A CRITICAL ANALYSIS OF THE CONCEPT AND EXTENT OF BASE EROSION AND PROFIT SHIFTING, AND ITS IMPACT ON SOUTH AFRICA VERSUS AUSTRALIA

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ABSTRACT

Tax avoidance by multinational enterprises is the focus of much media and political scrutiny. It is also the subject of a major Organisation for Economic Co-operation and Development (OECD) project called Base Erosion and Profit Shifting (BEPS). The objective of this thesis was to gain a greater understanding of BEPS, particularly in a South African and Australian context, and to determine whether BEPS is as great a problem as the OECD portrays.

A detailed analysis of the OECD BEPS Report and Action Plan was undertaken to understand what the term BEPS means. A review of current BEPS literature was then performed to assess the extent of BEPS. This was followed by a comparative analysis of South Africa and Australia, including a comparison of their tax systems and various economic indicators.

It was found that there is no simple definition of BEPS. It encompasses the spectrum of international tax planning strategies used by multinational enterprises. Furthermore, these tax strategies are usually legal, which makes measuring the extent of BEPS conceptually difficult. Despite being legal, many observers believe that BEPS behaviour by multinational enterprises is ethically unacceptable. This thesis also discussed the ethics of tax avoidance, and argued that countries should assess BEPS with reference to the many benefits which multinationals bring to a country.

The benefits of multinational enterprise activity are especially important to developing countries like South Africa. Despite similar tax systems, South Africa and Australia vary greatly in terms of their economic and social position. This thesis concluded that South Africa, as a developing country, is more likely than Australia to tolerate BEPS behaviour in order to maintain or even attract foreign investment.

The OECD Action Plan calls for urgent internationally coordinated actions against BEPS. It appears, however, that much more research is needed on the nature and extent of BEPS before countries formulate their response. This thesis acknowledges that aggressive tax planning by multinational enterprises does exist, but suggests that countries approach BEPS, and any estimates of its extent, with a degree of caution.

Key words: Base erosion and profit shifting; corporate tax; multinational enterprises; tax avoidance.

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CHAPTER ONE: INTRODUCTION

1.1 Context of the research

In recent years, high profile multinational enterprises have come under criticism for their alleged use of aggressive tax planning strategies to pay relatively little tax in countries where they have generated large amounts of revenue. The media spotlight, together with the public indignation that it has generated[1] resulted in the release by the Organisation for Economic Co-operation and Development ("the OECD") in 2013 of their report entitled Addressing Base Erosion and Profit Shifting ("the OECD BEPS Report") (OECD, 2013a). The OECD then followed this report with the release of its Action Plan on Base Erosion and Profit Shifting ("the OECD Action Plan") (OECD, 2013b), which contained 15 actions together with a narrow timeline to target what has become known as "BEPS".

The OECD Action Plan (OECDb, 2013:10) provides the following description of BEPS:

> BEPS relates chiefly to instances where the interaction of different tax rules leads to double non-taxation or less than single taxation. It also relates to arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place.

Most academic studies simply rephrase this OECD description of BEPS. Ault and Arnold (2013:2) note that "several widely publicised cases of low or no taxes on well-known companies highlighted these issues and brought the questions of tax avoidance and evasion into the public political debate." Van den Berg and Huisman (2013:60) explain that "the BEPS discussion boils down to alleged reduction of taxes by multinational enterprises by exploiting the loopholes that exist between the different taxation systems." Vann (2014:435) narrows the focus, and explains that "at the centre of the concern over BEPS is the recognition that many multinationals, especially those operating in the digital economy, are paying very little corporate income tax."

Although this OECD inspired focus is on multinationals and the digital economy, it is important to take note of Rosenzweig's (2014:1077) warning that "BEPS is taking on an immense challenge, with 15 separate action items ... The only common element among them

[1] A quick online search for "Google Tax Avoidance" yields numerous pages of news articles. One such article that illustrates the current public sentiment towards these multinational enterprises is that by Barford and Holt, "Google, Amazon, Starbucks: The rise of 'tax shaming"**.** BBC News Magazine, 21 May 2013. Available at http://www.bbc.com/news/magazine-20560359

seems to be that they involve international tax". In a rare South African article, Strydom and Kitcat (2013:100) explain that "the term 'base erosion' includes tax evasion, tax avoidance, tax underestimation and population flight. All of these phenomena have the effect of eroding an administration's tax base, thereby limiting the revenue that the administration can allocate towards its planned objectives."

It is therefore important that lawmakers understand what the real concern is. Two key yet separate topics arise from the OECD definition of BEPS. The first is the issue of "double non-taxation"; and the second is the issue of profits being taxed in a place other than where they were generated. These are two very different issues. Before making policy changes, it is imperative that governments understand what the "problem" is that they are trying to fix.

