technical services (on the basis that they will be passed on to local businesses and adversely affect their competitiveness) and for interest (which will be “grossed up” by the lender and paid by the borrower) are part of the mix in any policy discussion as to whether to tax and (perhaps more significantly) at what rate. However, they have hitherto not prevented developing countries from viewing such taxes, especially in the form of a withholding tax, as a relatively easily administered way of mobilising domestic resources for development.

The intention of the OECD/G20 work, as derived from its wording, seems to be to draw upon a consensus framework to deter countries from corporate income taxes, or other taxes such as those based on cash flow, which tax in effect the capture of value on the consumption side, instead leaving that side only to VAT. Such an alignment, which is contrary to the practice of many countries (including most of those adopting the so-called “interim measures” addressed by the Interim Report), should at least be done more openly, with a fuller discussion of its consequences and with neither side of the debate facing a higher burden of proof of the type suggested by Schön. The OECD did some valuable work on VAT regimes in its 2015 report on the digitalized economy,⁴⁸ but even that useful work bears some risk of becoming “collateral damage” if it is seen as having a larger agenda with negative implications for the income tax policy space of countries.

⁴⁸OECD (2015), *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264241046-en>.

7. “Interim Measures” and value creation

7.1. What are “interim measures”?

The 2018 Interim Report recognizes that, with no consensus on taxation of the digital economy, countries have resorted to “uncoordinated” unilateral measures. The report does not recommend for or against such measures but suggests that those adopting the report have agreed to certain design principles that should govern the use of such measures.⁴⁹ They are regarded as “interim measures”, pending the sought-for 2020 consensus which should render them unnecessary.⁵⁰

The Interim Report groups such measures into four categories: (i) alternative applications of the permanent establishment threshold (such as “significant presence” tests or “virtual” permanent establishments); (ii) withholding taxes (and in particular industries such as advertising, broader definitions of royalties or fees for provision of technical services); (iii) turnover taxes such as on internet advertising, digital services levies or “equalization” levies; and (iv) specific regimes to deal with large MNEs such as the UK and Australian Diverted Profit Taxes and the recent US Base Erosion Anti-Abuse Tax.⁵¹ How the Interim Report treats these measures seems to portend what those most active in the drafting envision as a 2020 consensus that they could accept, even though the discussion is said to be without prejudice to longer-term outcomes.⁵²

7.2. The design principles

The Interim Report is quite bold in proposing “design principles” to be followed in any interim measures put in place to tax the digitalized economy, even though it does not formally make a recommendation for or against such measures. It states that “there is merit in setting out guidance on the design considerations that need to be taken into account to limit the possible adverse consequences associated with any interim measure”.⁵³

The Interim Report continues to use the language of obligation when it provides that⁵⁴

Countries that are in favour of the introduction of interim measures recognise the need to take the following considerations into account: (i)

⁴⁹Interim Report, p. 178 ff.

⁵⁰*ibid.*

⁵¹Interim Report, p. 135 ff.

⁵²Interim Report, p. 180.

⁵³Interim Report, p. 180.

⁵⁴Interim Report, pp. 180-181.

be compliant with a country’s international obligations; (ii) be temporary; (iii) be targeted; (iv) minimise over-taxation; (v) minimise impact on start-ups, business creation and small businesses more generally, and (vi) minimise cost and complexity. ... These constraints may place significant restrictions on the design options for any interim measure.

This might appear to be the basis for a consensus in 2020, as on its face there already seems to be broad agreement. Yet, the potential implications of these design principles might be more closely examined by participating countries.

The roll-out of the Interim Report by the OECD Secretariat reinforced the language of obligation.⁵⁵ Although such measures are clearly within the sovereignty of a country, such language in a report adopted by all Inclusive Framework members risks being construed as an attempt to bind countries, at least at a political level, in the exercise of their sovereignty. The national consequences of the adoption of reports by the Inclusive Framework might, objectively, benefit from clarification, though many countries might prefer that the consequences be left uncertain.

A first point to be made is that these interim measures potentially involve the two issues noted above – the question of whether they are justified as a matter of jurisdiction by the country, and the question of whether they may be valid as domestic law provisions – but their effect needs to be moderated in the give and take of allocating taxing rights at treaty level, to ensure double tax is avoided. Which level of exercise of tax jurisdiction is being talked about at any one point is not clear in the Interim Report.

It would be better to keep the rules defining the tax jurisdiction of a country in domestic law and the rules allocating the taxable income between two jurisdictions quite distinct, as they fulfil two very different functions.⁵⁶ Business interests would prefer countries to bind themselves at the level of domestic law principles, since that would apply even in the absence of a treaty. It might also particularly facilitate actions in domestic courts.

One can well conceive of taxpayers claiming that countries imposing such measures are bound by or “estopped” from contradicting a report that they have signed off on in an exercise of self-limiting tax sovereignty. With more than 110 countries signing onto the Interim Report, one might predict the argument that this is emergent customary international law of taxation that binds other countries also.

⁵⁵OECD, Tax Talk No 9. Available at <http://www.oecd.org/tax/beps/tax-talks-webcasts.htm>; Martin, J. “OECD report reveals disagreement on taxation of digital firms” (March 16, 2018). Available at <https://mnetax.com/oecd-interim-report-reveals-disagreement-among-nations-on-taxation-of-digital-firms-26655>.

⁵⁶Vanistendael F. (2018), “An Octogenarian on Value Creation”, *Tax Notes International* (18 June), p. 1385.

This argument, at least, seems easily rebutted – country practice is not enough to constitute customary international law, and the belief must exist in countries that they are bound as a matter of course, even without having signed up to the Report. This *opinion juris*, once described as the “philosopher’s stone which transmutes the inert mass of accumulated usage into the gold of binding legal rules”,⁵⁷ seems clearly to be lacking, but the apparent self-limiting by countries proposing interim measures does raise the risk of challenges to such measures.

Proposing limitations on domestic law jurisdiction as part of some agreement or under pretence of economic or policy coherence is far more serious and far less likely to be agreed to than some allocation of underlying taxing rights under a treaty. Perhaps for this reason, the Interim Report is quite muddled about what it proposes as the range of consensus for 2020. Developing (and developed) countries should ensure that the further work clarifies that all that is proposed as a consensus is a set of allocation rules to be agreed bilaterally or multilaterally, and that no intention exists to limit taxing rights independently of the overriding nature of such a treaty relationship.

7.3. The “interim” character of the measures

The Interim Report states that:⁵⁸

Any interim measure should be introduced recognising the policy intent of it being temporary; ceasing to apply once a global response to the tax challenges raised by digitalisation has been agreed and is implemented. This follows from the very policy rationale that justifies the introduction of an interim measure. It also reflects the consensus among all Inclusive Framework members that a comprehensive global solution is to be preferred over the adoption of unilateral measures It is essential that countries maintain a commitment to achieve a broader global consensus and ensure that, once a global solution is found, it can be implemented in a swift and coordinated manner and that the interim measure remains purely that, without undermining or jeopardising global action. Where a country has already adopted an interim measure, such measure should operate on a similar understanding.

A wide range of measures treated by the Interim Report have been introduced with no conception of them being “interim” by nature, such as fees for technical services. It therefore seems wrong and unhelpful to the countries implementing them to brand them as a temporary fix. Obviously if something better comes

⁵⁷ Thirlway H. (1972), *International Customary Law and Codification*, AW Sijthoff, p. 47.

⁵⁸ At p.184.

along as a consensus, *any* policy is up for review and possible overriding by a different treaty rule, so in that sense all is in flux. However, the measures under domestic law would still, presumably, operate under domestic law in the absence of a relevant treaty relationship. They should therefore not generally be treated as interim measures *per se* but only to the extent that they are later overridden by a particular treaty relationship applying to a particular set of circumstances.

7.4. Income tax-related measures

There is no doubt that international obligations should be taken account of when considering domestic policy. However, the Interim Report also somewhat muddies the point that for most countries, a domestic measure that is contrary to what tax treaties provide – such as by providing withholding tax rates in most countries – does not substantively conflict with any tax treaty obligation because it is overridden by them as a matter of domestic law. The domestic law will still operate with full force and effect for non-treaty cases, as it should.

Thus, the issue of the relationship between the interim measures and treaty obligations appears more nuanced, and less alarming, than appears from the Interim Report. This is perhaps another sign that key drafters would prefer a consensus operating directly at the domestic law level, rather than as an international law overlay that can, in relevant cases, override at the domestic level.

Even accepting the political importance of meeting international obligations, the fairly dismissive approach in the Interim Report⁵⁹ and its roll-out⁶⁰ as to the possibility of income tax-related measures does not reflect adequately, if at all, that the OECD Model (like the UN Model) recognizes that some anti-avoidance measures should be regarded as entirely consistent with the treaties – in a sense “under-riding” rather than overriding them.⁶¹ This appears to be one of the arguments used to defend

⁵⁹Interim Report, p. 181: “Tax treaties that are in line with the OECD Model Tax Convention on Income and on Capital (OECD, 2017[1]) will, therefore, generally prevent countries from imposing a tax on the income derived by a non-resident on the supply of digital services if it is in the form of a tax that is covered by that tax treaty.”

⁶⁰OECD Secretariat (2018), OECD Tax Talks no. 9 (16 March), <https://youtu.be/MthkxfnUnWI>, at 42:10 minutes (“the tax, whatever the tax might be, the tax cannot be an income tax. If it was an income tax you’d be violating your treaties if you applied them to non-residents in the absence of a permanent establishment”).

⁶¹OECD Model Commentary on Article 1, para. 7 and following. Para. 9.4 notes that “it is agreed that States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into.”

the UK interim measure, the Diverted Profits Tax.⁶² The Australian legislation⁶³ is similarly constructed as an anti-avoidance measure to avoid conflict with double tax agreements.

7.5. The relevance or otherwise of user participation

Perhaps the most interesting design principle is one relating to cross-border transmission of services where there is said to be little user participation. The Interim Report states:⁶⁴

The interim measure should also be restricted to certain specified e-services and not apply to all services simply on the basis that they are provided over the internet. ...

A number of countries maintain that a targeted interim measure could focus on internet advertising and digital intermediation services because they perceive that these categories of e-services businesses typically operate remotely and rely heavily on intangible property, data, user participation and network effects and believe that therefore value is being created in their jurisdiction.

The Interim Report here very clearly rejects the relevance of engagement with a market by itself as a basis for tax jurisdiction – for example, seeking instead some active engagement with the consumer that a streaming service alone would not entail. Nonetheless, many countries and sub-federal authorities are introducing taxes on online video and audio providers, including streaming services such as Netflix and Spotify.⁶⁵ Many such countries will rely on a VAT, and even though the Interim Report and the EU directive carve out such services, it is hard to see why developed, much less developing, countries should tie their hands on such domestic measures and reduce their policy space going forward. If as part of the 2020 consensus they choose to override that ability to tax, they should be

⁶²Her Majesty's Revenue and Customs, Diverted Profits Tax: Open Day slides (8 January 2015), p. 5: "But even if the diverted profits tax were covered by UK tax treaties, the entry conditions for the diverted profits tax mean that it will only be applied to arrangements designed to exploit the provisions of tax treaties to avoid tax. Therefore the arrangements it targets are the kind where there is no obligation to provide relief under international law". Available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/400340/Diverted_Profits_Tax.pdf. See also Buchanan H. and S. Bond, "DPT Myth Busting", *Tax Journal* (7 December 2017). Available at <https://www.taxjournal.com/articles/dpt-myth-busting-07122017>.

⁶³Treasury Laws Amendment (Combating Multinational Tax Avoidance) Act 2017. Available at <https://www.legislation.gov.au/Details/C2017A00027>.

⁶⁴At p. 185.

⁶⁵See, for example: "Some sort of 'Netflix tax' has to be in Canada's future", *Hamilton Spectator*, editorial (7 June 2018). Available at <https://www.thisspec.com/opinion-story/8655554-editorial-some-sort-of-netflix-tax-has-to-be-in-canada-s-future/>

calculating the likely revenue losses going forward and any preference the choice gives to remote providers of services, from abroad, over domestic providers.

The Interim Report indeed seems somewhat skewed in how it addresses the implications of taxing provision of services without significant user input. In particular, it takes note of the risks of provision of services being taxed more heavily than the provision of goods,⁶⁶ but not the risk of leaving the former untaxed while taxing the latter.⁶⁷

7.6. Fees for technical services

In practice countries take very different approaches to the taxation of services. In the OECD, a majority view has been that in a bilateral treaty the test for which country should have the right to tax profits should be the same as the equivalent test for services. That is, in terms of geographical presence, in deciding whether the country where the services are provided may retain its domestic law taxing rights under a treaty, the same physical presence tests should apply as for a “bricks and mortar presence”.⁶⁸

A minority of OECD countries have taken the view, however, that services are different from goods and that engagement in an economy that justifies retention of those taxing rights under the treaty can be shown with a lighter physical presence.⁶⁹

Where OECD countries *have* been in agreement is expressed in the OECD Model Commentary on Article 5:⁷⁰

It should be noted, however, that all [OECD] member States agree that a State should not have source taxation rights on income derived from the provision of services performed by a non-resident outside that State. Under tax conventions, the profits from the sale of goods that are merely imported by a resident of a country and that are neither produced nor distributed through a permanent establishment in that country are not taxable therein and the same principle should apply in the case of services. The mere fact that the payer of the consideration for services is a resident of a State, or that such consideration is borne by a permanent

⁶⁶Interim Report, p. 185: “A broad tax on all e-services may also result in different tax treatment depending on whether the underlying supply is made in physical or digital form.”

⁶⁷This concept appears indirectly, noted as a positive in relation to Diverted Profit Taxes at pp. 147-148: “This regime usually improves the level of compliance of large MNEs that have an incentive to engage in aggressive international tax planning strategies, and restores a level playing field with more conventional businesses or SMEs that operate mostly at the domestic level.”

⁶⁸OECD Model, pp. 154-155.

⁶⁹OECD Model, p. 155.

⁷⁰OECD Model, p. 156.

establishment situated in that State or that the result of the services is used within the State does not constitute a sufficient nexus to warrant allocation of income taxing rights to that State.

Outside OECD countries that view is far from uncontested. Developing countries increasingly seek, and obtain, provisions in their treaties to allow for taxing income from the provision of a broad range of services into their countries in the form of fees for technical services provision, without any reference to the need for a permanent establishment. Such a provision has been added to the UN Model in 2017 to reflect that country practice.⁷¹

There is even less reason to doubt the legitimacy of such a constraint on tax jurisdiction under domestic law. No principle of international economic law prevents income taxation of services provided into a country, as the permanent establishment principle in treaties applies only if, and to the extent that, an applicable treaty exists.

It is therefore hard to conceive of any real consensus among the members of the Inclusive Framework on limiting their domestic measures to cases with significant user input,⁷² especially since the Interim Report says that “[g]iven that businesses in the era of digitalization are increasingly concerned with the provision of services, as opposed to the manufacture of tangible goods, it makes good sense to broaden our consideration of value creation along those lines.”⁷³

8. The prospects for a consensus by 2020

Taxation of a multinational based on engagement with an economy on the consumption side reflects a current and legitimate reality of State exercise of sovereignty over taxation. It can also be justified on the basis that income taxes are not – and should not be – directed only to cases where value has been *created* by a business model, to which consumers have responded, but also to where value has been *captured* by a business, whether or not it can be seen to have created anything (such as in the case of a purchase and immediate sale of shares or property).⁷⁴

⁷¹United Nations (2017), Model Double Taxation Convention between Developed and Developing Countries, Article 12A. Available at http://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT_2017.pdf. See also Moreno, A.B. (2015), “The Taxation of Technical Services under the United Nations Model Double Taxation Convention: A Rushed – Yet Appropriate – Proposal for (Developing) Countries?” World Tax Journal (7) 3. See also the Interim Report, p. 140.

⁷²Interim Report, p. 185.

⁷³Idem., p. 35.

⁷⁴Haslehner, W (2018) “Taxing where value is created in a post-BEPS (digitalized) world?” Kluwer International Tax Law Blog (30 May 2018). Available at <http://kluwertaxblog.com/2018/05/30/taxing-value-created-post-beps-digitalized-world/>.

Such profits are frequently treated as subject to an income or similar tax, rather than being left to a VAT (as evident from the Interim Report’s analysis of tax policy developments, including so-called “interim measures”).

Thus, the only way forward to any comprehensive and genuine consensus to address taxation of multinationals through a value creation approach would seem to be to allow such a broad use of the term *value creation* as to address *value capture*. This creates its own uncertainties, but they can to a great extent be mitigated by transparency in country interpretations. And country disagreements on interpretation are nothing new, as the UN and OECD commentaries on the respective models make clear, as do the helpful OECD Member Observations disagreeing with particular OECD Commentary interpretations and similar non-OECD Member “positions” on them.

If the disagreements cannot be resolved, the best way forward is to encourage countries to make their positions clear and, where achievable, to make sure one interpretation or other is clearly chosen during treaty negotiations to govern its interpretation.

To nudge perceptions of what is an internationally justifiable domestic tax policy away from the consumption side and towards the supply side, as some aspects of the Interim Report seem to support, without specific debate on the issues and clear conclusions, would seem contrary to the promise in the Action Plan that:⁷⁵

[w]hile 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.

Perhaps the BEPS outcomes have already diverged somewhat from that promise by introducing the “value creation” or “substance” component into the allocation formula.⁷⁶ However, if that approach is seen as selectively focussing on the supply side and suggesting that the consumption side be left to VAT, the promise of the Action Plan will be well and truly in question.

⁷⁵At p. 11.

⁷⁶Devereux, M. and J. Vella (2014), “Are We Heading towards a Corporate Tax System Fit for the 21st Century?”, *Fiscal Studies* (35) 449-475, p. 463.

8.1. Is a consensus the holy grail?

It seems that a full debate on this issue of limiting consideration to the supply side would probably not lead to a consensus by 2020. And, in fact, to revert to Schön's analogy, the siren song for developing countries (among others) might be the push for consensus by 2020. Caution and a degree of scepticism are warranted, and developing countries may need to show a willingness to prefer no deal in 2020 over a bad deal that may effectively constrain policy space for decades.

Moving from the more readily accepted activities excluded by the term "value creation" to the more contested issues, it should be borne in mind that attempts to achieve a consensus in so large a body of countries as the Inclusive Framework, especially one composed of developing, emerging and developed economies, are unlikely to exhibit complete coherence in either legal or economic terms. As Schwarz has noted, it would be disingenuous to treat what is really a political debate as a matter of legal analysis.⁷⁷ The same could be said for economic coherence. The lack of overall economic coherence in the current tax treaty allocation rules dating from the 1920s has been noted,⁷⁸ as so-called "source States" have the primary taxing right for active income and so-called "residence States" have the primary taxing right for passive income. The consequent allocation of taxing rights on the basis of the type of gain does not fit neatly into an approach based on either a benefit or an ability to pay.⁷⁹

Other issues deserve a separate article on the depth, timing and practical ability, for many developing countries, of participation in developing the approach taken in the Interim Report, even though the Inclusive Framework (essentially an implementing body⁸⁰ incorporating what amounts to a monitoring role for the digital economy⁸¹) has formally made the Interim Report its own.

