Public Discussion Draft of BEPS Action 11 – a response

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Comments on
BEPS Action 11 Discussion Draft: Improving the Analysis of BEPS

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In my view the single most important factor hindering meaningful statistical analysis of BEPS is the lack of suitable data. The Discussion Draft does an excellent job in setting out the deficiencies of available existing data. So it is disappointing that the Discussion Draft itself does not go further in identifying what data is needed, how it could be collected, and what constraints would need to be overcome to make it available to researchers. This is the key to a successful outcome for Action 11, which after all begins: “Establish methodologies to collect and analyse data on BEPS and the actions taken to address it”.

The indicators that the document suggests fall short of being able to provide convincing evidence of BEPS; and very much short of being able to identify the effects of “the actions taken to address it”. Although the Discussion Paper contains numerous caveats about these indicators, it seems likely that these caveats would be lost in political debate if they are presented as official or semi-official OECD estimates of BEPS.

1. Data

Chapter 1 of the Discussion Draft, “Assessment of Existing Data Sources relevant for BEPS Analysis”, sets out a clear analysis of existing data sources, identifying their relative strengths and their limitations. I will not review the details of the analysis here. But it is worth highlighting some of the conclusions of this review (these quotations are all taken from the list of Key Points in Chapter 1).

- **This chapter concludes that the significant limitations of existing data sources mean that, at present, attempts to construct indicators or undertake an economic analysis of the scale and impact of BEPS are severely constrained and, as such, should be heavily qualified.**

- **While there are several different private data sources and aggregated official sources currently available to researchers, they are all affected by various limitations that affect their usefulness for the purposes of analysing the scale and impact of BEPS and BEPS countermeasures.**

- **Private firm-level financial account databases are more useful, but are not comprehensive in their coverage, have significant limitations in their representativeness in some countries, do not include all MNE entities and/or all of their associated financial information, and do not have information about taxes actually paid.**

- **While tax return data covering all subsidiaries of MNES are potentially the most useful form of data, most countries do not have or make such data available for the purposes of economic and statistical analysis, even on an anonymised or confidential basis.**
These statements are all justified, and the analysis of Chapter 1 provides detailed support for all of them.

Perhaps, not surprisingly, the concluding element of the Key Points of Chapter 1 is therefore:

- More comprehensive and more detailed data regarding MNEs is needed to provide more accurate assessments of the scale and impact of BEPS.

The most important element of the work on Action 11 should therefore be the creation of new data to support research and analysis of the scale of BEPS.

The main problem with existing data is that it is typically not possible to identify fully (or even anything close to fully) the activities of a multinational company. This is clearly closely related to the issues discussed in Action 13 on country-by-country reporting. Existing datasets created from financial accounts are not comprehensive. Tax return data is typically specific to a single country. There are a very small number of countries which make broader data available, but these are far from comprehensive.

The ideal dataset for the purposes of analysing BEPS would include information on the activities of each affiliate of a multinational group, the ownership pattern within the group, and all the financial flows between the constituent parts. Realistically, it seems unlikely that such a dataset would ever be constructed. There are tradeoffs involved in the construction of new datasets, taking into account cost and confidentiality as well as the benefits of more comprehensive information. Identifying how these tradeoffs can and should be resolved is the single most important issue for Action 11. It is a pity that this has not yet been addressed.

2. Indicators

Chapter 2 of the document sets out “potential indicators that may assist in tracking the scale and economic impact of BEPS over time”. It is hard to see how the use of such indicators in the future can ever be more than illustrative, without the provision of more informative data.

In general, the discussion of the indicators contains little analysis to justify their use, although it does include a number of caveats for each measure. Here I make just a few brief comments on the interpretation of the proposed measures.

a. Indicator 1: Concentration of Foreign Direct Investment

This indicator would calculate the net FDI position for each country as a proportion of its GDP; it would compare the average ratio for the 15 countries with the highest ratios with the average ratio of all remaining countries. The net FDI position is defined as the FDI stock in the country owned by investors from OECD countries, less the FDI stock in OECD countries owned domestically.

It is hard to see how this measure reveals information about BEPS. International flows of debt and equity are included in FDI. Consider, for example, a company that routes financial flows from country A to country B through a tax haven with the aim of ultimately identifying profit as arising in the haven. If A and B were both OECD countries, then it is not clear why this would have any effect on the haven’s net FDI position, so defined. If only A was an OECD country, then there would be a
positive effect on the net FDI position in the haven. But if only B was an OECD country, then there would be a negative effect.