Despite the negative attention surrounding BEPS, there is a body of research which cautions that BEPS may not be the "crisis" it has been portrayed as. Dharmapala (2014) attempts to clarify the extent of BEPS, and concludes that recent empirical studies, using new and richer sources of data, estimate the extent of BEPS to be much lower than earlier research. Mitchell (2006) argues strongly against the interference in tax law by the OECD and similar organisations. He states that tax competition encourages better tax law and refers further to Figura (2002:130), who argues that "tax competition serves a...beneficial role. It forces greater fiscal responsibility and affords taxpayers the ability to enjoy more of what they earn. This in turn draws savings, investment, and skilled labour into the economy".

Lee-Makiyama and Verschelde (2014) question specifically the OECD's targeting of the digital economy and critically assess some of the proposed reforms. They state (2014:2) that "there is a danger that the cure could end up being worse than the disease". They claim (2014:3) that the evidence for base erosion is ambiguous at best, and that "existing evidence rather seems to suggest that the corporate tax base across OECD member countries has remained stable and that no actual base erosion has taken place".

The OECD itself admits the problem of measuring BEPS. It concludes that "with the data currently available, it is difficult to reach solid conclusions about how much BEPS actually occurs. Most of the writing on the topic is inconclusive, although there is abundant circumstantial evidence that BEPS behaviours are widespread" (OECD 2013a:15).

Finally, Arnold and Wilson (2014) present a balanced view of BEPS and its "problems". They acknowledge that "superficially" the tax-policy issues underlying aggressive international tax avoidance are clear – including *inter alia* reduced government tax revenues and increased compliance costs; undermined integrity of the tax system; undermined fairness; and distortions in the location of investment. However, they argue (2014:6) that the "tax-policy analysis of BEPS for any particular country is much more subtle and difficult" than these "problems" suggest.

The governments of both Australia and South Africa have responded to the OECD BEPS Action Plan. In South Africa, the Davis Tax Committee was established in 2013 with a mandate (as noted in their Terms of Reference published on their website www.taxcom.org.za) to review the corporate tax system, with "special reference to tax avoidance (e.g. **base erosion**, income splitting and **profit shifting**...)" (emphases added). In Australia, the Treasury released their 2013 Scoping Paper into Risks to the Sustainability of Australia's Corporate Tax Base (Australian Government the Treasury, 2013). Australia also chaired the 2014 Group of 20 (G20) Summit, where the G20 countries committed to finalising in 2015 the G20/OECD Base Erosion and Profit Shifting Action Plan to modernise international tax rules (Group of 20, 2014).

There are similarities as well as differences between South Africa and Australia in areas relevant to BEPS, which makes a comparison of the two countries useful. By way of context for the research goals of this thesis, these are briefly described below. The three major tax bases in both South Africa and Australia are personal income tax, company income tax, and the consumption tax (Value-Added Tax in South Africa and Goods and Services Tax in Australia). The corporate tax rate is 30% in Australia and 28% in South Africa, both of which are higher than the OECD average of 25% (OECD, 2014c; National Treasury & South African Revenue Service, 2014). In addition, both countries have a residence basis of taxation, and, it is submitted, both have well-functioning tax administration systems.

However, important differences also exist. Australia is a member of both the OECD and G20 (and, as noted above, has chaired the recent 2014 G20 summit). South Africa is a member of the G20, but is not a member of the OECD, although it has a working relationship with the OECD. The World Bank classifies Australia as a developed country and South Africa as a developing country (World Bank, 2015). The unemployment rate in South Africa in 2014 was 25.1% but only 6% in Australia (World Bank, 2015), while the Goods Trade Balance (that is, exports minus imports of goods) in South Africa in 2012 was negative US$14.9 billion but positive US$5.8 billion in Australia (OECD, 2014c). It is submitted that these characteristics may influence how a country is affected by, and responds to, corporate tax base erosion due to profit shifting by multinational enterprises.

It seems that clarity is needed before hasty actions are taken against BEPS. The tax strategies of multinational enterprises (including "profit shifting") are only one example of how a country's tax base is possibly eroded. Profit shifting (the "PS" of BEPS) potentially results in base erosion (the "BE"), and yet "BEPS" is the term now associated specifically with multinational enterprise aggressive tax planning. It is difficult to measure the extent of BEPS, and much of the "evidence" of BEPS appears to be circumstantial. There is also debate about how BEPS affects developing versus developed countries, and how each should respond.

1.2 Goals of the research

The overarching goal of this research is thus to gain a greater understanding of what BEPS is, and whether it presents as great a problem as the OECD's BEPS Report and Action Plan makes it appear to be. This goal will be addressed by way of the following sub-goals:

- the first goal of this research is thus to critically analyse the term "BEPS";
- the second goal is then to discuss whether, and for which type of countries, BEPS may be a problem, by means of comparative analysis of BEPS in a South African and Australian context in order to understand the impact of BEPS on these two similar yet different countries, and what their response to BEPS should be.