Even in that body, non-OECD/G20 countries participate as "associates" on an "equal footing" (another undefined term). In determining to what extent the associates have truly become partners, an assessment would need to be done of the future drafting and interpreting roles of the OECD Secretariat (overwhelmingly, especially in policy development, from OECD country governments) and OECD Working Parties (such as WP 1 on treaties and WP 6 on transfer pricing), of which the non-OECD countries are only observers.

⁷⁷Schwarz, J. (2018), "Value Creation: Old wine in new bottles or new wine in old bottles?", Kluwer International Tax Law Blog, 21 May 2018.

⁷⁸Devereux, M. and J. Vella (2014), "Are We Heading towards a Corporate Tax System Fit for the 21st Century?", *Fiscal Studies* (35) 449-475, p. 451.

⁷⁹Ibid.

⁸⁰OECD (2017), "Background Brief: Inclusive Framework on BEPS". Available at <http://www.oecd.org/tax/beps/background-brief-inclusive-framework-for-beps-implementation.pdf>, p. 8 and p. 10.

⁸¹Idem., p. 14.

The relevance of a short tour of these issues is the recognition that developing countries need to evaluate carefully, with the assistance of regional bodies and academia, any proposed consensus as it is developed. They need to know in good time what policy space any consensus leaves them or does not leave them, how interpretations that may affect the dimensions of that policy space are to be made, and how it will be implemented, monitored and enforced.

In this context, Christians reminds us that the term “value creation”, while lacking history or coherence, has become popular because it is a mode of⁸²

allocating income to one or another jurisdiction [which] has very little to do with capturing income accurately, and everything to do with preserving a distributive status quo that cannot be defended on normative grounds. As such, the idea of value creation seems likely to disappoint the assumptions and expectations of some, while preserving those of others. The former likely will be those whose interests do not seem particularly attended to in traditional international tax processes. If so, the legacy of BEPS will not be enhanced tax cooperation to the mutual benefit of all participating nations. Instead, it will be deeper division until those who gather nations together in tax coordination exercises can understand and acknowledge that tax allocation is a fundamentally distributive task, and not fundamentally about anything economic or scientific. As such, whether the distribution is accomplished through arm’s-length pricing, unitary taxation, or some other method, we cannot expect those distributed the least to cooperate indefinitely.

That seems a useful assessment and means that developing countries should focus on what the reports in 2018, 2019 and 2020 are likely to imply for their taxing rights – without feeling bound by any sense of historical developments or allegiance to theory. They should carefully consider the potential consequences of adopting any reports and join with each other on establishing or agreeing to the contents.

The very important quest for more certainty for both administrations and taxpayers is best served not by rigid rules on tax jurisdiction, especially at the domestic level below the operation of tax treaties, but rather by several actions: achieving transparency in rule-making and understanding of the practical effect of proposed rules, not signing on unless countries are satisfied on these points, supporting each other in this approach regionally and inter-regionally, and establishing a way of developing interpretations that is highly inclusive both in theory and in practice.

⁸²Christians A. (2018), “Taxing According to Value Creation”, *Tax Notes International* (June 18), 1379.

More specifically, developing countries should seek to clarify that their domestic jurisdiction of tax will not be diminished but should rather address only an overlay of treaty-level agreements on that domestic law, as governed by the terms of any treaty.

9. Conclusions

Lack of consensus is given as the reason why the Interim Report makes on interim measures.⁸³ It is also, however, noted as a reason why countries have looked to such “uncoordinated” interim measures for a solution.⁸⁴ This suggests that in the absence of consensus on a single set of rules (unattainable and probably undesirable), a consensus on the matrix of options – noting their potential pros and cons, and on transparent and predictable approaches, is the best way of satisfying as many participants in tax systems as much as possible, with as much coordination and as much certainty for countries, taxpayers and their advisers, as is realistically possible.

Curiously, the Interim Report, though formally adopted by the now 116 member countries⁸⁵ of the Inclusive Framework, seems even less supportive than the OECD’s 2003 TAG Report of members’ legitimate taxing rights based on companies profiting from engagement with the domestic market. This seems to reflect some push for norms restricting the taxing rights of the takers in the digitalized world in favour of the makers. As such, it seems to reveal that the BEPS and Inclusive Framework structures and processes are not providing the checks and balances likely to produce a consensus borne out of close consideration.

Even if absolute consensus and absolute coherence exist as individually attainable goals in this arena of taxing the digitalised economy, they seem not to be attainable together. There is great pressure on many actors to achieve the first. Developing countries should not feel that pressure as the driving force. Consensus achieved by agreeing to an unreasonable bargain would be a failure rather than a success. And although businesses may laud such an outcome, it is unlikely to be reflected in practical implementation.

What does need to be given more consideration, including in any 2019 and 2020 BEPS reports on the digitalized economy, is what exactly it is that we are seeking to tax – and to what extent that can legitimately vary among countries owing to differing positions and priorities. In particular, is the passive versus active income distinction still (as) useful? Or is the question of mobility or immobility more useful in

⁸³Interim Report, p. 178.

⁸⁴Idem., p. 134.

⁸⁵As of May 2018: <https://www.oecd.org/ctp/beeps/inclusive-framework-on-beeps-composition.pdf>.

crafting a tax system that reflects current economic business and political realities and best serves development in countries generally?

A better approach to balancing consensus and coherence, and taking into account differing but legitimate views, would therefore be to have in 2020 a consensus document that has five basic pillars: (1) it recognizes the relevance of differences between countries realities and priorities and what such differences may mean for taxing policy and administration; (2) it fairly outlines the perceived pros and cons of different approaches, addressing which may be more or less relevant for countries that are in different stages of development and have legitimately differing priorities; (3) it tries to minimize the ways in which different approaches are expressed – reducing permutations in achieving the same goals and providing a common and well-understood language for discourse; (4) it emphasizes commitments to transparency about decisions taken; and (5) it expresses a commitment to meet obligations assumed as part of a consensus, including cases where similarity of views allows for a credit or exemption for taxes paid.

There could also be a sixth pillar – a peer review process – but that would have to be carefully calibrated and implemented with recognized areas of policy space reserved to States within the framework of the consensus. It could not formally or in practice take sides on matters on which consensus cannot be reached.

Such an approach seems to achieve the best balance in recognizing both legitimate country sovereignty in taxation and the need for maximizing taxpayer certainty, the best friend of which is a sense of ownership of the outcomes by all participating States.

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The Mauritius Convention on Transparency and the Multilateral Tax Instrument: models for the modification of treaties?

Nathalie Bravo*

The investment treaty network and the tax treaty network comprise more than 3,000 treaties each. The provisions of these treaties generally are highly customized on the basis of the investment flows and economic interests of the contracting States. The number of treaties in force and their customization potentially turn the amendment of these treaty networks in their entirety into a cumbersome and long process. To modify the treaty networks in a swift and coordinated manner, the investment treaty makers and the tax treaty makers almost contemporaneously developed the idea of implementing treaty changes through a single multilateral convention. On 10 December 2014, the United Nations adopted the Convention on Transparency in Treaty-based Investor–State Arbitration, also known as the Mauritius Convention. In addition, on 24 November 2016, the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (BEPS), commonly referred to as the Multilateral Tax Instrument, was concluded under the aegis of the Organisation for Economic Co-operation and Development (OECD). The Mauritius Convention and the Multilateral Tax Instrument share the object and purpose of modifying an extensive number of treaties. However, due to their novelty, little research has been done until now on their common characteristics and differences. The article aims at filling this gap by comparing both multilateral conventions. It also aims at drawing lessons from the analysis of both multilateral conventions that might be of benefit for future modifications of an extensive number of treaties through a single instrument.

Keywords: Multilateral Tax Instrument, BEPS, bilateral tax treaties, bilateral investment treaties, Mauritius Convention

* Nathalie Bravo has an L.L.M. in International Taxation and is a PhD candidate of the Doctoral Program in International Business Taxation (DIBT). She is the recipient of the DOC Fellowship of the Austrian Academy of Sciences at the Institute for Austrian and International Tax Law, WU (Wirtschaftsuniversität Wien).

1. Introduction

International investment agreements (IIAs) are concluded between States to promote and protect the investments made by investors from one of the contracting States in the territory of another contracting State.¹ IIAs grant rights to investors against arbitrary conduct by host States² and, most importantly, typically allow for investment disputes to be resolved by international arbitration rather than by potentially biased domestic courts.³ In contrast, tax treaties are concluded between States to allocate taxing rights over the income of taxpayers active in their jurisdictions to only one of them and thus avoid double taxation.⁴ Tax treaties also provide for the resolution of double taxation disputes through an administrative procedure, known as the mutual agreement procedure, that in some treaties is complemented by a mandatory binding arbitration procedure.⁵ The ultimate object and purpose of IIAs and tax treaties is to remove barriers to international trade and impediments to economic growth.

In addition to their common object and purpose, the investment treaty network and the tax treaty network share a similar size, in that each comprises more than 3,000 treaties. The provisions of IIAs and tax treaties generally are highly customized on the basis of the investment flows and economic interests of the contracting States. Therefore, the provisions found in IIAs and tax treaties vary considerably. The number of treaties in force in the investment treaty network and the tax treaty network, and the customization of the treaty provisions potentially turn the amendment of these treaty networks in their entirety into a cumbersome and long process. To modify the treaty networks in a swift and coordinated manner, the investment treaty makers and the tax treaty makers almost contemporaneously developed the idea of implementing treaty changes through a single multilateral convention.

After recognizing the need for provisions on transparency in the resolution of treaty-based investor–State disputes to account for the public interest involved in such

¹ <http://investmentpolicyhub.unctad.org/IIA> (consulted on 8 June 2017).

² These rights include the right to not have investments unlawfully expropriated, the right to fair and equitable treatment, rights against discrimination in the forms of national and most-favored-nation treatments, and the right to free transfer of capital. For more details, see, for example, Davie, “Taxation Based Investment Treaty Claims”, 8 *Journal of International Dispute Settlement* (2015), at 202.

³ Boyarsky, “Transparency in Investor-State Arbitration”, 21 *Dispute Resolution Magazine* (Summer 2015), at 34.

⁴ However, the State of source and the State of residence frequently share taxing rights over the so-called passive income, e.g. dividends, interests and royalties.

⁵ The number of tax treaties that provide for mandatory binding arbitration procedure is limited since the mandatory binding arbitration procedure clause was introduced – in paragraph 5 of Article 25 of the OECD Model Tax Convention – only in 2008. Moreover, less developed economies in general reject the introduction of a mandatory arbitration procedure in their tax treaties, an action based in part on the argument that the notion of fiscal sovereignty does not allow for a third-party arbitrator to decide on tax-sovereign matters such as tax disputes.

arbitration procedures, the United Nations Commission on International Trade Law (UNCITRAL) enacted on 1 April 2014 the Rules on Transparency in Treaty-based Investor-State Arbitration (The Rules on Transparency).⁶ These Rules provide for the transparency and accessibility of treaty-based investor–State arbitration to the public. However, the Rules on Transparency can apply only to disputes arising out of IIAs concluded on or after 1 April 2014. To address the lack of transparency in investor–State arbitration procedures in IIAs concluded before 1 April 2014, the United Nations adopted the Convention on Transparency in Treaty-Based Investor–State Arbitration (the Mauritius Convention).⁷ The Mauritius Convention thus allows its parties to apply the Rules on Transparency to disputes arising out of IIAs concluded before 1 April 2014.

The Base Erosion and Profit Shifting (BEPS)⁸ Project of the G20 and the Organisation for Economic Co-operation and Development (OECD) derived from a public urge to counter tax planning practices, undertaken mainly by multinational enterprises that despite obtaining high income in certain jurisdictions paid almost no corporate taxes therein. The discussions on BEPS showed that eliminating such practices would require changes to tax treaties. On 24 November 2016, the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (the Multilateral Tax Instrument) was concluded to implement the required changes in tax treaties.⁹

This article aims to clarify how the Multilateral Tax Instrument and the Mauritius Convention modify treaties. It also aims to draw lessons from the analysis of both multilateral conventions that might be of benefit for future modifications of an extensive number of treaties through a single instrument. As already advocated in the *World Investment Report 2015*, policymakers who engage in the discussions of changes to IIAs and to tax treaties should consider the impact that these treaties have on investment and adopt coordinated solutions.¹⁰ This article shows that the techniques to modify both kinds of treaties lately used by policymakers are similar. Thus, if the Multilateral Tax Instrument and the Mauritius Convention turn to be successful, coordinated solutions could be simultaneously implemented in tax treaties and IIAs through a single multilateral treaty that could modify all of them. To this end, section 2 introduces the G20/OECD BEPS Project and the Multilateral

⁶ *UNCITRAL Rules on Transparency in Treaty-based Investor-State Arbitration*, U.N. Doc. A/68/109, available at <http://www.uncitral.org/pdf/english/texts/arbitration/rules-on-transparency/Rules-on-Transparency-E.pdf> (consulted on 8 June 2018).

⁷ *United Nations Convention on Transparency in Treaty-based Investor-State* (10 October 2014).

⁸ The OECD has defined BEPS as referring to “tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations”; available at <http://www.oecd.org/tax/beps/> (consulted on 8 June 2018).

⁹ *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (24 November 2016).

¹⁰ UNCTAD; *World Investment Report 2015: Reforming International Investment Governance*. New York and Geneva: United Nations; at 209.

Tax Instrument in more detail. Section 3 summarizes the techniques used in the Multilateral Tax Instrument to modify tax treaties, and section 4 summarizes the techniques used in the Mauritius Convention to modify IIAs. Section 5 compares the two multilateral conventions and draws lessons from the analysis of both. Section 6 concludes and draws lessons.

2. The G20/OECD BEPS Project and the Multilateral Tax Instrument

Taking advantage of the lack of coordination of the international tax rules and domestic tax systems, many taxpayers, particularly multinational enterprises, exploit arbitrages in tax treaties and domestic tax laws to reduce their worldwide tax burden. The recurring discussion in the public media of this phenomenon shaped a collective indignation that resulted in the perfect momentum for a multilateral reaction of the G20 and the OECD members. On 12 February 2013, the OECD released its report on BEPS. The report recognized that BEPS “constitute a risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike”¹¹ and, therefore, concluded that a multilateral and coordinated response to this phenomenon was needed.

Subsequently, on 19 July 2013, an action plan with 15 action points was published. The BEPS Action Plan set the stage for policy recommendations to eliminate the flaws detected in the international and domestic tax systems. The last action point, BEPS Action 15, referred to the development of a multilateral treaty to modify the entire tax treaty network. The purpose of BEPS Action 15 was summarized in the following terms:

Analyze the tax and public international law issues related to the development of a Multilateral Instrument to enable jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties. On the basis of this analysis, interested Parties will develop a Multilateral Instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution.¹²

On 14 September 2014, a deliverable on BEPS Action 15 was published.¹³ On 5 October 2015, the deliverable was released with very few changes as the Final

¹¹ OECD, *Addressing Base Erosion and Profit Shifting* (2013), at 5.

¹² OECD, *Action Plan on Base Erosion and Profit Shifting* (2013), at 24.

¹³ OECD, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties – Action 15: Deliverable* (2014).

Report on BEPS Action 15.¹⁴ In it, the OECD concluded that developing a multilateral instrument to update the tax treaty network was desirable and feasible.¹⁵ Moreover, the OECD indicated that in the context of the BEPS Project a multilateral instrument was an essential tool, since it would swiftly eliminate the flaws detected in the tax treaty network that allow multinationals to implement BEPS practices.¹⁶

The OECD's plan of concluding the Multilateral Tax Instrument was based on the idea that renegotiating and amending all the tax treaties in force would demand a monumental effort. And, the time required to amend the entire tax treaty network most probably would play against the BEPS Project. The longer that updating the tax treaty network were to take, the longer taxpayers could continue to exploit arbitrages in tax treaties and domestic tax laws. Moreover, if updating the tax treaty network were to take too long, the political willingness to do so might vanish. The Multilateral Tax Instrument, in principle, would allow the speedy and synchronized modification of the tax treaty network. In addition, it would result in uniform international tax rules designed to counter BEPS practices, avoiding the proliferation of uncoordinated unilateral or bilateral tax measures.¹⁷

On 6 February 2015, the OECD issued a mandate to launch the negotiations on the Multilateral Tax Instrument.¹⁸ On 27 May 2015, an ad hoc Group independent from the OECD was created to negotiate the Multilateral Tax Instrument.¹⁹ In general, the ad hoc Group was in charge only of designing the instrument – i.e. negotiating the form of the provisions of the Multilateral Tax Instrument – as its substance was already agreed. Indeed, the substance of the provisions of the Multilateral Tax Instrument was agreed and published in the 2015 Final Reports on BEPS Action 2, *Neutralising the Effects of Hybrid Mismatch Arrangements*;²⁰ BEPS Action 6,

¹⁴OECD, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties – Action 15: Final Report* (2015).

¹⁵OECD, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties – Action 15: Final Report* (2015), at 17.

¹⁶OECD, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties – Action 15: Final Report* (2015), at 16.

¹⁷OECD, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties – Action 15: Final Report* (2015), at 16.

¹⁸OECD, *Action 15: A Mandate for the Development of a Multilateral Instrument on Tax Treaty Measures to Tackle BEPS* (2015).

¹⁹OECD, "Work Underway for the Development of the BEPS Multilateral Instrument" (28 May 2015), available at <http://www.oecd.org/tax/treaties/work-underway-for-the-development-of-the-beps-multilateral-instrument.htm> (consulted on 18 June 2018).

²⁰OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements – Action 2: Final Report* (2015). Action 2 of the BEPS Project tries to establish a common approach to hybrid mismatch arrangements to prevent cases of double non-taxation. Among others, this Action establishes rules that seek to eliminate the tax benefits of mismatches, end the use of multiple deductions for a single expense and end the generation of multiple foreign tax credits for one amount of foreign tax paid.

Preventing the Granting of Treaty Benefits in Inappropriate Circumstances;²¹ BEPS Action 7, *Preventing the Artificial Avoidance of Permanent Establishment Status*;²² and BEPS Action 14, *Making Dispute Resolution Mechanisms More Effective*.²³ Within the ad hoc Group, a sub-group on arbitration was created to produce the form and substance of the provisions on a mandatory binding arbitration procedure, which were not discussed in the course of other Actions of the BEPS Project owing to the lack of support for it of many of the participants.²⁴

The ad hoc Group started its substantive work in November 2015. More than 100 States and non-State jurisdictions, including not only OECD members, G20 countries and other developed countries but also many developing countries, participated in the negotiation of the Multilateral Tax Instrument. Also, international organizations were represented in the negotiations.