The choice of 15 countries is arbitrary. Suppose the number of countries used for routing flows of investment and income increased from 15. Then gross FDI flows to and from the top 15 may diminish; but this may not reflect an increase in, rather than a reduction in, BEPS.

b. Indicator 2: Within MNE Profit Rate Differential

This indicator would calculate a rate of profit and an effective tax rate for affiliates of multinational companies, and also for the consolidated company. The idea is to allocate the consolidated profit of the whole company to 4 categories – affiliates with high and low rates of profit, and affiliates with high and low effective tax rates. The indicator shows the proportion of total income arising in affiliates that have a high rate of profit, and a low effective tax rate.

Care must be exercised in interpreting this indicator. First, the accounting measures used are subject to numerous definitional problems. An example is the measurement of intangible assets, which would be included in the denominator of the profit rate calculation; typically the accounting treatment can vary significantly, depending on how the company acquired the asset. Second, it is not clear that the comparison would identify BEPs behaviour. For example, suppose an affiliate in a country with a high statutory rate made a high royalty payment to another affiliate. That would reduce recorded profit in that jurisdiction, reducing the recorded profit rate. However, by reducing the denominator of the effective tax rate it would also increase the recorded ETR. Generally, the measured ETR is only informative if the measure of accounting profit used is not affected by the profit-shifting activity. If it completely reflects that profit shifting, then we would expect the ETR to be close to the statutory rate, irrespective of the degree of profit shifting.

But in any case, it is not clear why the ETR should be used at all. The ETR could also be affected by, for example, investment incentives, which are unconnected with BEPS. At the margin the benefit of BEPS in terms of lower tax liabilities should be reflected by the marginal statutory tax rate, not an average effective tax rate. So a comparison with the statutory rate would be more convincing.

Most significantly, though, the process is subject to the missing data problems identified by the document in Box 2, where it is stated that, in the context of using such data:

In a micro-database used by many researchers to analyse BEPS, the financial information for the key affiliate (Y) in the low tax country was missing. This reveals a clear disconnect between the information revealed through targeted public enquiries of some MNEs and the incomplete available financial information for those same MNEs from financial accounts. Much of the important information for tax analysis is simply absent. The fact that such observed instances of BEPS are not visible in firm-level financial account databases highlights concerns regarding the reliability and representativeness of one of the most frequently used existing data sources.

c. Indicator 3: High Profit Rates of MNE Affiliates in Low Tax Jurisdictions

Indicator 3 uses the same data sources and key variables as Indicator 2. The only difference is the way the indicator is constructed. It is therefore subject to the same criticisms as made for Indicator 2. These indicators should clearly not be regarded as providing independent evidence of the extent of BEPS.
d. Indicator 4: Profit Rates Compared to Effective Tax Rates for MNE Domestic and Foreign Operations

This indicator uses broadly the same approach as the previous two, except that the comparison is now made with the profit rate and effective tax rate in the “domestic” country. Again, then it is therefore subject to the same criticisms as made for Indicator 2, and again these indicators should clearly not be regarded as providing independent evidence on the extent of BEPS.

Beyond this, it is not clear why a comparison with the “domestic” country adds very much to evidence about BEPS. There are further complications in using the domestic country if that country taxes the worldwide income of the MNE.

e. Indicator 5: Effective Tax Rates of MNEs compared to Domestic Firms

This indicator is again similar to the previous ones, and is again subject to the same criticisms and lack of independence. The merit of this approach depends on how well the MNE can be matched with a set of comparable domestic firms through propensity score matching or other techniques.

f. Indicator 6: Concentration of Royalty Payments relative to R&D Expenditures

This indicator uses country-level macro data on current R&D expenditures and royalty payments received. This is more closely focused on a single BEPS issue – namely the payment of royalties to shift profit to low-taxed jurisdictions. But it is a weak measure. There is a problem of timing – royalty payments are more likely to be associated with past, rather than current, R&D spending. And a company may receive royalties on the use of purchased intangible assets, rather than assets created from its own R&D spending; this is not necessarily evidence of BEPS, but depends on how previous transfers may have been taxed.

As with other measures, the indicator is arbitrary, based on a comparison of the 5 countries with the highest ratio of royalty receipts to R&D spending relative to other countries. It is not clear why 5 is the appropriate measure of comparison.

g. Indicator 7: Interest expense to income rations of MNE affiliates in countries with above average statutory tax rates

This indicator returns to the affiliate level micro data, with the associated problems identified above. Unlike the previous measures using such data, it relies on the statutory rate to identify tax-advantaged jurisdictions. As argued above, this seems more appropriate.

No indication is given of the potential problem that interest received is likely to be a missing variable for many affiliates. It is also not obvious why the sample should be split at the average corporation tax rate. If companies intend to shift income through interest payments, they would presumably aim to shift income to the lowest taxed jurisdictions. This is just another example, of the arbitrary nature of many of these indicators; it should be feasible to design a more general measure.