Specific research questions to be asked include:

1) What is BEPS?
2) How big a problem is BEPS?
3) What are the factors that influence how a country is affected by BEPS?
4) What should South Africa's and Australia's response to the OECD BEPS Action Plan be?

1.3 Methods, procedures and techniques

An interpretative research approach will be adopted for the present research as it seeks to understand and describe (Babbie & Mouton: 2009). The research methodology to be applied can be described as a *doctrinal* research methodology. This methodology provides a systematic exposition of the rules governing a particular legal category, analyses the relationships between the rules, explains areas of difficulty and is based purely on documentary data (McKerchar: 2014).

The research is conducted in the form of an extended argument, supported by documentary evidence. The validity and reliability of the research and the conclusions will be ensured by:

- adhering to the rules of the statutory interpretation, as established in terms of statute and common law;
- placing greater evidential weight on legislation, case law which creates precedent or which is of persuasive value (primary data) and the writings of acknowledged experts in the field;
- discussing opposing viewpoints and concluding, based on a preponderance of credible evidence; and
- the rigour of the arguments.

This study will therefore be primarily qualitative in nature. An extensive literature survey will be performed to document and evaluate the current international research into BEPS, focusing specifically on how BEPS is defined in the literature, as well as on research measuring the size and/or existence of BEPS.

A secondary analysis of South African and Australian country quantitative data will be performed in order to compare and contrast the two countries in areas related to BEPS. This data will be extracted from publicly available databases and publications produced by organisations such the OECD, and will include information such as corporate tax as a percentage of GDP.

The tax systems of South Africa and Australia will be also be compared and discussed. Data and statistics will be extracted from South African Revenue Service and the Australian

Taxation Office databases and publications. General information about the functioning of the tax system and administration will be drawn from academic literature, as well as from the websites and publications of each country's taxation and treasury departments.

As all the data is publicly available, no ethical issues arise.

1.4 Overview of the chapters

This chapter introduces the topic of BEPS, and provides context for the research. It briefly describes the difficulties in defining and measuring BEPS, and explains the choice of South Africa and Australia for a comparative analysis of BEPS. It then sets out the goals of the thesis, and explains the methods, procedures and techniques that were used.

Chapter Two begins by discussing what a tax base. It then examines the common components of a country's tax base, before discussing the various ways in which tax base erosion can occur. Base erosion is a result of BEPS, but this chapter puts BEPS into a broader context by explaining how base erosion from profit shifting is only one cause of lost tax revenue.

Chapter Three critically analyses the term BEPS. It provides a detailed review of the OECD BEPS Report and the OECD Action Plan to understand how these key reports define BEPS. It then examines the studies that are referenced in the OECD BEPS Report and describes the content of these studies in relation to BEPS.

Chapter Four focuses on the extent of BEPS and seeks to determine how big a problem BEPS really is. It begins by discussing the conceptual difficulties in measuring BEPS. It then examines BEPS research produced by academic researchers, and contrasts this with the reports generated by social and economic advocacy groups. It also examines various governmental inquiries into BEPS to show the range of political reactions. It concludes with a discussion about the ethics of tax avoidance by multinational enterprises, which is fundamental to the BEPS debate.

Having analysed the definition of BEPS, and considered its extent, Chapter Five then presents a comparative analysis of South Africa and Australia. It compares their relationship with the OECD, their tax systems, and various economic features of the two countries. It discusses how BEPS will affect South Africa and Australia differently, and therefore how their response to BEPS will differ.

Chapter Six reviews the findings from each of the chapters and concludes this research. It summarises the meaning of the term BEPS, and the difficulties of attempting to objectively measure BEPS. It concludes that given the complex nature of BEPS, the best response for any country is to approach BEPS cautiously, recognising the benefits that multinational enterprises produce, and questioning the need for hasty action against what may not be a big problem after all.

CHAPTER TWO: BASE EROSION

2.1 Introduction

In February 2013, the first OECD BEPS Report was released (OECD, 2013a). This was quickly followed in July 2013 by the publication of the OECD Action Plan (OECD, 2013b). These reports form the basis of the OECD's major BEPS project. It calls for the international coordination of actions to address BEPS, which it considers a critical problem.

Despite this urgency, there appears to be no single definition of BEPS, although the term is starting to be used widely by both researchers and the media. The main goal of this thesis is to analyse the term BEPS, and this chapter begins with a discussion of the "BE" of BEPS – base erosion. The implication of the term "BEPS", and the content of the OECD BEPS Report, is that tax base erosion is caused by profit shifting. This chapter discusses what a tax base is, and how it can be eroded. It will be shown that different countries have different tax bases, and that base erosion can happen in various ways and to various tax bases.