The negotiation process lasted for almost a year and a half. During this period, a public consultation was launched to obtain input from civil society on what technical issues would arise from implementing the Multilateral Tax Instrument, in their view, and how to overcome them.²⁵ In addition, during this period, so-called speed matching sessions took place between the parties to the tax treaties subject to modification. In those sessions, the parties discussed and matched their positions on the application of the provisions of the Multilateral Tax Instrument to their common tax treaties. As the instrument implements a complicated system of opting-ins, alternative provisions and reservations, the speed matching sessions

²¹OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances – Action 6: Final Report* (2015). Action 6 tries to prevent treaty abuse, including the implementation of treaty-shopping strategies. For such a purpose, Action 6 includes several provisions, some of which are presented as alternatives to each other (although they can also complement each other), as is the case with the general anti-avoidance rule, known as the principal purposes test or PPT, and the specific anti-abuse rule that limits treaty benefits to taxpayers that do not fulfil certain objective predetermined conditions, known as the Limitation on Benefits or LoB.

²²OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status – Action 7: Final Report* (2015). Action 7 suggests updating the concept of permanent establishment. The changes suggested in Action 7 addresses techniques used to inappropriately avoid the tax nexus, including the replacement of distributors with commissionaire arrangements or the artificial fragmentation of business activities.

²³OECD, *Making Dispute Resolution Mechanisms More Effective – Action 14: Final Report* (2015). Action 14 suggests changes to the mutual agreement procedure in order to provide taxpayers with a more effective and timely resolution of their tax disputes. It also suggested the implementation of a mandatory binding arbitration procedure.

²⁴Although more than 45 countries actively participated in the BEPS Project, only 20 agreed to implementing mandatory binding arbitration in their tax treaties. The participants that committed to mandatory binding arbitration are Australia, Austria, Belgium, Canada, France, Germany, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Slovenia, Spain, Sweden, Switzerland, the United Kingdom and the United States. See OECD, *Making Dispute Resolution Mechanisms More Effective, Action 14: Final Report* (2015), at 41.

²⁵OECD, “OECD releases discussion draft on the multilateral instrument to implement the tax-treaty related BEPS measures” (31 May 2016), available at <http://www.oecd.org/ctp/treaties/discussion-draft-beps-multilateral-instrument.htm> (consulted on 8 June 2018).

had the purpose of ensuring agreements between the parties to tax treaties on the forms in which their tax treaty relations would be modified through this instrument.

The Multilateral Tax Instrument was concluded on 24 November 2016, and on 7 June 2017 a signing ceremony was held. During the signing ceremony ministers and high-level officials from 68 States and non-State jurisdictions signed or formally expressed their intention to sign the Multilateral Tax Instrument.²⁶ The signing ceremony was ground-breaking for two reasons: the Multilateral Tax Instrument is the first multilateral treaty of its kind in the international tax law arena, and the support expressed by States was tremendous, especially considering that all previous worldwide initiatives to coordinate international tax rules related to the allocation of taxing rights had failed.²⁷

Since the signing ceremony, other States have signed the Multilateral Tax Instrument or have expressed their intention to do so.²⁸ As of 29 June 2018, the Multilateral Tax Instrument had 82 parties and signatories. Nine of them have ratified the Multilateral Tax Instrument and notified their final positions on the application of the provisions of the instrument.²⁹ The Multilateral Tax Instrument entered into force on 1 July 2018, and it will start producing effects as from 1 January 2019.

3. Techniques used in the Multilateral Tax Instrument to modify tax treaties

The object and purpose of the Multilateral Tax Instrument is to swiftly incorporate into the tax treaty network the treaty changes proposed in the course of the BEPS Project.³⁰ The scope of the Multilateral Tax Instrument has been established in its Article 1 in the following terms: “This Convention modifies all Covered Tax Agreements as defined in subparagraph a) of paragraph 1 of Article 2 (Interpretation of Terms).” According to Article 2(1)(a) of the Multilateral Tax Instrument, a Covered

²⁶OECD, “Ground-breaking multilateral BEPS convention signed at OECD will close loopholes in thousands of tax treaties worldwide” (7 June 2017), available at <http://www.oecd.org/tax/ground-breaking-multilateral-beps-convention-will-close-tax-treaty-loopholes.htm> (consulted on 8 June 2018).

²⁷As, for example, the United Nations initiatives developed between the 1920s and the 1950s and the OECD initiatives developed between the 1950s and the 1960s.

²⁸OECD, “Major step forward in international tax co-operation as additional countries sign landmark agreement to strengthen tax treaties” (24 Jan. 2018), available at <http://www.oecd.org/tax/major-step-forward-in-international-tax-cooperation-as-additional-countries-sign-landmark-agreement-to-strengthen-tax-treaties.htm> (consulted on 8 June 2018).

²⁹Signatories and Parties to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, Status as of 29 June 2018. <http://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf> (consulted on 29 June 2018).

³⁰OECD, *Explanatory Statement to the Multilateral Tax Instrument* (2016), para. 14.

Tax Agreement is a treaty for the avoidance of double taxation with respect to taxes on income in force between two or more parties to the Multilateral Tax Instrument as long as each of the parties has notified it as a treaty covered by the Multilateral Tax Instrument.

The definition of Covered Tax Agreement thus contains two conditions, both of which must be fulfilled. First, the treaty must have been concluded with the intention of avoiding double taxation with respect to taxes on income, and it must be in force between two or more parties. Second, each of the parties to the tax treaty must have sent a notification to the depositary listing this tax treaty and any amending or accompanying instruments thereto as a Covered Tax Agreement. Only if both conditions are fulfilled may the respective tax treaty be considered a Covered Tax Agreement subject to modification through the Multilateral Tax Instrument.³¹

The Multilateral Tax Instrument reflects a positive-listing approach, as its parties must notify the tax treaties they are willing to modify. In this sense, the Multilateral Tax Instrument provides States with flexibility, since they do not need to notify all their tax treaties as Covered Tax Agreements. As a consequence, not all the tax treaties of the parties to the Multilateral Tax Instrument will necessarily be modified through the instrument. The Explanatory Statement to the Multilateral Tax Instrument indicates that this flexible approach was adopted because parties may prefer to renegotiate some tax treaties on a bilateral basis or because a tax treaty may have been recently renegotiated and already implements the anti-BEPS measures.³² On the basis of the tax treaty network of the members of the ad hoc Group, the OECD initially estimated that more than 2,000 tax treaties could be modified through the Multilateral Tax Instrument.³³ However, a review of the notifications sent by the parties and signatories to the depositary as of 29 June 2018 shows that from the total of 2,563 tax treaties notified, only 1,367 tax treaties have been notified by all their contracting States as Covered Tax Agreements.³⁴ Thus, only 1,367 Covered Tax Agreements will be modified through the Multilateral Tax Instrument once the instrument enters into force for the respective parties. However, the possibility that the parties to the Multilateral Tax Instrument will notify other tax treaties – whether entered into force before or after the Multilateral Tax Instrument – as Covered Tax Agreements should not be underestimated.

³¹For more details, see Damberger, “Scope of the Multilateral Instrument”, in *The OECD Multilateral Instrument for Tax Treaties – Analysis and Effects* (M. Lang et al., eds., Wolters Kluwer, 2018), at 4-14.

³²OECD, *Explanatory Statement to the Multilateral Tax Instrument* (2016), para. 26.

³³OECD, “Countries adopt multilateral convention to close tax treaty loopholes and improve functioning of international tax system”, available at <http://www.oecd.org/tax/countries-adopt-multilateral-convention-to-close-tax-treaty-loopholes-and-improve-functioning-of-international-tax-system.htm> (consulted on 8 June 2018).

³⁴OECD, MLI Database – Matrix of options and reservations, available at <http://www.oecd.org/tax/treaties/mli-database-matrix-options-and-reservations.htm> (consulted on 30 June 2018).

The general rule of the Multilateral Tax Instrument is that its parties are bound by the entire instrument unless the parties make a reservation. However, all the provisions of the Multilateral Tax Instrument providing for anti-BEPS measures are subject to reservations. In addition, the Multilateral Tax Instrument provides for some opting-in mechanisms in the form of unilateral declarations and alternative provisions that apply only if the parties expressly opt in to such optional or alternative provisions.³⁵ The objective of the tax treaty makers was to provide for a high level of flexibility so that all States and non-State jurisdictions interested in fighting BEPS could join the Multilateral Tax Instrument so as to swiftly implement the anti-BEPS measures into their tax treaty network despite their different tax policies and economic interests.³⁶ As a consequence, the Multilateral Tax Instrument, to a great extent, favors universal participation over the integrity of its text.

Nonetheless, the treaty makers have adopted several measures to ensure a certain level of coordination in the implementation of the provisions of the Multilateral Tax Instrument. For example, with the exception of the reservations on the scope of the cases subject to mandatory binding arbitration,³⁷ each of the provisions establishing anti-BEPS measures lists the only reservations that parties and signatories can make and precludes them from making any reservations not listed.³⁸ Therefore, although parties do not need to accept all the commitments provided in the Multilateral Tax Instrument to fight BEPS practices, they can exclude or modify the effects of the provisions of the Multilateral Tax Instrument only by making the reservations that were acceptable for the tax treaty makers from an international tax policy perspective in the fight against BEPS. If parties avail themselves of the flexibility provided by the tax treaty makers and reserve the application of some of the rules of the Multilateral Tax Instrument, they will not adopt all the rules of the instrument. However, they still will implement coordinated rules across the tax treaty network, instead of unilateral or bilateral measures.

The coordinating effect of the Multilateral Tax Instrument is even more obvious when one considers that reservations apply to all the Covered Tax Agreements

³⁵For details on the functioning of the opting-in mechanisms in the Multilateral Tax Instrument, see Miladinovic and Rust, "Options under the Multilateral Instrument", in *The OECD Multilateral Instrument for Tax Treaties – Analysis and Effects* (M. Lang et al., eds., Wolter Kluwer, 2018), at 139-164.

³⁶OECD, Frequently Asked Questions on the Multilateral Instrument, available at <http://www.oecd.org/tax/treaties/MLI-frequently-asked-questions.pdf> (consulted on 18 June 2018).

³⁷Unlike in the rest of its provisions, the Multilateral Tax Instrument does not include an exhaustive list of defined reservations that States can make in connection with the scope of the mandatory binding arbitration procedure. Article 28(2) sets out that a State "may formulate one or more reservations with respect to the scope of cases that shall be eligible for arbitration under the provisions of Part VI (Arbitration)". States are, therefore, free to decide on the scope of the cases subject to arbitration.

³⁸Article 28(1) of the Multilateral Tax Instrument states that "Subject to paragraph 2, no reservations may be made to this Convention except those expressly permitted by:" and continues by listing each of the paragraphs of the provisions of the instrument that exhaustively list the permitted reservations.

of a reserving party.³⁹ Thus, when parties decide on their reservations, they must make decisions based on tax policy rather than on their economic interests vis-à-vis other parties to a Covered Tax Agreement. This feature of the reservations should contribute to the creation of an international tax playing field and avoid the creation of new disparities that could be used for BEPS practices. Opting-ins and alternative provisions established in the Multilateral Tax Instrument also, in general, apply to all the Covered Tax Agreements of the party that declares to opt in to those provisions.⁴⁰ It is expected that the coordinated implementation of the BEPS tax treaty output will diminish the competitive advantages or disadvantages derived from the use of certain tax treaties and, consequently, diminish treaty-shopping and tax arbitrage opportunities.⁴¹

The Multilateral Tax Instrument can attain further coordination of the tax treaty network if its parties decide in the future to opt in to some of the optional provisions or alternative provisions. That can also be the case if parties decide to withdraw or replace some of their reservations by a new formulation having a more limited scope.⁴² In this sense, a party that may be initially skeptical about the application of certain provisions of the instrument can change its position in the future and further modify its tax treaties by opting in to a provision or withdrawing or replacing a reservation. This is particularly relevant for the provisions setting out the mandatory binding arbitration procedure. As mentioned earlier, the implementation of a mandatory binding arbitration procedure did not receive broad support from the participants in the BEPS Project, nor did it receive broad support from the members of the ad hoc Group that negotiated the Multilateral Tax Instrument. Therefore, the provisions setting out the mandatory binding arbitration procedure are optional, which means that parties must opt in to their application. As of 29 June 2018, of the 82 parties and signatories of the Multilateral Tax Instrument, only 28 have opted in to the application of the mandatory binding arbitration procedure.

³⁹This effect of the reservations of the Multilateral Instrument is found in Article 28(8), according to which “a list of agreements notified pursuant to clause ii) of subparagraph a) of paragraph 1 of Article 2 (Interpretation of Terms) that are within the scope of the reservation as defined in the relevant provision (and, in the case of a reservation under any of the following provisions other than those listed in subparagraphs c), d) and n), the article and paragraph number of each relevant provision) must be provided when such reservations are made...”

⁴⁰The only exceptions to this rule can be found in Article 5, dealing with the application of methods for the elimination of double taxation and in Articles 18 to 26, dealing with mandatory binding arbitration, particularly in connection with Covered Tax Agreements that already provide for mandatory binding arbitration of unresolved issues arising from a mutual agreement procedure case, as they can be excluded from the scope of the Multilateral Tax Instrument through reservations. For more details, see Articles 5(8), (9) and 26(4) of the Multilateral Tax Instrument.

⁴¹In this sense, see Helminen, *The Nordic Multilateral Tax Treaty as a Model for a Multilateral EU Tax Treaty* (IBFD, 2014), at 6, which discusses the coordinating effects of multilateral tax treaties in general.

⁴²For more details, see Walker, “Reservations to the Multilateral Instrument”, in *The OECD Multilateral Instrument for Tax Treaties – Analysis and Effects* (M. Lang et al., eds., Wolters Kluwer, 2018), at 186-189.

However, if objections commonly made against the implementation of a mandatory binding arbitration procedure can be overcome by, for example, ensuring affordable proceedings, providing competent tax authorities with expertise and having access to unbiased arbitrators, more parties to the Multilateral Tax Instrument – especially less developed countries⁴³ – may be willing to accept the arbitration procedure in their tax treaty relations and, therefore, opt in to those provisions of the Multilateral Tax Instrument.

The provisions of the Multilateral Tax Instrument providing for anti-BEPS measures bind only those parties that have previously concluded a Covered Tax Agreement. Thus, the provisions of the Multilateral Tax Instrument modify the provisions of the Covered Tax Agreements without changing their bilateral structure and reciprocal effects.⁴⁴ After the Multilateral Tax Instrument enters into force, the obligations to avoid double taxation, whether by exempting certain items of income or by giving a credit for the tax paid in another State, will continue to be binary; that is, between a State of residence and a State of source. The exact form in which the provisions of the tax treaties will be modified through the Multilateral Tax Instrument is set out in compatibility or conflict clauses that interact with notification clauses and the notifications made by the parties.

The Multilateral Tax Instrument also includes compatibility clauses in each of its provisions establishing anti-BEPS measures.⁴⁵ The compatibility clauses describe the provisions of the Covered Tax Agreements that are subject to modification. Through such descriptions the tax treaty makers try to overcome the difficulties deriving from the fact that, owing to customization, Covered Tax Agreements may use different terminology and have different enumeration styles, different wording and even different scopes. In addition, the compatibility clauses prescribe the effects of the provisions they relate to on the provisions of the Covered Tax Agreements.⁴⁶

⁴³On these matters, see Owens, Gildemeister and Turcan, "Proposal for a New Institutional Framework for Mandatory Dispute Resolution", 82 *Tax Notes International* (2016), and United Nations – Committee of Experts on International Cooperation in Tax Matters, *Secretariat Paper on Alternative Dispute Resolution in Taxation*, E/C.18/2015/CRP.8 (2015), http://www.un.org/esa/ffd/wp-content/uploads/2015/10/11STM_CRP8_DisputeResolution.pdf (consulted on 18 June 2018).

⁴⁴Exceptionally the provisions of Article 5 and some of the provisions of Article 7 of the Multilateral Tax Instrument may be applied by only one of the parties to a Covered Tax Agreement. However, agreement of the other parties to the respective Covered Tax Agreement is required so that the provisions of the Multilateral Tax Instrument can be applied unilaterally.

⁴⁵Except for the compatibility clause dealing with the mandatory binding arbitration procedure, which is established in Article 26 but applies to the entire Part VI of the Multilateral Tax Instrument.

⁴⁶For details on compatibility clauses, see Bravo, "The Multilateral Tax Instrument and Its Relationship with Tax Treaties", 8 *World Tax Journal* 3 (2016), at 285-287 and 296-300, and Govind and Pistone, "The Relationship Between Tax Treaties and the Multilateral Instrument: Compatibility Clauses in the Multilateral Instrument" in *The OECD Multilateral Instrument for Tax Treaties: Analysis and Effects* (M. Lang et al., eds., Wolters Kluwer, 2018), at 118-122.

These effects may be to replace, to change the scope of application, to supplement or to supersede.⁴⁷

The exact effect of the provisions of the Multilateral Tax Instrument on the provisions of a Covered Tax Agreement depends on the content of the latter, on the fact that none of the parties has made a reservation (or that all of them have opted in to the application of the provision) and on whether parties have notified that a similar provision exists or does not exist in the Covered Tax Agreement. Indeed, as mentioned earlier, the compatibility clauses of the Multilateral Tax Instrument interact with the notification clauses also found in each provision of the Multilateral Tax Instrument establishing anti-BEPS measures and the notifications made by the parties. These notifications ensure that parties agree on which provisions of their Covered Tax Agreement are or are not subject to modification through the Multilateral Tax Instrument. Even though the compatibility clauses interacting with the notification clauses and the notifications made by the parties may produce different effects (e.g. replace, change the scope of application, supplement or supersede), one should not lose sight of the fact that all of the compatibility clauses claim that the provisions of the Multilateral Tax Instrument must always prevail over those of the Covered Tax Agreements. The fact that all the compatibility clauses claim the prevalence of the Multilateral Tax Instrument is logical considering that the main object and purpose of this instrument is to modify the Covered Tax Agreements.

4. Techniques used in the Mauritius Convention to modify IIAs

The Mauritius Convention was adopted by the United Nations in its resolution 69/116 of 10 December 2014.⁴⁸ After a signing ceremony in Mauritius on 17 March 2015 and following ratification by Canada, Mauritius and Switzerland, the Mauritius Convention entered into force on 18 October 2017.⁴⁹ According to its

⁴⁷ The Multilateral Tax Instrument uses four types of compatibility clauses: (i) "in place of", (ii) "applies to" or "modifies", (iii) "in the absence of" and (iv) "in place of or in the absence of".

⁴⁸ *Resolution 69/116 adopted by the General Assembly on 10 December 2014 [on the report of the Sixth Committee (A/69/496)]*, available at https://treaties.un.org/doc/source/docs/A_RES_69_116-E.pdf (consulted on 8 June 2018).

⁴⁹ For more information, see "The United Nations Convention on Transparency in Treaty-based Investor-State Arbitration will enter into force in six months after ratification by Switzerland", available at <http://www.unis.unvienna.org/unis/en/pressrels/2017/unisl244.html> (consulted on 18 June 2018). Another 23 States have signed the Mauritius Convention since it was opened for signature on 17 March 2015. However, they have not completed the ratification process; see http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/2014Transparency_Convention_status.html (consulted on 18 June 2018). Also, UNCTAD, *Investment Policy Monitor* No. 17, at 11 (March 2017), and UNCTAD, *IIA Issues Note* No. 1, at 11 (March 2016), both available at <http://investmentpolicyhub.unctad.org/> (consulted on 18 June 2018).

preamble, the Mauritius Convention implements the Rules on Transparency in the investment treaty network with the purpose of contributing to the establishment of a harmonized legal framework for a fair and efficient settlement of investor–State disputes. The Mauritius Convention produces its effects irrespective of whether an IIA provides for arbitration rules or procedures different than the UNCITRAL arbitration rules. In particular, the Rules on Transparency “provide for the public release of information and documents generated as part of investment treaty arbitrations as well as the capacity for non-disputing third parties to attend or even participate in the proceedings.”⁵⁰ As the Rules on Transparency were enacted by UNCITRAL on 1 April 2014, the Mauritius Convention, like the Multilateral Tax Instrument, implements rules whose substance was previously agreed by consensus.

The Mauritius Convention establishes that all the IIAs of the parties – which include not only States but also regional economic integration organizations – concluded before 1 April 2014 will be modified through the Convention, unless they make a reservation. If reservations are not made by the parties, all their IIAs will be modified through the Convention in order to apply the Rules on Transparency to investor–State arbitration procedures to which they are a party as long as the investor’s host State is also a party to the Convention (bilateral or multilateral application), or the investor has agreed on the application of the Rules on Transparency after an offer made by the respondent State (unilateral application).⁵¹

Hence, the Mauritius Convention – unlike the Multilateral Tax Instrument – takes a negative-listing approach. In their reservations, parties must identify IIAs by title and by the name of the contracting States, to exclude them from the scope of application of the Convention. As a consequence, not all the IIAs of the parties to the Mauritius Convention concluded before 1 April 2014 will necessarily be modified through that Convention. Therefore, the negative-listing approach adopted in the Mauritius Convention also provides States with flexibility, as they do not need to implement the Rules on Transparency in all their IIAs.

The Mauritius Convention also allows a party to reserve the right not to apply the Rules on Transparency to an investor–State arbitration procedure in which it is a respondent if such an arbitration procedure is conducted using a specific set of arbitration rules or procedures other than the UNCITRAL arbitration rules,⁵² e.g. the International Centre for Settlement of Investment Disputes Convention and the Arbitration Rules of the International Chamber of Commerce. It also allows a party to reserve the right to exclude unilateral offers to investors of the application of the

⁵⁰ Shirlow, “Three Manifestations of Transparency in International Investment Law: A Story of Sources, Stakeholders and Structures”, 8 *Goettingen Journal of International Law* 73 (2017), at 87-88.

⁵¹ See Article 2 of the Mauritius Convention.

⁵² See Article 3(1)(b) of the Mauritius Convention.

Rules on Transparency in the context of an investor–State arbitration procedure in which it is a respondent,⁵³ which means that such a party accepts only the bilateral or multilateral application of the Convention. Furthermore, a party to the Mauritius Convention can reserve the right to not automatically apply eventual modifications to the Rules on Transparency.⁵⁴ All other reservations to the provisions of the Mauritius Convention are, however, precluded.⁵⁵ The list of reservations included in Article 3 of the Mauritius Convention is exhaustive and, as is also the case with the Multilateral Tax Instrument, parties to the Mauritius Convention can make only the reservations listed therein.

Interestingly, except for the reservation on the automatic application of modifications to the Rules on Transparency, which must be made within six months after such modifications have been adopted, parties to the Mauritius Convention can make reservations at any time.⁵⁶ As a consequence, reservations can be made by the parties even after the Convention has entered into force for them, in which case the reservations will take effect twelve months after the date of their deposit.⁵⁷ Reservations made after the Convention has entered into force for the reserving party – commonly referred to in treaty law as late reservations – would, in the case of the Mauritius Convention, diminish the party’s commitment to ensure transparency in investment arbitration procedures. Indeed, late reservations would allow parties to stop applying the Rules on Transparency at any point in the future with respect to certain IIAs or certain procedures, or as a result of unilateral offers to investors. The possibility of formulating late reservations implies that parties to the Mauritius Convention may unilaterally modify the obligation to apply the Rules on Transparency in the future, irrespective of the position adopted by other parties to an IIA. Moreover, late reservations play against the establishment of a harmonized legal framework for the fair and efficient settlement of international investment disputes, as the reserving parties may restrict their obligations under the Mauritius Convention.

Yet parties can also withdraw their reservations at any time, which means that more of their IIAs may be modified by the Mauritius Convention. A withdrawal of a reservation would produce the exact opposite effect of the formulation of a late reservation. The party withdrawing the reservation would increase its commitment to apply the rules of the Mauritius Convention, whether by covering more of its IIAs under the Convention, by accepting the application of the Rules on Transparency to investor–State arbitrations conducted under other arbitration

⁵³ See Article 3(1)(c) of the Mauritius Convention.

⁵⁴ See Article 3(2) of the Mauritius Convention.

⁵⁵ See Article 3(4) of the Mauritius Convention.

⁵⁶ See Article 4(1) of the Mauritius Convention.

⁵⁷ See Article 4(4) of the Mauritius Convention.

rules than the UNCITRAL rules, by applying the Rules on Transparency after the acceptance of unilateral offers made to investors, or by accepting the application of further modifications to the Rules on Transparency. Likewise, the withdrawal of a reservation would expand a party's commitment to ensure transparency in investment arbitration procedures and more thoroughly conform to the object and purpose of the Mauritius Convention.

Another interesting feature of the Mauritius Convention is that it allows its parties to unilaterally offer the application of the Rules on Transparency to investors in the context of investor–State arbitration procedures arising under an IIA, even where their home State has not ratified the Convention.⁵⁸ A unilateral offer of the application of the Rules on Transparency broadens the scope of application of the Mauritius Convention. It is not necessary that all the contracting States of an IIA are also parties to the Mauritius Convention for the rules of the latter to apply to an investor–State arbitration procedure. It is enough that the respondent State has ratified the Convention and has not made a reservation with respect to the right to unilaterally offer to an investor the application of the Rules on Transparency.⁵⁹

A unilateral offer can also be made by the respondent State to an investor when its home State has made a reservation excluding the respective IIA from the scope of application of the Mauritius Convention.⁶⁰ This means that reservations do not reciprocally apply in all cases. Indeed, even if the host State has made a reservation, the Rules on Transparency may still apply to investor–State arbitrations if the investor accepts the unilateral offer of the respondent State.⁶¹

The Mauritius Convention does not contain detailed compatibility clauses. However, its Article 2(4) establishes the following:

The final sentence of article 1(7) of the UNCITRAL Rules on Transparency shall not apply to investor–State arbitrations under paragraph 1.

The final sentence of Article 1(7) of the Rules on Transparency provides that if a conflict between such rules and the respective IIA arises, the provisions of the IIA shall prevail. Article 2(4) of the Mauritius Convention thus addresses the relationship between the Convention and underlying IIAs by clarifying that the final sentence of

⁵⁸Fry and Repousis, "Towards a New World for Investor–State Arbitration Through Transparency", 48 *New York University Journal of International Law and Politics* (2015-2016), at 839.

⁵⁹ See also, Johnson, "The Mauritius Convention on Transparency: Comments on the treaty and its role in increasing transparency of investor–State arbitration", Columbia Center on Sustainable Investment Policy Paper (2014), at 6 and 7.

⁶⁰For more details, see Bergman, "Introductory Note to United Nations Convention on Transparency in Treaty-Based Investor-State Arbitration", 54 *International Legal Materials* (2015), at 748.

⁶¹For more details, see Johnson, "The Mauritius Convention on Transparency: Comments on the treaty and its role in increasing transparency of investor-State arbitration", Columbia Center on Sustainable Investment Policy Paper (2014), at 11 and 12.

Article 1(7) of the Rules on Transparency shall not apply. Accordingly, if a conflict of treaties between the Mauritius Convention and the Rules on Transparency, on the one hand, and an underlying IIA, on the other hand, arises, then the Mauritius Convention and the Rules on Transparency should prevail over the IIA. This result is a logical one, considering that the object and purpose of the Mauritius Convention is to update the investment treaty network in order to implement the Rules on Transparency in more than 3,000 IIAs.⁶² Moreover, this result reflects the *lex posterior* principle enshrined in Article 30(3) and (4) of the Vienna Convention.⁶³ According to that principle, if the provisions of conflicting treaties cannot be implemented at the same time, the effects and consequences under the later treaty (the Mauritius Convention) must be implemented, giving them preference over the effects and consequences of the earlier treaty (the underlying IIA).⁶⁴

5. Comparison between the Multilateral Tax Instrument and the Mauritius Convention

The Multilateral Tax Instrument and the Mauritius Convention have similar characteristics as well as some differences. Those similarities and differences are highlighted in this section because they may be relevant for future modifications of an extensive number of treaties through a single multilateral instrument. They may also be relevant for policymakers engaged in the discussions of changes to IIAs and changes to tax treaties, if they decide to coordinate efforts to promote investment by aligning IIAs and tax treaties through a single multilateral treaty.

The Multilateral Tax Instrument and the Mauritius Convention were designed as streamlined mechanisms. If these multilateral conventions are successful in achieving a swift modification of the treaty networks, they most probably will serve

⁶²Fry and Repousis, "Towards a New World for Investor-State Arbitration Through Transparency", 48 *New York University Journal of International Law and Politics* (2015-2016), at 840.

⁶³Grinberg and Pauwelyn, "The Emergence of a New International Tax Regime: The OECD's Package on Base Erosion and Profit Shifting (BEPS)", 19 *Insights* 24 (2015), available at <https://www.asil.org/insights/volume/19/issue/24/emergence-new-international-tax-regime-oecd-s-package-base-erosion-and> (consulted on 18 June 2018); Fry and Repousis, "Towards a New World for Investor-State Arbitration Through Transparency", 48 *New York University Journal of International Law and Politics* (2015-2016), at 840; Johnson, "The Mauritius Convention on Transparency: Comments on the treaty and its role in increasing transparency of investor-State arbitration", Columbia Center on Sustainable Investment Policy Paper (2014), at 5.

⁶⁴McNair, *The Law of Treaties* (Clarendon Press, 1961), at 219 and Giegerich, "Termination or Suspension of the Operation of a Treaty Implied by Conclusion of a Later Treaty", in *Vienna Convention on the Law of Treaties* (Dörr and Schmalenbach, eds., Springer-Verlag, 2012), at 1012. For a more detailed explanation of the use of the *lex posterior* principle for resolving conflicts between modifying treaties and modified treaties, see Bravo, "The Multilateral Tax Instrument and Its Relationship with Tax Treaties", 8 *World Tax Journal* 3 (2016), at 287-289.

as models for the future. In fact, the Multilateral Tax Instrument and the Mauritius Convention have already inspired a study about the implementation of a permanent investment tribunal in treaty-based investor–State arbitration through a single instrument that could swiftly modify numerous IIAs.⁶⁵

The treaty makers of the Multilateral Tax Instrument and the Mauritius Convention sought to avoid the potential complexities of renegotiating and amending the States' entire treaty networks. Another objective of the treaty makers was to implement uniform rules in the tax and investment treaty networks, respectively. To achieve these objectives, the treaty makers opted for dealing with narrow subject matters. Indeed, the Multilateral Tax Instrument implements only treaty rules to prevent BEPS and the Mauritius Convention implements only the Rules on Transparency relevant for investor–State arbitration procedures. By dealing with narrow subject matters, the treaty makers of these multilateral conventions avoided engaging in the negotiation of controversial treaty issues for which consensus may be more difficult to reach – i.e., in the case of tax treaties the allocation of income to the State of source or the State of residence and in the case of IIAs substantive investment protection standards.⁶⁶ This approach allows States with different policies and economic interests to conclude multilateral treaties, despite of their differences.⁶⁷

To further encourage States with different policies and interests to conclude the Multilateral Tax Instrument and the Mauritius Convention, the treaty makers in both decided to provide for a high level of flexibility. As discussed in section 3, the Multilateral Tax Instrument combines the use of opting-ins, alternative provisions and reservations. Although the combined use of mechanisms to create flexibility in the Multilateral Tax Instrument adds complexity to its interpretation and application, these mechanisms are also essential tools to ensure universal participation. Without ensuring a high level of flexibility in the implementation of the Multilateral Tax Instrument, the number of signatories and parties probably would not have reached more than 80 States and non-State jurisdictions. Moreover, as discussed in section 4, the Mauritius Convention provides parties with flexibility by allowing them to either carve out specific IIAs or carve out all IIAs that establish procedures other than the UNCITRAL arbitration rules. All of this shows that, although the substance of both

⁶⁵ See Kaufmann-Kohler and Potestà, “Can the Mauritius Convention serve as a model for the reform of investor–State arbitration in connection with the introduction of a permanent investment tribunal or an appeal mechanism? Analysis and roadmap”, CIDS-Geneva Center for International Dispute Settlement (2016).

⁶⁶ See Kaufmann-Kohler and Potestà, “Can the Mauritius Convention serve as a model for the reform of investor–State arbitration in connection with the introduction of a permanent investment tribunal or an appeal mechanism? Analysis and roadmap”, CIDS-Geneva Center for International Dispute Settlement (2016), at 75-76.

⁶⁷ For a similar view, see Schill, “The Mauritius Convention on Transparency: A Piece of Constitutional Reform of the International Investment Regime”, 16 *Journal of World Investment & Trade* (2015), at 202.

multilateral conventions was agreed by consensus in advance and that adopting uniform rules was part of the object and purpose of both multilateral conventions, ensuring flexibility was essential for the treaty makers. Probably, the treaty makers feared that without offering a high level of flexibility, the conventions would not be successful in the modification of an extensive number of treaties. In the case of the Multilateral Tax Instrument, the treaty makers' fear seems to have been justified. Many parties and signatories have not opted in to the optional provisions, have chosen different alternative provisions – which means that their options are not always applicable to their tax treaties – and have made many reservations to limit the scope of the modifications applicable to their tax treaties.⁶⁸

As both multilateral conventions provide for a high level of flexibility and parties have availed themselves of it, large-scale harmonization of treaty rules across the tax treaty network and the investment treaty network will probably not be achieved. As a consequence of the flexibility granted by both multilateral conventions, their parties can modify only some of their treaties or parts of their treaties. Despite the existence of different sets of applicable rules in the tax treaty network and the investment treaty network, a certain level of coordination will still be achieved with these multilateral conventions because they establish an exhaustive list of permitted reservations. This means that the treaty makers have decided beforehand which reservations are acceptable from a policy perspective, avoiding that parties produce reservations that may be undesirable. Moreover, both multilateral conventions allow parties to withdraw or replace their reservations at any time as an incentive for the parties to further commit to the fulfillment of the conventions' object and purpose. Future modifications of an extensive number of treaties through a single instrument should carefully balance the benefits of implementing high levels of flexibility against the benefits of implementing harmonized rules across the treaty network. If universal participation is preferred, treaty makers should give preference to flexibility over the harmonized implementation of the treaty rules.

Instead of directly amending each treaty, the Multilateral Tax Instrument and the Mauritius Convention adopted the approach established in Article 30 of the Vienna Convention, which deals with successive treaties dealing with the same subject matter. Thus, these multilateral conventions coexist with the treaties they modify. Whereas the Multilateral Tax Instrument includes detailed compatibility clauses and notification clauses in each of its provisions establishing anti-BEPS measures that indicate the exact effects of those provisions on the ones of the Covered Tax Agreements, the Mauritius Convention follows the *lex posterior* principle. The

⁶⁸The list of opting-ins, alternative provisions and reservations made by the parties and signatories of the Multilateral Tax Instrument is available at <http://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf> (consulted on 30 June 2018).

different techniques used by the treaty makers, however, do not produce different effects. Unless the parties make a reservation or do not opt in to the application of optional or alternative provisions, the provisions of the multilateral conventions in all cases prevail over the ones of the treaties they modify, by either replacing them, modifying their scope of application or supplementing them.

Another difference between the Multilateral Tax Instrument and the Mauritius Convention is the approach used to determine their scope of application. However, as with the use of compatibility clauses combined with the use of notification clauses or the use of the *lex posterior* principle instead, the different approaches to determine the scope of application of the conventions implemented by the treaty makers also produce similar effects. The Multilateral Tax Instrument uses a positive-listing approach to determine the tax treaties that will be modified. Thus, to be subject to modification through the Multilateral Tax Instrument, all the parties to a tax treaty must notify it as a Covered Tax Agreement. The positive-listing approach adopted in the Multilateral Tax Instrument is the opposite of the negative-listing approach adopted in the Mauritius Convention. Indeed, under the Mauritius Convention all the IIAs of the parties concluded before 1 April 2014 will be modified unless at least one of their parties makes a reservation. Consequently, under both multilateral conventions, their parties have the freedom to exclude the treaties that they do not want to modify.

Although similar effects can be achieved by using the positive-listing approach or the negative-listing approach to determine the scope of application of a modifying multilateral convention, the author believes that the positive-listing approach adopted by the treaty makers of the Multilateral Tax Instrument may have an advantage over the use of the negative-listing approach. The advantage is that parties to the Multilateral Tax Instrument may notify future tax treaties as Covered Tax Agreements. This means that if those parties conclude new tax treaties without implementing all or some of the BEPS tax treaty output, pursuant to Article 29(5),⁶⁹ they can notify those tax treaties as Covered Tax Agreements to modify them through the Multilateral Tax Instrument so as to implement the anti-BEPS measures. Conversely, under the Mauritius Convention, parties cannot modify future IIAs because the convention can apply only in respect of treaties concluded before 1 April 2014. Thus, the Mauritius Convention cannot have effect on future IIAs.⁷⁰ This approach might be sound, because the Rules on Transparency are supposed to

⁶⁹ Article 29(5) of the Multilateral Tax Instrument states:

A Party may extend at any time the list of agreements notified under clause ii) of subparagraph a) of paragraph 1 of Article 2 (Interpretation of Terms) by means of a notification addressed to the Depository.

⁷⁰ See also Schill, "The Mauritius Convention on Transparency: A Piece of Constitutional Reform of the International Investment Regime", 16 *Journal of World Investment & Trade* (2015), at 203.

apply to all IIAs concluded after 1 April of 2014. However, if future modifications of an exhaustive number of treaties through a single instrument intend to turn political commitments into mandatory treaty rules, they should consider the advantages of adopting a positive-listing approach over a negative-listing approach.