2.2 What is a tax base?

The Oxford Dictionary of Accounting (2010) defines "tax base" as "the specified domain on which a tax is levied, e.g. an individual's income for income tax, the estate of a deceased person for inheritance tax, the profits of a company for corporation tax". The Merriam-Webster (2011) dictionary defines "tax base" as "the wealth (as real estate or income) within a jurisdiction that is liable to taxation". As a starting point, these dictionary definitions suggest that the composition of a country's tax base will depend on the combination of the various taxes imposed by law in that country.

The annual OECD Revenue Statistics (OECD, 2014c) classify taxes in terms of their base. These bases are:

- income and profits (including individual and corporate income taxes);
- payroll and workforce;
- property;
- goods and services;
- other; and
- social security contributions.

There is a growing emphasis in the BEPS literature dealing with the impact of BEPS on developed versus developing countries, and a fundamental difference between these types of countries is the structure of their tax base. The theory behind optimal tax structure is beyond the scope of this thesis. However, the composition of the tax base of South Africa (a developing country) and Australia (a developed country) will be explored in more detail in Chapter Five.

As will be described in Section 2.3, the term "BEPS" is being used by the OECD to refer specifically to the erosion of the *corporate* income tax base by multinational enterprise profit shifting. However, tax base erosion can refer to the erosion of any of the above types of tax bases. It will be argued that, in determining a response to BEPS, a country should consider the extent of BEPS (i.e. *corporate* tax base erosion) in relation to other forms of base erosion, as well as the costs and likelihood of reducing BEPS.

2.3 What is base erosion?

The erosion of a country's tax base ultimately results in a loss of potential taxation revenue for that country. Goffman (1960:563), describing erosion of the tax base, states that "[if] a gain is considered income in an economic sense, it ought to be so considered for tax purposes, without any special privileges. Otherwise, it is a source of erosion".

This section identifies some examples and causes of base erosion. It is not a comprehensive analysis, but the studies have been chosen because they present forms of base erosion alternative to BEPS. Many examples have also been included because they examine base erosion in developing countries, which will arguably have a different experience to that of OECD countries.

Fuest and Riedel (2009), one of the studies also included in the OECD BEPS Report, examine tax revenue losses in developing countries due to tax avoidance and evasion. They distinguish between a domestic and international component, and state (Fuest & Riedel, 2009: I) that "the domestic component includes tax evasion which occurs due to the domestic shadow economy. The international component includes profit shifting by corporations and offshore holdings of financial assets by private individuals".

Fuest and Riedel's (2009) literature review identifies the following causes (and extents, in some cases) of tax revenue losses in developing countries:

- tax evasion in the domestic shadow economy, which is estimated as costing developing countries US$285 billion per year (Cobham, 2005);
- corporate profit shifting out of developing countries, which is estimated to result in revenue losses of between approximately US$35 billion and US$60 billion per year;
- tax evasion by individuals, which they describe (Fuest & Riedel, 2009:55) as "wealthy individuals residing in developing countries who hold financial assets abroad and do not report this income in their country of fiscal residence". They quote estimates of this type of tax revenue loss to developing countries between US$15 billion per year (in the 1990s) and US$124 billion (more recently);
- tax havens, which are often blamed for tax revenue losses; and
- tax expenditures, which include "tax credits, exemptions, exclusions, deferrals, allowances, reduced tax rates and many more. They may be bound to certain geographic locations (tax free zones) or time spans (e.g. tax holidays)" (Fuest & Riedel, 2009:46). They note that tax expenditures may have undesirable traits (and are often blamed for revenue losses in developing countries), but that they may also have advantages depending on the policy objectives pursued.

In their later paper, Fuest and Riedel (2010:12) note that developing countries use these tax incentives to attract foreign investment, and that while the efficiency of these incentives is controversial "their revenue impact should be distinguished from the impact of tax avoidance and evasion".

It is submitted that countries (particularly developing countries such as South Africa) should consider the *relative* significance of base erosion due to multinational enterprise profit shifting compared to the other types of base erosion discussed in this section. The estimates provided by Fuest and Riedel (2009) show that other forms of base erosion may be quantitatively greater that profit shifting. It cannot be denied that multinational enterprises use tax minimising strategies (as would any reasonable taxpayer). But in developing countries the other forms of base erosion (especially the shadow economy and wealthy individual tax evasion described above) are potentially as large, and perhaps more harmful to the economy than BEPS. Certainly, the benefits of multinational enterprise activity in the country should be evaluated as well.

Various studies have explored other factors that affect a country's tax base. Nashashibi and Bazzoni (1994) found that imports constituted the largest segment of the tax base for Sub-Saharan African countries, and in such economies, the exchange rate is a critical element in determining tax revenues.