The Mauritius Convention may apply as a consequence of a unilateral offer of one of the parties to an investor. Therefore, an agreement between all the parties to an IIA is not necessary in order for the Rules on Transparency to apply to investor–State arbitration procedures. In the case of the Multilateral Tax Instrument, the unilateral application of treaty provisions is not possible without the agreement of all the parties to a Covered Tax Agreement. Some provisions may be applied by only one of the parties to a Covered Tax Agreement. However, this is possible only if the rest of the parties to that Covered Tax Agreement have previously agreed to such a result. The agreement of the rest of the parties to a Covered Tax Agreements results from the absence of a reservation rejecting the unilateral application of the treaty rule by the other party or from not opting in to the application of the same rule or a similar rule offered as an alternative in the Multilateral Tax Instrument.⁷¹

Finally, the Multilateral Tax Instrument allows parties to make late reservations in very few circumstances. Two reasons might explain the limitations on formulating late reservations. First, treaty makers may have felt that it was necessary to prevent parties from reducing their commitments to counter BEPS practices after they have accepted to tackle them through the Multilateral Tax Instrument. Second, limiting the formulation of late reservations avoids the possibility that a party could unilaterally modify the application of the Multilateral Instrument on a Covered Tax Agreement. Unilateral modifications would most probably affect the decisions taken by the other contracting States to a Covered Tax Agreement without their consent in order to tolerate BEPS opportunities, which might go against their will. Conversely, under the Mauritius Convention the practice of making late reservations is accepted, probably because the unilateral application of the Convention is also accepted. Again, in the case of future modifications of an exhaustive number of treaties through a single instrument, the treaty makers should carefully consider whether the nature of the treaty obligations is compatible with the formulation of late reservations or not and decide whether to permit such a practice.

The common characteristics of the Multilateral Tax Instrument and the Mauritius Convention as well as their differences are summarized in table 1.

⁷¹For details, see Articles 5 and 7 of the Multilateral Tax Instrument.

Table 1. Comparison of the two conventions

	Multilateral Tax Instrument	Mauritius Convention
Substantive or material provisions agreed before the negotiation of the multilateral treaty	Yes	Yes
Adopted with the object and purpose of modifying treaties and improving the coordination of the provisions found in the bilateral treaty networks	Yes	Yes
Obligation to modify all the treaties of the parties to the multilateral convention	No. The Multilateral Tax Instrument adopted for this purpose a positive-listing approach. That is, the parties must list the treaties that will be modified through the convention.	No. The Mauritius Convention adopted for this purpose a negative-listing approach. That is, the parties must make reservations to avoid the application of the convention to certain treaties.
Possibility of making reservations	Yes. However, the parties can make only the reservations expressly established in the text of the convention. All other reservations are precluded.	Yes. However, the parties can make only the reservations expressly established in the text of the convention. All other reservations are precluded.
Possibility to make reservations at any time	Reservations can be made until the party deposits its instrument of ratification. However, parties can opt in to the application of optional provisions and alternative provisions after the convention has entered into force for them. As a consequence of a late opting-in, the party will increase its treaty commitments.	Reservations can be made after the Convention has entered into force for the parties. As a consequence of a late reservation the party will reduce its commitment to applying the rules of the convention.
Possibility to withdraw reservations	It is possible to withdraw reservations at any time. As a consequence of the withdrawal the party increases its commitment to apply the rules of the convention.	It is possible to withdraw reservations at any time. As a consequence of the withdrawal the party increases its commitment to apply the rules of the convention.
Possibility to unilaterally apply the provisions of the convention	Only exceptionally. This is only possible if the rest of the parties to the Covered Tax Agreement have previously agreed to it.	It is always possible after the party has made a unilateral offer to the investor and the investor has accepted it.
Definition of the relation between the convention and the treaties it modifies	Compatibility clauses are found in each provision of the convention establishing anti-BEPS measures. The compatibility clauses interact with the notification clauses.	Detailed compatibility clauses cannot be found in each provision of the convention. However, in cases of treaty conflicts the Mauritius Convention should prevail over existing treaties on the basis of the application of the <i>lex posterior</i> principle.
Possibility to modify future treaties through the convention	Yes	No. The convention applies only in connection with IAs concluded before 1 April 2014.

6. Conclusions

This article has reviewed the techniques used in the Multilateral Tax Instrument and the Mauritius Convention. It has shown that despite the complexity of modifying, through a single instrument, treaty networks comprising more than 3,000 treaties with customized rules based on the investment flows and economic interests of the contracting States, treaty makers have multiple tools to effectively achieve such modifications. Thus, future modifications to numerous treaties can be done using tools similar to the ones implemented in the Multilateral Tax Instrument and the Mauritius Convention.

An important lesson from the comparison of the two conventions is that to attract universal participation, treaty makers need to focus on narrow subjects on which consensus is easier to reach and to provide for a high level of flexibility. The flexibility may be implemented through opting-in mechanisms, alternative provisions, reservations or a combination of all of these, as in the Multilateral Tax Instrument. Although flexibility may jeopardize the implementation of harmonized rules, treaty makers can always adopt measures to attain a certain level of coordination or uniform implementation of the rules across the treaty network; for example, providing for an exhaustive list of the permitted reservations and allowing parties to withdraw the reservations at any time so that parties can more thoroughly conform to the object and purpose of the treaties. If the Multilateral Tax Instrument and the Mauritius Convention succeed, it can be expected that the practice of modifying an exhaustive number of treaties through a single instrument will continue to be used in the future. Moreover, if the Multilateral Tax Instrument and the Mauritius Convention succeed, policymakers engaged in the discussions of changes to IIAs and changes to tax treaties could join forces to coordinate the implementation of treaty changes to IIAs and tax treaties that may be required in order to promote investment through a single treaty.

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Establishing the baseline: estimating the fiscal contribution of multinational enterprises[†]

Richard Bolwijn, Bruno Casella and Davide Rigo*

Tax revenues from multinational enterprises (MNEs) are an important source of public finance in developing economies. The research and policy debate so far have mostly focused on the “missing” part, i.e. the government revenues lost due to the tax avoidance practices of MNEs (Bolwijn et al., 2018). In this study, we take a different, but complementary, approach, looking at the taxes and other revenues actually paid by foreign affiliates of MNEs to developing-country governments. We present two alternative methodologies to estimate foreign affiliates’ fiscal contribution – the contribution method and the foreign direct investment (FDI) income method – and show that they lead to the same order of magnitude. The findings allow us to set a baseline for an informed discussion on tax avoidance by MNEs.

Keywords: multinational enterprise, fiscal contribution, BEPS, domestic revenues, developing countries

1. Introduction: objective and scope of the analysis

The main goal of this study is to arrive at a meaningful order of magnitude for the *fiscal contribution* of foreign affiliates of multinational enterprises (MNEs) to developing economies. The definition of “fiscal contribution” in this context encompasses all types of payments by foreign affiliates to host country governments, including taxes, social contributions and other revenues.

The analysis boils down to the estimation of three metrics: (a) the share of government revenues paid by foreign affiliates in total government revenues; (b) the share of government revenues paid by foreign affiliates in government revenues

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* Richard Bolwijn and Bruno Casella are at the United Nations Conference on Trade and Development. Davide Rigo is at the Graduate Institute of International and Development Studies, Geneva. The corresponding author is Bruno Casella (bruno.casella@unctad.org). The views expressed in this article are solely those of the authors and do not necessarily represent the views of the United Nations.

paid by the corporate sector; (c) the absolute amount of government revenues paid by foreign affiliates. Revenues paid by MNEs to home countries are excluded from the analysis.

The analytical effort is relevant to a number of current policy debates:

- On the financing of the Sustainable Development Goals, it helps to size the potential role of MNEs in mobilizing domestic resources for development.¹
- On base erosion and profit shifting (BEPS), it helps to draw a baseline to assess the weight of the tax leakage relative to the tax contribution. The goal is to compute the fiscal contribution after profit shifting, i.e. it targets what foreign affiliates actually pay (based on what they report) after BEPS has taken place.
- To measure BEPS, it is helpful to understand the relative sizes of the categories of MNE contributions when estimating the impact of different BEPS schemes.

Despite the relevance of the research question, to our knowledge no previous studies quantify the fiscal contribution of foreign affiliates to developing economies in a systematic and comprehensive fashion. The most likely reason for this gap is the scarcity of data on taxes paid by foreign affiliates in general, and in developing economies in particular. Most MNEs do not report taxes and other financial information at the level of their foreign affiliates.² Increasing pressure for country-by-country reporting may significantly improve information availability in the near future, but at the moment, access to relevant data on the operations and financials of foreign affiliates is still highly problematic.³

There are two main sources of information on taxes paid by foreign affiliates.

The ORBIS database from Bureau Van Dijk collects financial and business

¹ The *World Investment Report 2014* focuses on the role of FDI in mobilizing *external sources* of development financing in terms of private investments into the Sustainable Development Goals; this study complements that perspective highlighting the role of FDI in mobilizing *domestic resources*.

² MNEs in general do not have the obligation to report detailed business and financial information on their foreign affiliate activities. Recently, in the face of mounting pressure for tax transparency, an increasing number of MNEs are voluntarily opting to disclose tax information on their foreign operations.

³ Country-by-country reporting has been a longstanding pillar of tax transparency advocacy (see, for example, the Tax Justice Network website, <http://www.taxjustice.net/topics/corporate-tax/country-by-country>). It makes it possible to detect distortions and misalignments in business and financial indicators of foreign affiliates, potentially indicating profit-shifting practices. In the context of the BEPS-G20 process, countries agreed on a new standard for MNEs to report their economic activities (including profits and tax payments) to the tax authority on a country-by-country basis. However this measure per se would not increase access to foreign affiliate information for the broad public, as transparency remains confined to one-to-one communication with the tax authority. Aside from the BEPS project, other ongoing transparency initiatives provide useful complementary information on the activity of MNEs in their countries of operations. A notable example is the Extractive Industry Transparency Initiative, supporting member countries (participation is on a voluntary basis) in the full disclosure of company payments and related government revenues from oil, gas and mining activities. A review of corporate transparency initiatives currently in place appears in PwC (2013).

information from balance sheet and P&L data for over 100 million companies worldwide. It is by far the largest compiler of firm-level data. More crucially, it is the only firm-level database providing comprehensive information on the ownership structure of companies; this makes it, de facto, the only option when the analytical focus is on MNEs and the operations of their foreign affiliates. However, in particular for developing regions, ORBIS suffers from severe problems of inadequate coverage and availability of financial information.⁴ More specifically, whereas MNE financial information is usually available at the group level with some details (especially in the case of publicly listed MNEs from developed countries), reporting of unconsolidated financials on MNE foreign affiliates is extremely poor (see, for example, the discussions in Cobham and Loretz (2014) and Tørsløv et al. (2018)).

Examples of studies using ORBIS to analyse the tax dynamics of MNEs in developing countries include Markle and Shackelford (2012, 2013), Fuest et al. (2012), and Cobham and Loretz (2014). The studies of Markle and Shackelford and Fuest et al. apply econometric techniques to a sample of firms extracted from ORBIS to analyse taxation of MNEs, either by comparing MNEs with domestic firms or by comparing MNEs with different features. More specifically, Markle and Shackelford (2012, 2013) use consolidated data from ORBIS to analyse factors influencing business groups' effective tax rates (ETRs) – taxes paid over pre-tax profit reported by ORBIS – for a sample of both developed and developing countries. Interestingly they find no evidence of a substantial difference in the ETR between domestic companies and MNEs, whereas within the group of MNEs, the locations of the subsidiaries (in financial centres versus in other countries) matter. Also, Fuest et al. (2012) explore the determinants of ETRs, based on a sample of ORBIS data focusing specifically on developing economies. Results confirm that being part of an MNE does not play a significant role in determining the ETR (unlike institutional factors such as the level of corruption).

Cobham and Loretz take a more policy-oriented perspective, where the goal is to analyse the potential impact on countries of a change in the tax system, from the current system of separate accounting to one of unitary taxation. In particular, on the basis of financial and operational data extracted from ORBIS on a sample of foreign affiliates worldwide, the paper simulates how the tax base and the tax revenues would re-partition across countries if various apportionment formulas are

⁴ According to preliminary findings from UNCTAD, in 2015 ORBIS reported some 2,600 foreign affiliates operating in Africa. For some smaller African countries, it recorded implausibly low numbers (e.g. Burundi, 3 foreign affiliates; Benin, 8; the Congo, 15). In addition, out of the 2,600 foreign affiliates identified, more than 2,100 (more than 80%) either do not report tax data at all or report negative or null values. For other indicators, such as turnover or employment, the coverage does not improve substantially (with data unavailable for 65% of turnover and almost 80% of employment). As a further benchmark, the Zambian Central Bank surveyed 126 active foreign affiliates in 2013, whereas an UNCTAD extraction from ORBIS returned only 36 entries.

applied. Although data coverage is problematic for developing countries, the paper finds that apportioning profits according to measures of actual economic activity would result in a major redistribution of the tax base at the expense of specific jurisdictions, and in most cases towards the lower-income countries in the sample.

The second source of data on taxes paid by foreign affiliates is collected through national surveys. These foreign affiliates' statistics (FATS) include (a) statistics on the activity of affiliates operating in the reporting country (inward FATS), and (b) statistics on the activity of foreign affiliates of parents based in the reporting country (outward FATS). Since only a limited number of developed countries produce these surveys, when the object of the analysis is the activity of foreign affiliates in developing economies, the most relevant data are the outward FATS of developed countries (e.g. activity in developing economies of United States-headquartered MNEs). The coverage of FATS in terms of reporting economies depends on the financial indicators of interest. For "taxes paid" by foreign affiliates, complete FATS information is reported essentially only by the United States Bureau of Economic Analysis (BEA).⁵ Existing studies on MNE taxation that are based on FATS data are almost exclusively limited to foreign affiliates of United States MNEs. For a useful overview of issues related to the collection and interpretation of BEA FATS data on taxation, see Yorgason (2009). For applications of BEA tax data, see for example Clausing (2009)⁶ or IMF (2014).⁷

Unlike previous studies, the goal of the analysis in this study is to comprehensively "size a population", i.e. to measure the *total* amount of taxes paid by *all* foreign affiliates in developing economies, rather than to explore the properties of a population (for example, tax behaviours of MNEs) by generalizing from a reasonable but limited sample of firms. For this purpose, the coverage issues of the tax information in ORBIS and FATS are even more challenging. In addition, it is important to recall that both ORBIS and the BEA FATS capture only a portion of

⁵ Bureau of Economic Analysis, International Economic Accounts (<http://www.bea.gov/international/>); see also Barefoot (2012). The Ministry of Economy, Trade and Industry of Japan (<http://www.meti.go.jp/english/statistics/>) reports some, albeit partial, data on taxation of foreign affiliates.

⁶ Clausing (2009) leverages BEA data to analyse international profit-shifting practices of United States MNEs. The paper investigates how the profitability of foreign affiliates of United States MNEs varies with tax rate differentials. Results confirm a responsiveness of MNEs to tax rate differentials, both in the form of financial profit shifting (stronger effect) and in the form of real profit shifting (more moderate effect).

⁷ Similar to Cobham and Loretz (2014), IMF (2014) runs a simulation of the effect of a shift towards formula apportionment but using BEA outward statistics on United States MNEs rather than ORBIS data. Empirical evidences suggest that developed economies would systematically receive a larger portion of taxable base to the detriment of so-called conduit economies (Bermuda, Ireland, Luxembourg, the Netherlands, Singapore and Switzerland). However, for developing economies the picture is more nuanced: they would "gain" tax base only if the apportionment formula places heavy weight on employment.

the total fiscal contribution by foreign affiliates.⁸ It is not surprising that in a context where the availability of data on the P&L-transparent component, the corporate income tax, is poor, data on other contribution items (“above the line”) are barely existent. The *Doing Business* total tax contribution approach developed by the World Bank jointly with PwC⁹ circumvents the issue by computing by-country total tax corporate contributions on a pro forma basis instead of using actual data.¹⁰ This approach captures differences in the tax regimes of different countries and makes possible the assessment of the fiscal burden borne by the average firm across countries and regions, but it provides limited insights on the size of the total contribution (a function not only of the tax regime in place in a country, but also of the volume and distinctive features of the business activities performed).¹¹

This study takes a stepwise approach that does not directly use information on taxes and other government revenues paid by foreign affiliates, subject to the major data constraints just discussed. The initial data inputs are government revenues data reported by countries; from these, the approach zooms in on overall corporate contributions (domestic and foreign), and finally on foreign affiliate contributions (figure 1). Such an approach ensures that margins of error in estimations are confined at each step along the way. Nevertheless, as the data available on foreign operations and tax payments of MNEs are limited and fragmented, the analytical approach has been heuristic, employing a variety of sources and methods to converge towards a meaningful order of magnitude of MNE contributions.

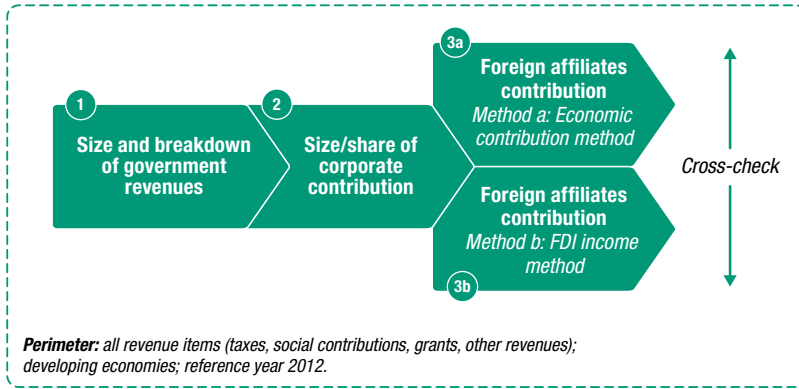
Section 2 derives a convenient representation of the average government revenue collection (size and composition of government revenues as shares of GDP) in developing countries from available government finance data (step 1 in figure 1). Section 3 shows how to allocate government revenues, according to the payer, either to business or to individuals and consumers; the objective is to size the corporate contribution (step 2). Section 4 estimates the portion of the corporate contribution borne by foreign affiliates (step 3). The calculation is performed employing two methods, leading to comparable results: the *economic contribution method*, presented in section 4.1 and the *FDI income method*, presented in

⁸ In ORBIS this portion is limited to the corporate income tax, whereas the BEA also reports an additional category, “taxes other than income and payroll taxes”; however, it is too aggregated to provide meaningful information on the contribution side. The category is also defined as “indirect business taxes” and includes a variety of taxes, such as sales taxes, value added taxes, excises, property taxes, international trade taxes and so on. For the purpose of establishing the taxes borne by foreign affiliates, it is too aggregated as it also encompasses some taxes collected but not paid, e.g. value added taxes.

⁹ See World Bank and PwC (2015).

¹⁰ The approach uses a case scenario to measure the taxes and contribution paid by a standardized business under each country’s tax regime.

¹¹ In particular the prototypical company driving the *Doing Business* calculation is defined as a domestic small to medium-size company, and thus potentially very different from the average foreign affiliate of a multinational group.

Figure 1. Overview of the methodology

Source: UNCTAD.

section 4.2. The results of the three-step procedure are summarized in section 5, where they are presented both as stand-alone findings and, as baseline indicators, in relationship to UNCTAD estimations of revenue losses (from Bolwijn et al., 2018, in Part 1 of this Special Issue). Section 6 highlights some limitations of the approach and discusses ideas for future development.

2. Size and composition of government revenues

From available national accounts data, we derive a meaningful representation of government revenue collection in developing economies. In this context, government revenue collection refers to the average size (measured as a share of GDP) and composition (at a convenient level of granularity of the revenue components) of all revenues collected by governments. The average values for the various country groupings are then computed from national government revenue data, after weighting each country according to its GDP.

For cross-regional analysis the most relevant global sources of government revenue data are the International Monetary Fund Government Finance Statistics (IMF GFS) database and the International Centre for Tax and Development (ICTD) Government Revenue Dataset (ICTD DB).¹² All these datasets face an obvious trade-off between the granularity of the revenue structure and country coverage. Such a trade-off can

¹²The first version of the ICTD DB was released in September 2014. For a detailed description of it, see Prichard et al. (2014).

be particularly penalizing for developing economies, where information available from national governments is more limited.

The goal is to select a reference database that guarantees acceptable country coverage at a meaningful level of granularity (i.e. at a level of granularity most appropriate for the research questions).

The ICTD DB presented the most attractive balance between granularity and country coverage for developing economies. It captures data from about 120 developing countries, the largest available perimeter among government revenue databases. As explained in Prichard et al. (2014), the ICTD DB also has a number of other advantages related to consistent treatment of revenue information across countries and regions as well as a focus on natural resource revenues. Occasionally, our methodology also makes use of the IMF GFS dataset as a complementary source to extract relevant information that ICTD DB does not report. At the time of the analysis (2015), the main limit of the ICTD DB was related to timeliness: the most recent year for which it presents a consistent and rich set of revenue data was 2009 (whereas, for example, most IMF GFS data were reported up to 2015).¹³ However, validation procedures comparing the ICTD DB 2009 with the IMF GFS 2009 and 2012 show significant alignment in the government revenue collection for various country groupings across time. Table 1 reports the results of the comparison for developing economies. The most visible difference is the higher weight assigned by the ICTD DB to “Other revenues” at the expense of “Taxes”. This is due to a systematic reallocation of the natural resource revenue items from “Taxes” to “Other revenues” performed in the ICTD DB.¹⁴

Data provided by the ICTD DB (2009) make it possible to explore government revenue collection at the global or the regional level in great detail. Such analysis reveals large variations in government revenue collection between countries and regions. A key driver for such variations is the level of income of economies (figure 2). High-income countries collect about 40% of GDP in taxes, social contributions and other revenues, low-income countries less than 20%. Looking at economic groupings and regions reveals a mixed picture because of heterogeneity between countries within each region. The weighted average collection ratio of developing countries is still more than 10 percentage points lower than that of developed countries. The 30% of GDP collected in Africa, which compares favourably with the developing-country average of 27%, is skewed by a few upper-middle-income

¹³ Notice that as the other steps of the estimation process are set at 2011 or 2012, the implicit assumption here is that on average the size and composition of government revenue collected (as a share of GDP) for developing economies has not changed significantly between 2009 and 2012. This is in line with evidence from comparison with the IMF GFS 2012 data (see table 1).

¹⁴ For a more detailed discussion on the issue, see Prichard et al. (2014: 26).

Table 1. High-level comparison between the ICTD DB and the IMF GFS database, share of GDP (Per cent)

	ICTD DB 2009	IMF/GFS 2009	IMF/GFS 2012
Total taxes	16	17	18
Income taxes	5	6	7
<i>Payroll</i>	0	0	0
<i>Property</i>	1	1	1
<i>Goods and services</i>	8	9	9
<i>International trade</i>	1	1	1
<i>Other taxes</i>	1	0	0
Social contribution	3	3	3
Other revenues	8	5	6
Grants	0	0	0
TOTAL REVENUES	27	26	27

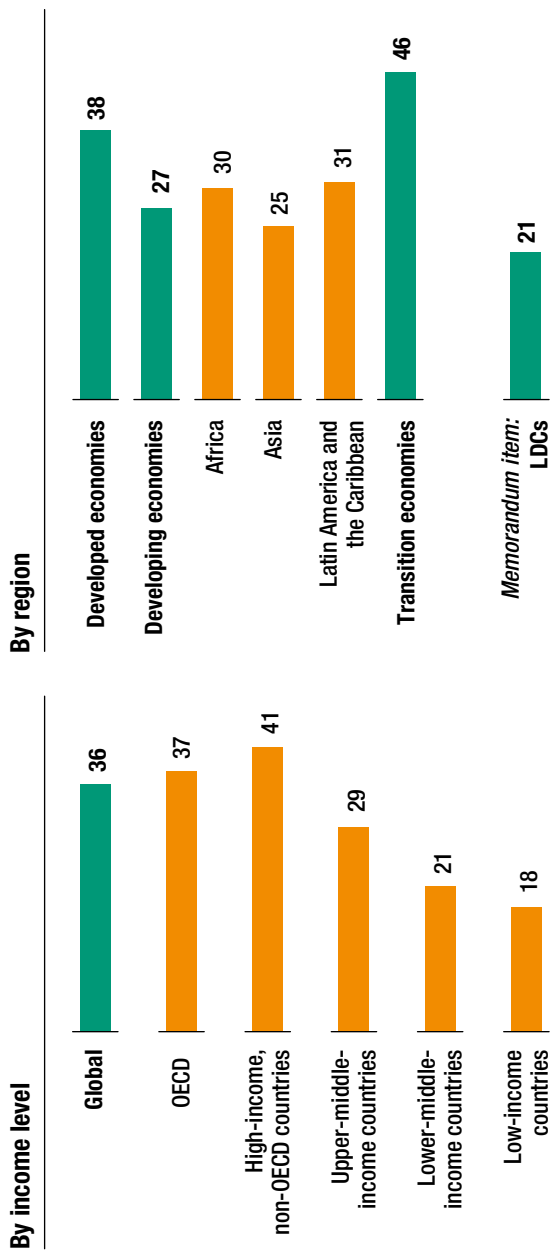
Source: UNCTAD elaboration from the ICTD Government Revenue Dataset and IMF GFS revenue data.

countries with above-average revenues (mostly due to income from natural resources) that make up for the much lower collection ratios in a large group of low-income countries. The lowest levels of revenue collection as a share of GDP are found among the least developed countries in Asia.

The breakdown in figure 3 confirms some distinctive elements of revenue composition in developing economies as compared with developed ones: (i) The substantial role of other (non-tax) revenues (which include, among others, royalties on natural resources, income on property and official development assistance or grants), particularly in Africa and LDCs (left-hand side of figure 3); (ii) the limited share of income taxes relative to other taxes such as indirect taxes and taxes on international trade (right-hand side); (iii) within income taxation, the prominence of corporate income taxes, almost twice the share of personal income taxes (as compared with one fourth in developed economies) (right-hand side of the figure).

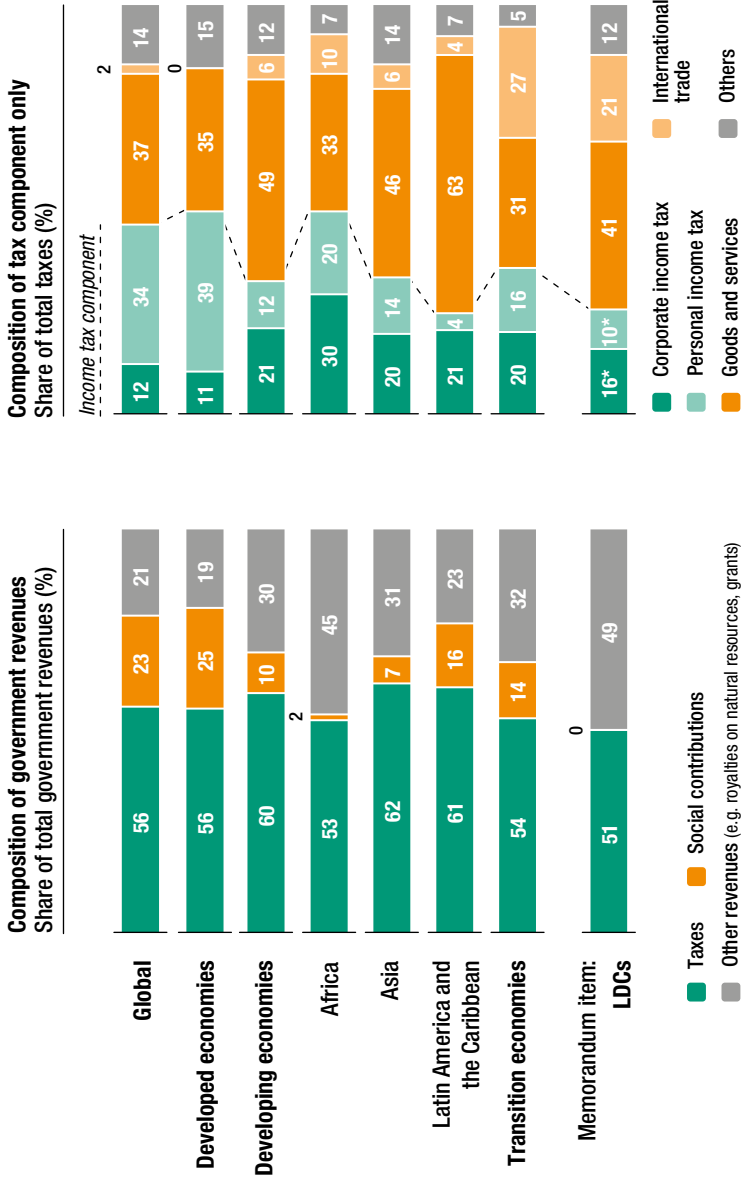
Figure 2. Differences in government revenue collection

Government revenues as a share of GDP, weighted averages (Per cent)



Source: UNCTAD analysis, based on the ICTD Government Revenue Dataset, release September 2014, reference year 2009.

Figure 3. Composition of government revenues, by region (Per cent)



Source: UNCTAD analysis, based on the ICTD Government Revenue Dataset.

Note: The classification is generally based on the standard IMF GFS classification. However in the left-hand graph, the category "other revenues" includes grants (very small, at 1.5% of total government revenues in developing economies). In the right-hand graph, income taxes (corporate and personal) reflect the IMF category "taxes on income, profit and capital gains" ("payable by corporations and other enterprises" and "payable by individuals"). The residual category "others" includes taxes on payroll and workforce, taxes on property and other taxes. Data with (*) are subject to very limited coverage.

3. Government revenues paid by corporations

In the process of approaching the main target (i.e. the calculation of the fiscal contribution of foreign affiliates), as an intermediate step, we estimate the share of government revenues paid by firms. For each component of government revenues derived in the previous section, our methodology arrives at an estimate for the corresponding share paid by firms (“corporate share”). It is possible to identify three main cases (figure 4).

The most straightforward case (type 1 in figure 4, column 3) arises when the estimation of the corporate share follows directly from the definition of the revenue category, so that the entire category is treated as either borne by business (corporate share at 100%) or not borne by business (corporate share at 0%). This includes, but is not limited to, corporate income taxes (fully borne by companies) as opposed to personal income taxes (fully borne by individuals). Other items falling in this category are international trade taxes, employers’ social contribution and property income contribution (fully borne by business); and, on the other side, taxes on goods and services and employees’ social contribution (not borne by business).¹⁵

In some cases (type 2 in figure 4), revenue items cannot be clearly allocated because they are too heterogeneous. They lie typically either at the lowest possible level in the government revenue classification (no further breakdown is available for their allocation) or at a level such that the more granular level exhibits too limited coverage to derive reliable statistics. Given the uncertainty about the allocation, the corporate share for these categories is set at 50%. As these categories represent a

¹⁵ Although allocation in this category is relatively straightforward, it does involve simplifying assumptions. In particular, two caveats should be kept in mind. First, the allocation criteria are necessarily established a priori and apply equally to all jurisdictions. As such, they reflect the formal definition and the default application of the revenue category, but they do not accommodate exceptions or nuances related to the actual implementation of the tax legislation. For example, value added tax is treated as a tax fully borne by consumers (corporate share at 0%). This approach is valid in general, but it does not capture cases of irrecoverable value added tax, effectively borne by companies. Second, the full (100%) allocation to the corporate component should not be interpreted too strictly; it reflects the fact that the *bulk* of the revenue item is paid by business. This is the case for example for the revenue item “Property income” within “Other revenues”. In this approach “Property income” is fully allocated to business. However, it is a quite heterogeneous category, encompassing a number of subcategories, the most relevant being “Interest”, “Dividends” and “Rent”. Although a part of this is paid by individuals (e.g. public residential housing), it is reasonable to expect that in developing economies the lion’s share is financed by corporations, e.g. as natural resource-related fees or rents. This is particularly true for the ICTD DB where the corporate share of “Other revenues” is even larger due to the reallocation of natural resource revenues from the category “Taxes”. Similarly the assumption that taxes on “International trade” are largely paid by corporations follows from the prominent role that corporations and MNEs in particular play in international trade; UNCTAD estimates the share of trade involving MNEs at 80% of total trade (see *World Investment Report 2013*, p. 135).

residual portion of government revenues (about 20% of total government revenues; see figure 4, column 2), this approximation, albeit rough, does not substantially affect the aggregate estimates. The last type (type 3 in figure 4) arises when its sub-items have been allocated; hence the allocation of the overarching category follows algebraically from the corporate shares and the mix of the subcategories.

For each relevant revenue item, figure 4 shows (a) the relative weight in the average government revenue collection of developing economies (column 2), and (b) the key elements of the estimation of the corporate contribution, i.e. the item type (column 3), the corporate share (column 4) and the resulting corporate contribution (column 5), defined here as the share paid by the corporation over total government revenues.

The application of the corporate shares identified in figure 4 to economic groups confirms higher corporate contribution in developing countries (almost half of government revenues) compared with developed countries (one third) (figure 5). The difference is caused, as noted before, by higher revenues from corporate taxes (income taxes as well as taxes on international trade and other levies) and from other revenues, especially from natural resources and property. Relative to the size of economies however the corporate contribution to government revenues is surprisingly the same across developed and developing economies, at 13% of GDP. Higher corporate contribution in transition economies is due to relatively high income from natural resources and to the role of state-owned enterprises in the economy.

Figure 4. Overview of the estimation of the corporate contribution for developing economies (Per cent)

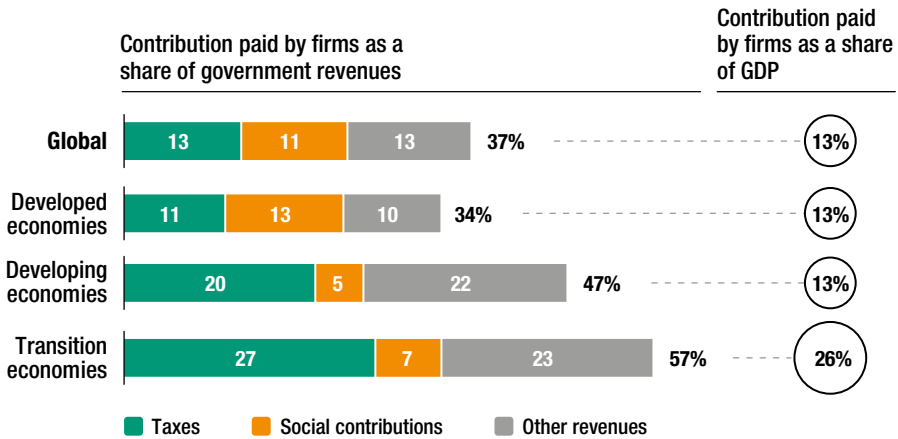
		Estimation of the corporate contribution		
Government revenue items	Weight (share of total revenues)	Item type	Corporate share (share of the revenue item paid by business)	Corporate contribution (share of total revenues paid by business)
Total taxes	61	type 3	33	20
Income taxes	20	type 3	65	13
Personal income	7	type 1	0	0
Corporate income	13	type 1	100	13
Payroll and workforce	0	type 2	50	0
Property	3	type 2	50	1
Goods and services	30	type 1	0	0
International trade	4	type 1	100	4
Other taxes	4	type 2	50	2
Social contributions	10	type 3	50	5
Employers	5*	type 1	100	5
Employees	5*	type 1	0	0
Other revenues	29	type 3	75	22
Property income	15*	type 1	100	15
Others	15*	type 2	50	7
TOTAL	100			47

Source: UNCTAD analysis, based on ICTD Government Revenue Dataset and the IMF GFS.

Note: "Others" within "Other revenues" include "Sales of goods and services", "Fines, penalties and forfeits", "Voluntary transfers other than grants" and "Miscellaneous and unidentified revenues". Grants are excluded a priori from this scheme as they are irrelevant for corporate contributions.

*Split based on data from the IMF GFS dataset. Occasionally the ICTD DB does not provide the information at a level of granularity that allows a straightforward allocation, whereas the IMF GFS dataset does (at a lower level of classification). This is the case for (a) "Social Contributions" for which the ICTD DB does not provide the necessary split between employee component and employer component, and (b) "Other revenues", where no further subcomponent is reported by the ICTD DB. In these cases, the methodology leverages IMF GFS data to complement the ICTD DB and derive the required breakdown.

Figure 5. Contribution to government revenues by firms, domestic and foreign
(Per cent)



Source: UNCTAD analysis, based on the ICTD Government Revenue Dataset; IMF GFS database as complementary source.

4. The main goal: the estimation of fiscal contributions of foreign affiliates

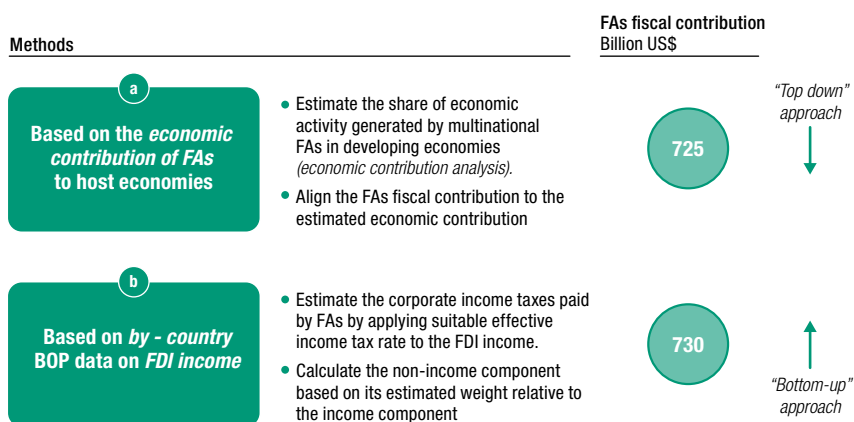
The estimation of the fiscal contribution of foreign affiliates is a very challenging exercise. First, there are no directly available data on taxes paid by foreign affiliates at the country level. Second, in this setting, fiscal contribution is interpreted in a very comprehensive way, including all revenue items paid by foreign affiliates in developing countries. As already noted, in the context of developing countries, the extension to non-tax revenues (including rents and royalties on natural resources) is crucial for realistic estimation of foreign affiliates' contribution.