Aizenman and Jinjarak (2009) investigated the effect of globalisation on the tax bases of developing countries. They found that globalisation has shrunk the tax revenue from traditional "easy-to-collect" taxes (including tariffs, inflation tax and financial repression) and forced countries to switch to "hard-to-collect" taxes (including Value-Added Taxes, income taxes, and sales taxes). They concluded (Aizenman and Jinjarak, 2009:668) that

> A good share of developing countries managed the adjustment by shifting the tax revenue to the hard to collect taxes. Yet, countries with a low level of institutional quality have found the adjustment more challenging, frequently ending with a drop in the net tax revenue/GDP.

Keen and Simone (2004) investigated the effect of tax competition on developing countries. They explain that increased tax competition between countries has resulted in a decrease in statutory corporate tax rates across both developed and developing countries. In developed countries, these rate cuts have been offset by base broadening reforms, "leaving revenue roughly unchanged" (Keen and Simone, 2004:1317). However, they found (2004:1318) "in some of the poorest and most vulnerable of the developing countries [corporate tax reform] has been rate-reducing but also base-reducing (or, at best, base-neutral)". They argue that this erosion of the corporate tax base can be attributable to base-narrowing policy reforms, and they highlight four specific forms of base-narrowing tax incentives: tax holidays; sector/region specific reduced statutory rates; direct tax breaks for exporters; and free-trade zones.

Alm, Bahl and Murray (1991) also investigated tax base erosion in developing countries. Although their study focused on erosion of the individual income tax base in Jamaica, they make several relevant points about base erosion in general. Despite being more than two decades old, many of their insights still hold true today. The tax base of developing countries is eroded by both legal tax avoidance and illegal tax evasion, "yet tax base erosion in developing countries is something about which precious little is known, and, in particular, the empirical evidence about the severity and the nature of the problem is all but non-existent" (Alm *et al*, 1991:849). They identified reasons for this lack of knowledge, including:

conceptual problems in measuring erosion of the tax base; the problem of comparability across countries (varied legal and illegal avoidance channels); cultural factors in defining the line between compliance and non-compliance; and lack of data to measure the full tax base.

Most of these reasons are still valid today in both developing and developed countries. The OECD BEPS Report makes it clear that there is a need for further measurement of tax base erosion. One of the major reasons identified by the OECD BEPS Report as providing opportunities for BEPS is the many varied yet interacting domestic tax systems. The line between legal avoidance and evasion is still at the heart of BEPS. And, it is argued, a country's response to BEPS should be determined by the factors affecting its own tax base – which first requires measurement of its full tax base.

The study by Alm *et al* (1991) generated "micro-level estimates of the amount of income that escapes individual income taxation via both legal and illegal means", which were then used in the Jamaican 1986 tax reform program. They claim that such "sweeping reform" would not have been possible without "detailed individual information on the potential tax base" (Alm *et al* 1991:850). Similarly, it is submitted that detailed micro-level estimates of corporate tax base erosion by multinationals are needed in order for a country to best respond to BEPS.

Alm *et al* (1991) also identified the following reasons for the erosion of the individual income tax base in Jamaica: tax credits; non-taxable fringe benefits to employees; preferential tax treatment for overtime activities; underreporting of taxable income; and failure to file tax returns. It is important to remember that "base erosion" happens not only through profit shifting by multinational enterprises, and Alm *et al* (1991:868) remind readers that "tax base erosion is a complicated, multistage process".

A broader macro-economic perspective is provided by Tanzi (1988). He argues that a country's macro-economic policies can have an effect on tax revenue. He finds that appreciation of a developing country's exchange rate is likely to result in "an immediate and direct loss in one of its most important revenue sources" – import duties (Tanzi, 1988:5). This is because of the direct link between the exchange rate and the base on which import duties are levied – the official domestic value of the imported products. He also finds that in certain developing countries with a long tax collection lag, "the effect of inflation on tax revenue is unambiguously negative" (Tanzi, 1988:14).

Regarding interest rate policy, Tanzi (1988:19) argues that a country that keeps its interest rates at low levels unattractive to savers can negatively affect its tax base. This can happen in four ways: First, when "individuals avoid official institutions and borrow and lend directly from each other"; second, through "the hoarding of real assets … for which the implicit nominal rate of return is not taxable"; third, through "currency substitution, where savers…channel their savings towards dollar bills physically held in the country"; and fourth, through the incentive for individuals to take their money out of the country, where "the tax base is essentially transferred to another country".

These macroeconomic influences on a country's tax base illustrate the interaction between a country's economic and tax policies. Tanzi (1988:18) argues that "macroeconomic policies pursued independently of tax policy often have important and relatively direct influences on tax revenue and, through these, on the overall incidence of the tax system". This argument also applies in the opposite direction. A country's tax policies can have a direct effect on economic performance. This is especially true in the case of the tax treatment of multinational enterprises, which may generate large revenues and provide jobs, but also have the ability to base themselves in the most favourable location. The benefit of having multinational enterprises located in a country is discussed briefly in Chapter Five. It is worth noting here that the OECD Guidelines for Multinational Enterprises (OECD, 2011:14) recognises multinational enterprise activities as bringing "substantial benefits to home and host countries"[2].