For robustness purposes, the estimation is carried out employing two alternative methods: (a) the economic contribution method (section 4.1), and (b) the FDI income method (section 4.2). Figure 6 summarizes the main features and the resulting estimates of the two methods.

4.1. Approach based on the economic contribution of foreign affiliates

It seems reasonable to assume that the portion of the corporate contribution attributable to foreign affiliates should reflect the economic value generated by those affiliates for the host economy (*economic contribution*). Economic value in this context must refer to reported economic value, i.e. economic value after profit shifting.

Figure 6. Overview of the estimation of the foreign affiliate contributions for developing economies



Source: UNCTAD analysis, reference year 2012.

As the corporate contribution consists of different and heterogeneous components, we employ *multiple drivers* of economic value creation. Each driver applies to the most appropriate components of the corporate contribution in order to best approximate the corresponding share paid by foreign affiliates.

Figure 7 illustrates the idea. Selected drivers of value creation are profits, employment, exports and value added. Each driver is naturally associated with some revenue items.¹⁶ Finally, the last column reports for each driver the estimated share generated by foreign affiliates. Notice that value added (fourth bucket) is used as the default driver for the revenue categories that do not have a dedicated tailored driver. In the appendix we provide a comprehensive account of the empirical background behind the estimation of the foreign affiliate shares.

¹⁶For taxes related to labour and social contributions (second bucket), the ideal driver would be remuneration of employees, for which only very limited data are available; thus employment was selected as the second-best option. It is plausible that MNEs pay on average higher salaries than domestic companies and that therefore using employment as a driver would understate the foreign affiliate's fiscal contribution. This bias is addressed by rounding up the estimated foreign affiliate share of employment (at 6%–9%) to 10%. See exact figures in the appendix. As *international trade taxation* (third bucket) includes both taxes on import (import duties) and taxes on exports, and the two components cannot be easily separated, the driver “exports” is used here as a generic indicator of foreign affiliates' penetration in trade.

Figure 7. Estimation of foreign affiliates' economic contribution in developing economies

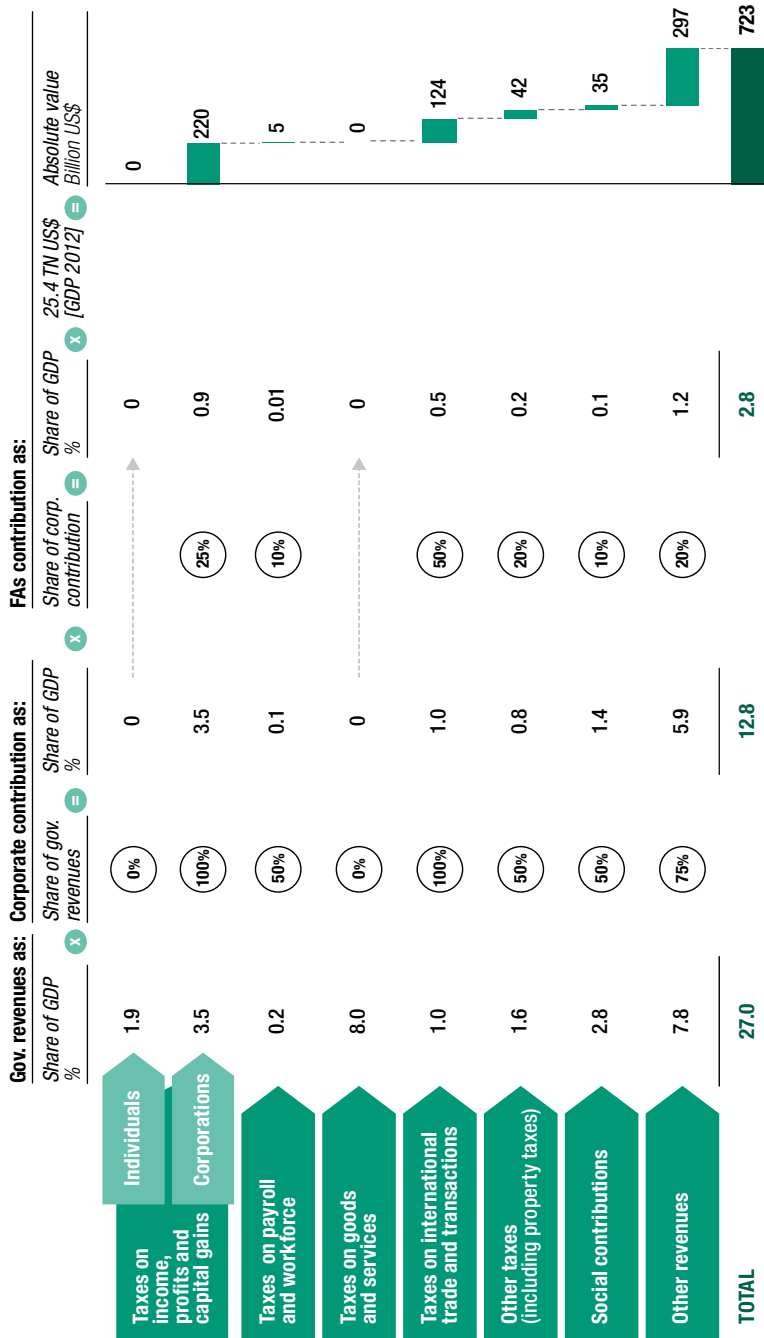
Drivers	Associated components of corporate contribution	Share generated by FAs
1 Profits	<ul style="list-style-type: none"> Corporate income taxes 	25%
2 Employment	<ul style="list-style-type: none"> Taxes on payroll and workforce Social contributions 	10%
3 Exports	<ul style="list-style-type: none"> Taxes on international trade 	50%
4 Value added	<ul style="list-style-type: none"> All other relevant gov. revenue items: <ul style="list-style-type: none"> Other taxes (including property taxes) Other revenues 	20%

Source: UNCTAD elaboration on multiple sources.

Note: Other revenues include (non-tax) revenues from property income (mostly royalties) and the other items classified as "Other revenue" in the IMF GFS classification, namely "Sales of goods and services", "Fines, penalties and forfeits", "Voluntary transfers other than grants" and "Miscellaneous and unidentified revenues". Grants are excluded a priori from this scheme as they do not involve any corporate contribution.

Figure 8 builds on figure 4 and figure 7 and shows the whole sequence of calculations leading from revenue collection statistics to the estimate of the fiscal contribution of foreign affiliates. The estimated values presented here should be interpreted as orders of magnitude. They represent central values in range estimate intervals, due to approximations and limitations of the methodology (further explained in the last section, on limitations and areas for further research). The overall estimate of \$725 billion is the midpoint of a range with a lower bound of about \$650 billion and an upper bound of about \$800 billion. Note that this level of approximation does not have a substantial impact on the relevance of the foreign affiliates' fiscal contribution: (i) as a share of total government revenues, it falls in a range between 9% and 12%; and (ii) as a share of total corporate contribution, it falls in a range of 20%–25%.

Figure 8. Estimation of FAs fiscal contribution to developing economies according to the economic contribution method



Source: UNCTAD elaboration on multiple sources, reference year 2012.
 Note: Differences in totals are due to rounding. Grants are excluded a priori from this scheme as they do not involve any corporate contribution.

4.2. Approach based on the FDI income

The FDI income method is driven by balance-of-payments (BoP) data on FDI income¹⁷ rather than government revenue data. It just borrows from the corporate contribution analysis of section 3 the estimation of the average mix of the corporate contribution.

Figure 9 summarizes the key elements of the approach. The FDI income method is characterized by two building blocks:

1. It leverages BoP data on FDI income (equity component)¹⁸ to estimate the corporate income taxes paid by foreign affiliates, after applying a suitable effective income tax rate.
2. It exploits the estimation of the corporate contribution performed in step 2 (section 3) to estimate the size of the non-income component relative to the income component.¹⁹

The two building blocks are independent until the last step of the calculation where the weights of the different components from (2) are applied to the corporate income taxation paid by foreign affiliates from (1) in order to estimate the total fiscal contribution of foreign affiliates.

Unlike the economic contribution method, the FDI income method proceeds from the bottom to the top: it first estimates the fiscal contribution of foreign affiliates for each developing region and then sums the results to obtain the aggregate estimate for developing economies. The total fiscal contribution, at \$730 billion, comes out as broadly consistent with the results of the economic contribution approach (at \$723 billion, figure 8, last row). The estimate of the corporate income component of the fiscal contribution is also aligned (at \$200 billion in figure 9, column 3; against \$220 billion estimated by the contribution approach, figure 8, second row).²⁰ From a methodological perspective, the consistency of the two estimates of the corporate income component is particularly helpful because at this stage of the

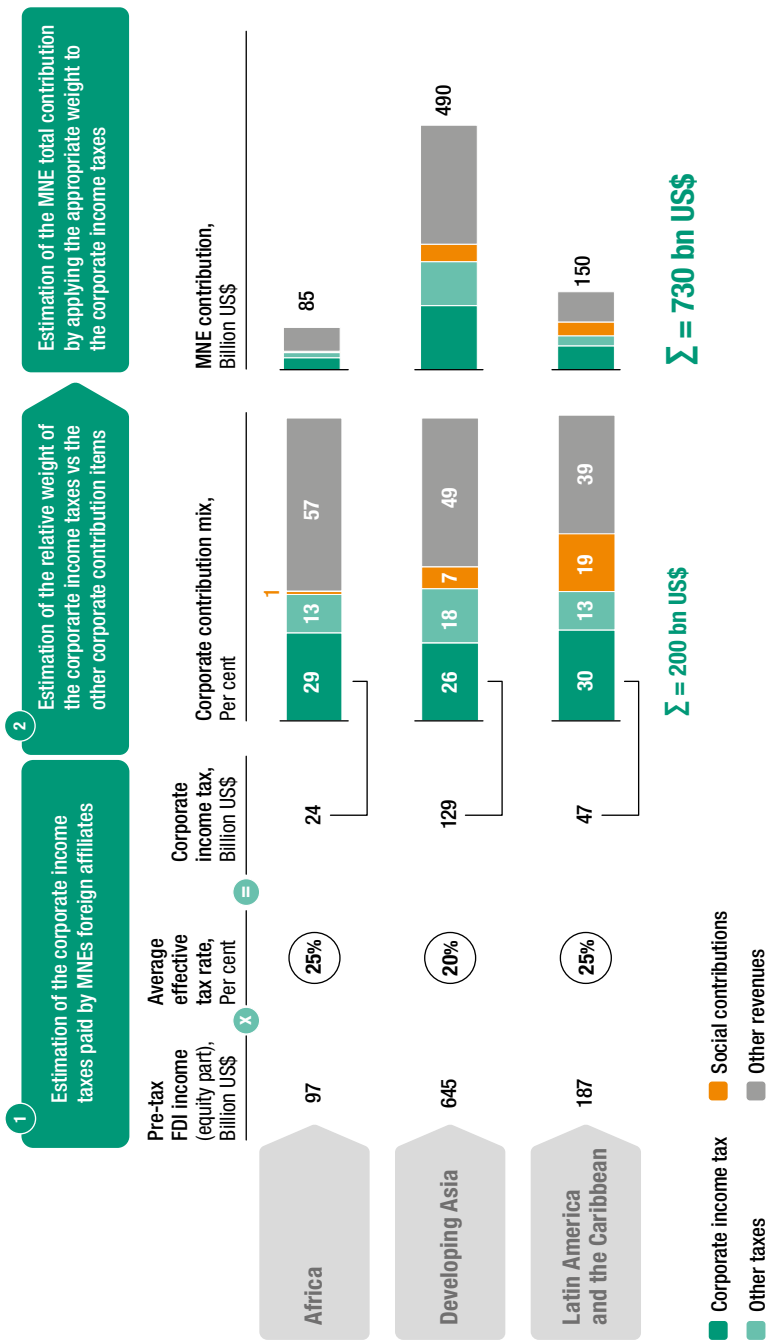
¹⁷Country data available from IMF, BoP statistics.

¹⁸The values of pre-tax FDI income are not directly retrievable from by-country BoP data. Instead, they are estimates obtained by applying to the total FDI stock of the region the average rate of return of the equity income for the reporting countries. Furthermore, as BoP-reported FDI income is by definition "after-tax" the determination of the pre-tax FDI income requires adding a (corporate income) tax component calculated using the average effective tax rates reported in column 2.

¹⁹The distribution of the corporate contribution by region is estimated following the same logic applied in figure 4 to developing economies. The only difference is that the average government revenue collection, i.e. the "starting point" (column 2 in figure 4), is calculated by region rather than for developing economies as a group.

²⁰For the non-income component there are some moderate differences between the estimates because whereas the contribution mix resulting from the economic contribution method is specifically tailored to foreign affiliates, by construction, the contribution mix from the FDI income method inherits (from the procedure described in section 3) the contribution mix of the "average firm".

Figure 9. Estimation of the foreign affiliate contribution to developing economies according to the FDI income method



Source: UNCTAD.
 Note: Minor inconsistencies due to rounding.

procedure the two calculations are independent, i.e. there is no overlapping of the two methodologies that may induce convergence in the results.

The two approaches should not necessarily lead to the same result. In fact, the FDI income method should in theory yield a lower estimate, given that it can take into account only the income on the foreign-owned part of directly invested enterprises, rather than the full income of foreign affiliates (although the difference should not be large, especially in developing countries).²¹

The value added by the FDI income method to the overall estimation process is twofold:

- Due to data constraints, the economic contribution method becomes less reliable when the perimeter of the estimation is restricted from developing economies to developing regions (Africa, Asia, Latin America and the Caribbean). In these cases, the FDI income method can provide more reliable regional estimates of the fiscal contribution of foreign affiliates, as it builds on data with better regional coverage.
- Given the fact that it is largely exogenous, the FDI income method represents a valuable validity check to test the estimation performed by the economic contribution method, which, as explained above, is imperfect.

The most challenging step of the FDI income method is to “centre” correctly the ETRs by region (figure 9, column 2). The literature review for this study did not identify any prior studies that specifically target ETRs for foreign affiliates and only a few that address developing economies. Critically, even for the same region, the literature proposes different ETRs, sometimes covering a range as large as 15%–30%, depending on the data source, the sample of firms and countries and, above all, the methodology used for the calculation.²² Clearly, such a large variability

²¹ Interestingly, the estimation of the corporate income component from the FDI income method, at \$200 billion, against the \$220 billion from the contribution method is consistent with the interpretation of the FDI income method as a lower bound. However, when calculating the non-income contribution items, the FDI income method applies the weights of the corporate contribution derived in step 2 rather than the weights of MNE contribution from the contribution method in step 3.a (this serves the methodological purpose of keeping the FDI income and the contribution approaches separate). The use of different weights is responsible for the convergence of the final estimates; given corporate income taxation at \$200 billion, if MNE contribution weights were applied to the FDI income method, the final estimate for MNE total contribution would be \$660 billion, a proper lower bound to the \$725 billion derived with the contribution method.

²² There are two main approaches to the calculation of the ETRs: forward-looking and backward-looking. Forward-looking metrics measure the tax burden on a pre-defined investment project. More specifically, they measure how taxes affect the cost of capital (i.e. the minimum required rate of return on an investment project). They are calculated on a stylized hypothetical investment and incorporate all the tax payments due over the lifetime of an investment, along with all the other cash flows of the investment projects. Backward-looking metrics are calculated as the plain ratio between corporate income tax payments and pre-tax income from reported accounting data. The two measures can lead to substantially different results, and this partially explains the variability observed in the literature between estimates of the effective tax rates.

may have non-negligible repercussions on the final estimate. Examples of papers addressing ETRs for developing countries include Ali Abbas et al. (2012), Markle and Shackelford (2012, 2013) and Fuest et al. (2012).²³ Ali Abbas et al. (2012) employs a forward-looking measure of the effective tax rate,²⁴ while Markle and Shackelford (2012, 2013) and Fuest et al. (2012) resort to backward-looking approaches. The two studies of Markle and Shackelford are based on the notion of average effective tax rate (AETR), whereas that of Fuest et al. is based on the marginal effective tax rate (METR).²⁵ As the purpose of this study is intrinsically descriptive, i.e. to derive a measure of corporate income taxation as close as possible to historical data, the backward-looking AETR approach of Markle and Shackelford, which is based on actual accounting data, seems the most appropriate. Thus, the ETRs employed in the estimation (figure 9, column 2) are substantially aligned with Markle and Shackelford (2012, 2013). Additional validation checks performed by UNCTAD on a sample of foreign affiliates from ORBIS also confirm these levels. The rounding of the ETRs at the 5 percentage point mark reflects the level of variability observed between the papers of Markle and Shackelford and the UNCTAD benchmark.

5. Summary results

The main result of the methodology described in the preceding sections is a comprehensive and multi-layered picture of the fiscal contribution of foreign affiliates: (a) covering both absolute contribution and contribution relative to the other actors in the economic system; (b) broken down by the main contribution items; and (c) including not only traditional tax items but also other revenues. Figure 10 summarizes the key numbers qualifying the MNE fiscal contribution to developing countries, calculated according to the economic contribution method (but similar numbers would result from application of the FDI income method). Of almost \$7 trillion annually received by developing countries as government revenues, just

²³ Also, Chen and Mintz (2013) and World Bank and PwC (2015), although they do not focus specifically on developing economies, provide effective tax rates for a number of developing countries as part of their annual ranking of countries' effective tax rates.

²⁴ Other examples of forward-looking approaches include Chen and Mintz (2013) and, to some extent, World Bank and PwC (2015).

²⁵ Although both Markle and Shackelford (2012, 2013) and Fuest et al. (2012) use a backward-looking formula, the approaches are different. In Markle and Shackelford, ETRs are calculated as the AETR within the sample of companies, i.e. the plain ratio between the sum of corporate income taxes paid and the sum of all the pre-tax reported profits. In Fuest et al., they are estimated through a regression model and are consequently interpreted as METRs; i.e. they represent the corporate income tax that would be paid (by the average company) on the marginal unit of profit. Resulting estimates may differ significantly as the first measure incorporates all the heterogeneity of the sample and the effect of the starting conditions, whereas the second is designed to net them off and capture the "pure" relationship between taxes and profits. Indeed, the values of the ETR estimated by Markle and Shackelford (roughly 20–25%) turn out to be higher than the values estimated by Fuest et al. (at 10–15%).

less than half (\$3.2 trillion) is paid by corporations. The foreign affiliates' portion of the corporate contribution corresponds to about 20% or some \$725 billion, the first key number in our calculation. The tax component, strictly speaking, amounts to 60% of foreign affiliates' contribution (\$430 billion), whereas the remaining part is made up of other revenues (mainly rent and royalties related to the use of natural resources). Finally, the share of foreign affiliates' taxes covered by corporate income taxation is 50%, corresponding to \$220 billion, our second main figure.