Avi-Yonah (2009) provides a reminder that many countries choose to implement tax policies that explicitly erode the corporate tax base, in order to compete for inbound foreign investment. He states (Avi-Yonah, 2009:788) that

> In the last two decades, an increasing number of countries have competed for inbound investment by offering foreign corporate investors tax holidays. Multinational companies can with relative ease relocate production facilities in response to variations in foreign tax rates. Multinationals use such "production tax havens" to derive the bulk of their foreign income free of host country taxation.

[2] The OECD (2011:14) further describes that "these benefits accrue when multinational enterprises supply the products and services that consumers want to buy at competitive prices and when they provide fair returns to suppliers of capital. Their trade and investment activities contribute to the efficient use of capital, technology and human and natural resources. They facilitate the transfer of technology among the regions of the world and the development of technologies that reflect local conditions. Through both formal training and on-the-job learning enterprises also promote the development of human capital and creating employment opportunities in host countries".

Avi-Yonah (2009) also offers a reason for why OECD countries have not experienced declining tax revenues despite increased tax competition over the last few decades. He believes (Avi-Yonah, 2009:791) that "the effort to cut back on preferential regimes in OECD member countries, plus an increased vigilance on transfer pricing and a concerted effort to lower the permanent establishment ... threshold have prevented a decline". These findings suggest that OECD countries may already be dealing effectively with BEPS.

Finally, Markle and Shackelford (2011) point out that reduced tax revenues can be caused simply by relocation of domicile. They refer to Braithwaite (2008) where it is anonymously quoted that "half the FTSE 100 is looking at [redomiciling outside the United Kingdom]". They also explain that it is not only companies that are relocating, and that "Jones and Houlder (2010) report that one-quarter of London's hedge fund employees have recently moved to Switzerland to avoid higher taxes" (Markle & Shackelford, 2011:2).

These varied forms of tax base erosion range from legal to illegal, controllable to uncontrollable, and are even often the result of tax competitive policy choices. What is clear is that "base erosion" has many causes other than "profit shifting". An analysis of a country's full tax base, and the causes of its erosion, should be undertaken before unnecessary or rushed actions are taken against BEPS.

2.4 Conclusion

This chapter provided an overview of the composition of a country's tax base and how tax base erosion can occur. It put the concept of BEPS into a broader tax and economic policy perspective, and argued that a country's approach to BEPS should be based on an understanding of the composition of its own tax base. It is submitted that the expression "Base Erosion and Profit Shifting" has unfairly directed the public and popular media's attention on multinational enterprises as the main cause of lost tax revenues. However, as shown in this chapter, significant base erosion can result from other features of a country's economy. These can include such varied factors as interest rate levels, exchange rates, and specific tax incentives.

The next chapter will discuss the definition of BEPS, and show that the term BEPS is being used to refer to aggressive tax strategies by multinational enterprises, and by implication the resultant loss of corporate tax revenue. However, multinational enterprises contribute positively to other aspects of a country's development, such as the benefits described by the OECD (2011) itself, and discussed in Chapter Five. It is suggested that researchers and policy makers take a cautious approach to BEPS and multinational enterprises before making major reforms to corporate tax legislation. The tax base of any country is a fluid concept that can be eroded by complicated factors. These can be controllable, such as economic policy or tax legislation, or uncontrollable such as business cycles and globalisation. The relative significant of BEPS compared to other forms of tax base erosion should first be assessed for each country.

CHAPTER THREE: DEFINING BEPS

3.1 Introduction

The major goal of this thesis is to gain a greater understanding of what BEPS is. It was argued in Chapter Two that "base erosion" (the "BE" of BEPS) means the reduction in tax revenues from any of a country's tax bases. This could include, for example, tax evasion by wealthy individuals, reduced import duties from exchange rate fluctuations, or even specific tax policies such as tax holidays or free trade zones.

It is clear that the term BEPS is being used with a much narrower meaning, and this chapter aims to clarify what this meaning is. The OECD BEPS Report and Action Plan provide an appropriate starting point when attempting to define the term "BEPS". These reports have been a focus for much of the recent research into the topic, and have provided the impetus for the focus of the OECD/G20 on BEPS.

The aim of the OECD BEPS Report was to "present the issues related to BEPS in an objective and comprehensive manner" (OECD 2013a:6) and it includes a chapter examining research into BEPS. The OECD BEPS Action Plan then takes the approach that BEPS is happening and is a problem, and proceeds to itemise fifteen "Actions" together with tight deadlines in which to achieve them.

This chapter examines how the OECD BEPS Report and Action Plan define BEPS. It also examines the studies included in the OECD BEPS Report to determine how these relate to BEPS. It will be shown that the simple acronym, BEPS, is being used by the OECD to describe aggressive yet legal multinational enterprise tax planning. However, BEPS is not a simple concept. There are many complicated and interrelated international corporate tax issues that allow the development of these corporate tax strategies.

3.2 How does the OECD BEPS Report define BEPS?

Surprisingly, the OECD BEPS Report does not clearly define what BEPS is. The Executive Summary (OECD, 2013a:5) states firmly that "base erosion is a serious risk to tax revenues, tax sovereignty and tax fairness". It continues with the observation that profit shifting is a "significant" source of base erosion, but then admits that "further work on the data relating to base erosion and profit shifting (BEPS) is important and necessary".

The body of the report begins (OECD, 2013a:13) by discussing the "perception" that governments lose corporate tax revenue by companies "shifting profits ... to locations where they are subject to more favourable tax treatment". It then states that this has grown into a "perception" that the rules on taxation of cross-border profits are broken, and that multinational enterprises are "being accused of dodging taxes worldwide".

The term BEPS is thereafter used to describe something that companies "do". The OECD BEPS Report discusses (OECD, 2013a:18) the use of low or no tax countries "for BEPS purposes". The studies reviewed in the report are described (OECD, 2013a:18) as "an attempt to demonstrate the existence of **BEPS behaviour** or the absence of such behaviour" (emphasis added).

If BEPS is a behaviour, then it is important to understand who is doing it, and what they are doing. The OECD BEPS Report provides an overview of "available data", and these studies will be examined in section 3.4 in order to understand what they investigate, and how they relate to BEPS, if at all. It will be shown that these studies, used in the OECD BEPS Report to provide information about BEPS, often produce contradictory results, and in many cases did not intend to provide insight into BEPS.

The closest the OECD BEPS Report comes to providing a definition of BEPS is the statement that "broadly speaking, BEPS focuses on moving profits to where they are taxed at lower rates and expenses to where they are relieved at higher rates" (OECD, 2013a:39). With this description, the term "BEPS" has been introduced to its wide audience. The two separate issues of "base erosion" and "profit shifting" have been coupled as a single concept, with profit shifting held as the cause of base erosion. Furthermore, with the focus of the OECD BEPS Report evidently on profit shifting by *multinational enterprises*, the term BEPS is being used to refer to the erosion of *corporate* tax revenue because of multinational enterprise profit shifting. The OECD BEPS Report has created the impression that multinational enterprises are chiefly responsible for the erosion of a country's tax base.

However, the "BE" of BEPS is a misnomer. A country's tax base may be eroded in many different ways (as explained in Chapter Two), only one of which is through the erosion of its *corporate* tax base. In addition, it is submitted that the "PS" of BEPS is also misleading. While profit shifting is indeed a possible cause of loss of corporate tax revenue, there are many other factors which may reduce a country's corporate tax base. Unfortunately, the ambiguous term "BEPS" is being used by the OECD to describe the specific behaviour of aggressive tax planning by multinational enterprises. This is illustrated by the following observation in the OECD BEPS Report (OECD, 2013a:45):

> While these corporate tax planning strategies may be technically legal and rely on carefully planned interactions of a variety of tax rules and principles, the overall effect of this type of tax planning is to erode the corporate tax base of many countries in a manner that is not intended by domestic policy.

The OECD BEPS Report (OECD, 2013a:33-39) also discusses the "key tax principles and opportunities for base erosion and profit shifting". It identifies the following four main areas of taxation and then explores the BEPS "opportunities" created by each.

- **Jurisdiction to tax**

  The OECD BEPS Report discusses the concept of a country's jurisdiction to tax in terms of whether it employs a territorial or worldwide tax system, and how the interaction of different domestic tax systems and rules results in overlaps and mismatches. It then lists specific examples of the tax strategies presented by these mismatches, which include: low taxed branches, hybrid entities, hybrid instruments, conduit companies, and derivatives. These strategies form the "PS" of BEPS – the profit shifting activities of multinational enterprises.

  The report states that these mismatches result in an overall loss of tax paid, "although it is often difficult to determine which of the countries involved has lost tax revenue" (OECD, 2013a:39). It also argues that these mismatches allow multinational enterprises to gain a competitive disadvantage over smaller domestic companies only because they operate cross-border and have access to sophisticated tax expertise.

  Common "enablers" of BEPS appear to be specific United States tax rules (such as the "check-the box" provision), and the United States *worldwide* tax system, both of which are common features of many high-profile multinational enterprise tax avoidance strategies. For example, Ting (2014:58) analyses Apple's international tax structure, and concludes that the check-the-box regime "together with the statutory look through rule in the CFC [Controlled Foreign Company] regime, is a structural flaw in the United States tax system. It effectively disables to a large extent the CFC regime and facilitates tax avoidance structures using hybrid entities".