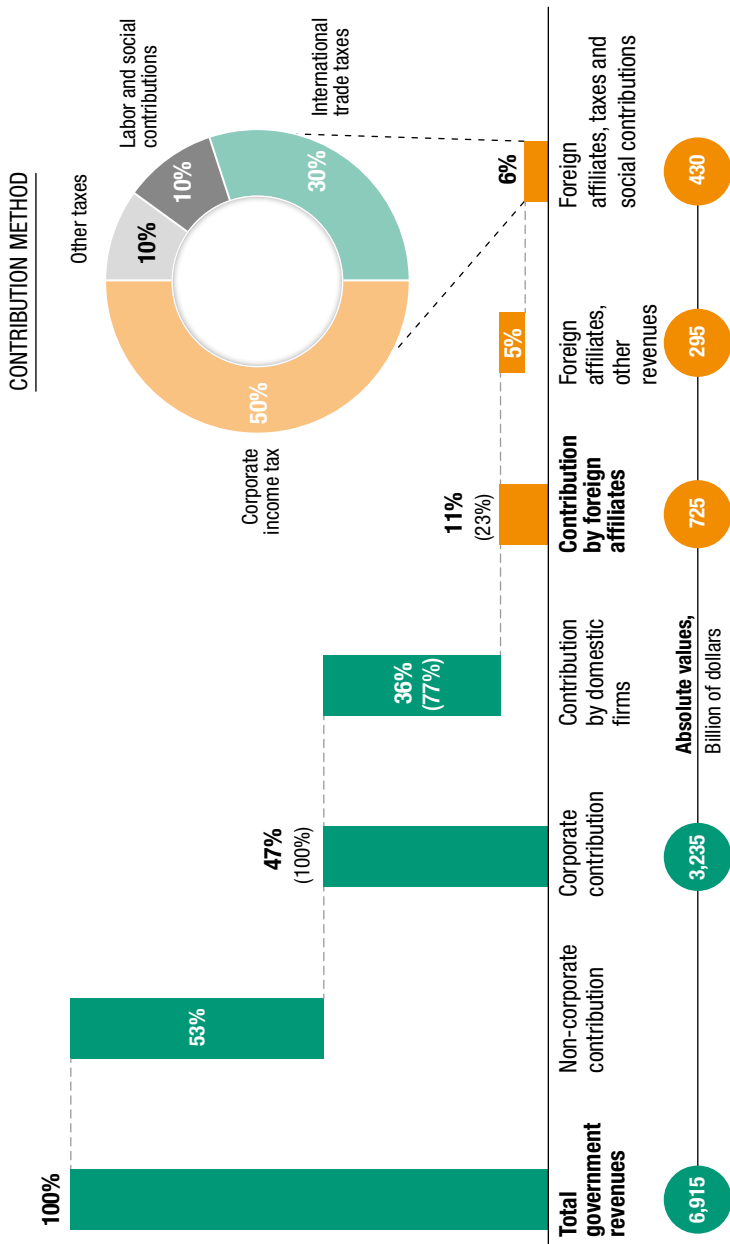
In addition to information on the breakdown of government revenues, figure 10 provides a baseline to assess the relative scale of the revenue losses generated by MNE tax avoidance. A proliferation of revenue loss estimates in recent years (e.g. UNCTAD, 2015; Bolwijn et al., 2018; OECD, 2015; Crivelli et al., 2016; Tørsløv et al., 2018) has stimulated an intense discussion on the actual size of the value at stake (see, for example, the discussion in Forstater, 2015). To have an idea of the orders of magnitude, UNCTAD's estimate of revenue losses for developing countries, at some \$100 billion annually (Bolwijn et al., 2018), is comparable to the total annual amount of official development assistance (ODA) granted to developing economies (at \$115 billion in 2012, according to OECD figures).

However, it is more informative to assess the figure's magnitude relative to some meaningful baseline. To this end, it is quite common in the literature to provide revenue loss estimates as shares of GDP or total corporate income tax (e.g. Crivelli et al., 2016; OECD, 2015). GDP and corporate income tax baselines can be retrieved from national accounts with no or minimal analytical elaboration. Although they may be useful for further qualifying the scale of the revenue losses, they primarily depend on the underlying structure of the economy (e.g. the relative mix between foreign and domestic business) rather than on the tax behaviours of MNEs.

Hence, they are unable to help answer the most relevant questions: How much foreign affiliates avoid relative to what they should pay? How much foreign affiliates avoid relative to what they actually pay in total? The first question requires a quantification of corporate income tax currently paid by foreign affiliates; the second one, an estimate of all government revenues contributed by foreign affiliates, including corporate income tax, other taxes and other (non-tax) revenues. To our knowledge, this paper is the first one to pursue both directions, resulting in a comprehensive estimation of the key baseline figures, as reported in figure 10.

On the one side, revenue losses due to profit shifting and the avoidance of income taxes (\$100 billion) is about half of the corporate income tax actually paid (\$220 billion); or, more meaningfully, foreign affiliates manage to avoid paying one third of the corporate income taxes theoretically due to governments in developing economies. This number, more than figures in absolute value, reveals the extensive use of tax avoidance practices by MNEs. On the other side, the ratio of revenue losses to total fiscal contribution (at 14%; i.e. \$100 billion relative to \$725 billion)

Figure 10. Government revenues contributed by foreign affiliates of MNEs
 Share of government revenues, developing countries, reference year 2012 (Per cent and billions of dollars)



Sources: UNCTAD estimates, based on the ICTD Government Revenue Dataset, IMF GFS database, UN System of National Accounts, Eurostat, US Bureau of Economic Analysis, International Labour Organization and literature review.

suggests that foreign affiliates significantly contribute to government collection in developing countries, *even after* profit shifting and revenue losses generated by tax avoidance.

Clearly, these ratios refer to the aggregate picture and can't be directly applied to individual countries, for example to size the impact of international or national tax measures to counter tax avoidance at the country-level. Impact can widely change depending on countries' economies, size and exposure to global production. Yet, on a global scale, they expose the double imperative of stopping the severe leakage of government revenues due to tax avoidance on the one side, while preserving the revenue stream generated by MNE investment on the other. The balance between these two dimensions is at the core of the policy challenges addressed by UNCTAD in its guidelines for coherent international tax and investment policies (see *World Investment Report, 2015*; chapter V).

6. Limitations and areas for further research

This study is designed to provide an *order of magnitude* for the fiscal contributions of foreign affiliates and to stimulate further efforts aimed at consolidating and refining the estimate. It is possible to envisage a number of analytical areas of improvement and related avenues for future investigation.

First, the most critical issue concerns the collection and exploration of operational statistics on the activity of foreign affiliates. Currently the economic contribution method relies primarily on FATS supported by a collection of heuristic and empirical evidence from a variety of other sources. Although the only consistent source of foreign affiliates data so far, FATS suffer from being driven exclusively by developed economies, either as investors (outward FATS) or as recipients (inward FATS). A more objective picture of the activity of foreign affiliates in developing economies requires complementing FATS with additional data. *ORBIS* is the natural and, in the short term, most feasible complement to FATS. However, analytical work needs to be done to define a methodology to select and clean *ORBIS* data in order to have a consistent set of foreign affiliates (ideally consistent with FATS data). In addition, robust imputation procedures are needed to complete the significant amount of missing data in developing economies. Collection of FATS data by central banks of developing countries, following some scattered examples such as those of Zambia (Bank of Zambia, 2014) or Thailand (Tattawasart, 2011), would considerably improve the information available, providing an inward FATS perspective on developing economies. Finally, public country-by-country reporting would mark a real improvement in the possibility to measure and monitor the activity of foreign affiliates in developing economies.

Second, another key issue relates to the identification of the effective income tax rate of foreign affiliates in developing economies. As explained earlier, the literature supports a range of options, leading to quite different results. In addition, a difficult question is whether differentiated rates should be used for foreign affiliates and domestic companies. As mentioned earlier, other studies have failed to find a significant difference in rates between domestic and foreign firms. An UNCTAD preliminary analysis through ORBIS, comparing AETRs of large samples of domestic companies and foreign affiliates from different developing regions, also does not reveal any systematic gap between the two groups. Moreover, ORBIS firm-level evidence suggests ETRs for developing regions that are aligned with (or slightly above) those found in similar studies (Markle and Shackelford, 2012, 2013).

As uniform ETRs for foreign affiliates and domestic firms may appear counterintuitive, two important points should be made:

- i. The fact that domestic firms and foreign affiliates are found to have similar ETRs does not preclude that MNEs, at the consolidated level, may have significantly lower ETRs due to BEPS. (ETRs are applied to the tax base that remains in foreign affiliates after profit shifting.)
- ii. Many developing countries provide fiscal incentives to MNEs, which (insofar as they lower the tax rate rather than the base) would normally imply lower ETRs for foreign affiliates compared with domestic firms. Although incentives may have a significant impact at the individual country level, at the aggregate level the empirical evidence does not show any effect. Better and more disaggregated data and further research will be needed to quantify the effect of fiscal incentives.

The economic contribution method does not directly use ETRs but assumes that the ETRs of domestic companies and foreign affiliates are aligned. Consistently, in the FDI income method, the ETRs used are not “tailored” to foreign affiliates but reflect the AETRs applied to firms in the regions. The issue is sensitive and open to debate and deserves renewed empirical effort;²⁶ its implications, beyond this study, will be relevant for the ongoing policy discussion on tax incentives and development.

Third, a number of factors may lead to potential over- or under-estimation of foreign affiliate contributions. A factor leading to potential over-estimation lies in the derivation of profits via operating surplus (see explanation in the appendix).

²⁶For example, it would be interesting to investigate whether ORBIS may suffer from a selection bias on companies reporting tax information (excluding from its monitor exactly those companies that pay low or no taxes).

Although operating surplus ratios constitute a generally accepted proxy for profit ratios in national account statistics, it cannot entirely eliminate some forms of profit shifting, in particular thin capitalization. A number of factors qualify this limitation:

- The FDI income method, which does not present this problem (it is based on reported profits of foreign affiliates), is consistent with the 25% share of foreign affiliates in total corporate profits applied in the contribution method.
- UNCTAD's preliminary firm-level analysis based on ORBIS does not reveal a systematically higher foreign affiliate share in operating surplus than in profits.

Conversely, a factor leading to potential under-estimation of the contribution, again related to the contribution method, is the treatment of "mixed income" in the calculation of the profit share from national account statistics. In particular, the contribution method presently does not strip out the non-corporate business income component from the baseline for the calculation of the foreign affiliate contribution. Removing non-corporate business income, which would be unlikely to contain any foreign affiliate contribution, would have the effect of increasing the foreign affiliate share in the remaining corporate income part, thereby increasing the foreign affiliate contribution rate. Simulation of this effect under a reasonable, conservative hypothesis of mixed income at 20% of total value added in developing economies²⁷ yields an upper-bound estimate for the total foreign affiliate contribution of about \$800 billion. Other factors leading to potential over- or underestimation cannot be excluded a priori.

²⁷Country data on mixed income for developing countries are scarce. However, on the basis of available data and evidence from other studies (Guerrero, 2012; Trapp, 2015), a conservative assumption is mixed income at 20% of value added.

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Appendix. Estimating the contribution profile of foreign affiliates

There is no unique source that can provide a comprehensive picture (across the different drivers) of the economic contribution of foreign affiliates in developing economies; instead the estimation is the result of the enquiry of multiple sources that jointly form the contribution profile of foreign affiliates in developing economies (figure 7, column 3). The methodological choice to round the contribution shares at the 5 percentage point level reflects the expected degree of approximation of the estimate, as well as the ultimate objective of the analysis: to arrive at an order of magnitude estimation.²⁸

Employment (figure 7, item 2) and value added (item 4):

- For employment and (gross) value added generated by foreign affiliates, outward FATS from the United States (BEA) and Europe (Eurostat) represent the primary sources of data. As existing outward statistics capture the activity of foreign affiliates only from a sample of investor countries (the United States and European Union (EU) countries), an up-scaling step is needed to extrapolate the worldwide data. Up-scaling is based on the shares of reporting (investor) countries in the FDI stock of developing economies.

In order to calculate the contribution share, the indicator used as the baseline for employment is the *total number of employees* from International Labour Organization (ILO) statistics, targeting paid employees; for the value added it is the *gross value added* retrievable from UN National Accounts data. The reference year is 2011, the most recent year for which Eurostat outward data were available at the time of the analysis (the BEA reported also preliminary 2012 statistics).

- The resulting estimates are the following:
 - (2) *Employment*. Estimated share of employment generated by foreign affiliates in developing economies: (a) simple average: 9% (of which Africa, 10%; Asia, 12%; Latin America, 6%), and (b) weighted average: 6% (of which Africa, 6%; Asia, 6%; Latin America, 5%).
 - (4) *Value added*. Estimated share of value added generated by foreign affiliates in developing economies: (a) simple average: 21% (of which Africa, 21%; Asia, 23%; Latin America, 20%), and (b) weighted average: 19% (of which Africa, 22%; Asia, 20%; Latin America, 16%).

²⁸ Approximation of the contribution shares clearly affects the final estimation. The impact of approximations remains within the overall estimation interval from \$650 billion to \$800 billion.

- As a benchmark, it is also useful to consider the foreign affiliate share for developed economies, which can be retrieved using inward FATS from the BEA and Eurostat. Unlike outward statistics, these data have the advantage of providing an exhaustive picture of all foreign affiliates operating in each reporting country and, as such, they do not need up-scaling. On average the estimated foreign affiliate shares for both employment and value added do not differ significantly from the shares for developing economies (however, significant differences emerge between the EU and the United States).
 - (2b) *Employment – developed economies*. Weighted average: 9% (of which EU, 15%; United States, 5%);
 - (4b) *Value added – developed economies*. Weighted average: 13% (of which EU, 22%; United States, 9%).

Profits (item 1):

- As outward FATS on profits are extremely scarce (virtually limited to the United States), an alternative argument is used, combining the preceding estimates of the foreign affiliate share for employment and value added with information retrievable from UN National Accounts statistics on the partition of the value added in developing economies. On average, the labour share of the value added generated in developing economies is about one third.²⁹ Notice that in developed economies the picture is approximately inverted with the *capital income component* roughly at one third of the value added.³⁰ In this context, given a foreign affiliate share of the labour component of the value added at 10%, the corresponding share of the capital income component must be at 25%

²⁹ Guerriero (2012) finds a slightly higher share, at some 40% of the value added; such a difference does not substantially affect the final estimate.

³⁰ The split between the labour and capital components of the value added proposed by national accounts statistics for developing economies should be interpreted with caution. The capital component includes the *mixed income* generated by self-employment; this is a hybrid item that is allocated from an accounting perspective to the capital component but that economically pertains partially also to the labour component (as remuneration of labour). As this item is particularly relevant for developing economies, the effect tends to penalize the labour share in developing economies compared with developed ones. Guerriero (2012) recalculated the labour share using more sophisticated indicators that account for the mixed-income effect and found that the labour share for developing economies would increase significantly, reaching a level almost comparable with that of developed economies (at about 60%–70% of value added).

to align the foreign affiliate share of the value added to the estimated 20%. The share in the capital income component is then taken as a proxy for the foreign affiliate share in total profits.³¹

- Notice that with these shares of labour and capital income, the split of value added for foreign affiliates is even more skewed towards the capital income component than for domestic companies, exceeding 80% of the value added. This is arguably due to higher productivity of labour in foreign affiliates,³² as well as higher penetration in capital-intensive sectors.
- As for employment and value added, foreign affiliate shares for developed economies that are based on inward FATS present values close to the estimated shares for developing economies. In particular, the estimation from Eurostat inward FATS on gross operating surplus for a number of European countries gives a weighted foreign affiliate share of 25% (30% as a simple average).

Exports (item 3):

- Exports are also not systematically reported by FATS statistics. In addition, as exports are not a standard item of the balance sheet, coverage is also very limited in firm-level databases such as ORBIS. Nevertheless, leveraging insights from UNCTAD's previous analyses, especially on global value chains (see *WIR13*), and integrating them with the scattered evidence available from individual countries, a conservative estimate of the foreign affiliate share is proposed, at about 50% of total exports from developing economies.
- The *World Investment Report 2013* (see figure IV.8) estimates that on average foreign affiliates generate some 35%–45% of the (domestic) value added incorporated in developing countries' exports. The bulk of this value added is arguably part of foreign affiliates' exports, so that the range represents a *lower bound* for the share of exports generated by foreign affiliates.³³

³¹ This step entails some assumptions. In national accounts statistics, a generally accepted proxy of (pre-tax) profits is the *net operating surplus*. Although the net operating surplus is the largest constituent of the capital income component of the value added, it is not the only one; *depreciation* and *taxes and other subsidies* also enter into the computation. The implicit assumptions here are that the share of foreign affiliates (at 25%) is the same for all the elements of the capital income component of the value added and that the share of foreign affiliates in profits is the same as in operating surplus. This caveat was discussed in the section on limitations and areas for further research.

³² Using firm-level data from a sample of European countries, Altomonte et al. (2013) show that the productivity of labour is higher for more internationalised firms. In developing economies this effect is expected to be even more pronounced.

³³ The component to add on top of the 35%–45% share to obtain the foreign affiliate share in exports is the part of the domestic value added incorporated into foreign affiliate exports that is generated by domestic companies.

- The *World Investment Report 2013* (figure IV.14) also states that about 80% of global trade involves MNEs, of which one third is intra-firm trade, one third arm's length trade and the remaining third non-equity-mode-generated trade. It is reasonable to assume that the MNE share in trade in developing economies would be at least equally high and that the contribution of foreign affiliate exports to intra-firm trade and arm's length trade would represent a major component of that share.
- A number of studies at the level of individual countries also confirm the prominent role of foreign affiliates in trade.
 - *Developing economies.* Available information at the country level suggests a share of exports generated by foreign affiliates in developing economies equal to or higher than 50% of total exports.
- In China in 2012, foreign affiliates accounted for 50% of exports and 48% of imports (see *World Investment Report 2013*, box IV.3).
- In smaller countries the share may be significantly higher. From inward FATS data collected by Thailand's national bank, in 2007 the share of exports generated by foreign affiliates was 75%, and the share of imports was 72% (see Tattawasart, 2011).
- Similarly, the Bank of Zambia estimates the share of exports generated by foreign affiliates at 81.6% of total exports in 2013 (55.1% of imports) (see Bank of Zambia (2014)).
 - *Developed economies.* For benchmark purposes it is useful to recall also the available data on the foreign affiliate share of exports for developed economies (expected to be substantially lower than developing economies).
- From *World Investment Report 2013*, box IV.3, the foreign affiliates in the United States accounted in 2010 for 20% of exports; in France they accounted for 34%.
- The OECD also reports some scattered statistics on foreign affiliates' exports. In 2007 the foreign affiliate share in exports from European countries varied considerably: from 22% in Italy to over 50% in Poland and Estonia.
 - *Historical perspective.* From a more historical, but still meaningful, perspective, the *World Investment Report 1992* provides estimates of foreign affiliate shares in exports for a number of developing economies, documenting that, already in the late 1980s, those shares in many Asian and Latin American countries were over 25%–30%, with some peaks of 40%–50%.

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