Furthermore, many of the available studies on company effective tax rates use United States data, and the conclusions (as discussed in section 3.4) vary in terms of whether United States multinational enterprises are taxed too little or too high. Other countries should consider how effective their own response to BEPS will be, given how often their local multinational enterprises will interact with United States multinational enterprises and thus with United States tax policies. It will be shown in Chapter Five that the United States is a major trading partner of both South Africa and Australia. It is argued that their response to BEPS should include an analysis of their tax legislation in terms of mismatches with United States tax rules.

- **Transfer pricing**

The OECD BEPS Report defines transfer pricing as rules to determine "the relevant share of profits which will be subject to taxation" (OECD, 2013a:36). A common assertion in BEPS literature is that the global digital economy has further complicated transfer pricing regimes and enabled BEPS opportunities. However, nearly *forty* years ago, Stewart (1977:354) wrote that

> "profit switching transfer pricing" may serve as the main vehicle by which multinational firms switch liquid resources from subsidiary to subsidiary in order to reduce exchange risks, or to **minimise tax payments**, etc. Tax payments may be reduced not only by **increasing profits artificially** in countries with low or zero taxes, but also by avoiding the declaration of losses by a subsidiary ... Such action also involves a **redistribution of tax revenue**, usually from high tax countries to low tax countries (emphases added).

This decades old description appears as if it has been taken off the pages of the OECD BEPS Report. Transfer pricing, with its complications, is not a new topic, and has been an important OECD project for decades. Transfer pricing has always been a difficult, and, by its very nature, artificial mechanism. As McDonald (2008:5) states, "attempting to determine arm's length pricing for transactions that are not arm's length, and perhaps would not even take place at arm's length, can be difficult in practice".

It appears unlikely that a quick or comprehensive solution will be found, and certainly not the timetabled development of "rules to prevent BEPS" as called for in three of the OECD BEPS "Actions". For example, although "Action 8" ("Assure that transfer pricing outcomes are in line with value creation: intangibles") has met its interim September 2014 deadline (with the publication of the report "Action 8: Guidance on Transfer Pricing Aspects of Intangibles" (OECD, 2014a)), much of the report consists of "interim drafts of guidance, **not yet fully agreed** by delegates" (emphasis added) (OECD, 2014a:10).

- **Leverage**

  The issue of leverage in relation to BEPS concerns the different tax treatment of debt versus equity. The OECD BEPS Report states that "leveraging high tax group companies with intra-group debt is a very simple and straightforward way to achieve tax savings at group level" (OECD, 2013a:43).

- **Anti-avoidance rules**

  The OECD BEPS Report discusses, briefly, some common anti-avoidance rules. It then describes some strategies that circumvent these rules.

"Profit shifting" is a convenient but one-dimensional term used to summarise these BEPS "opportunities". Rather, it is the interaction of various tax principles together with complicated multinational enterprise tax strategies which allows BEPS (or, no or low tax on multinational enterprises, as implied by the OECD BEPS Report) to occur. The OECD BEPS Report itself acknowledges (OECD, 2013a:44) this complexity:

> The interaction of withholding tax rules in one country, the territorial taxation system in another country, and the entity characterisation rules in a third country may combine to make it possible for certain transactions to occur in a way that gives rise to no current tax and have the effect of shifting income to a jurisdiction where, for various reasons, no tax is imposed.
>
> Often it is not any particular country's tax rule that creates the opportunity for BEPS, but rather the way the rules of several countries interact.

In other words, "BEPS", as coined by the OECD and embraced by the G20, is not easy to define or explain. It refers to multifaceted international corporate tax strategies, perhaps enabled by the present high technology, globalised age, and is something that policymakers will grapple with for years to come.

The first OECD BEPS Report explicitly recognised the complicated nature of BEPS. However, the OECD BEPS Action Plan, released only five months later, uses more forceful, emotive language in describing BEPS and initiates an extensive timetabled list of actions to be taken against BEPS. It is submitted that the OECD and G20's urgent call to action may not be the best way to understand and manage BEPS.

3.3 How does the OECD BEPS Action Plan define BEPS?

In its "Background" chapter, the OECD BEPS Action Plan explains (OECD, 2013b:10) that

> BEPS relates chiefly to instances where the interaction of different tax rules leads to double non-taxation or less than single taxation. It also relates to arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place.

It further states its objective that "this Action Plan should provide countries with domestic and international instruments that will better align rights to tax with economic activity" (OECD, 2013b:11). These references to economic and profit creating activities are perhaps indicative of what is at the heart of the BEPS "problem" – the ethics of corporate tax avoidance, and when aggressive, yet legal, tax strategies cross the boundary of ethical corporate behaviour. The ethics of tax planning often includes the debate over tax havens, which are often implicit in multinational enterprise aggressive tax strategies. This ethical debate is discussed in Chapter Four.

The OECD BEPS Action Plan departs from the restraint expressed in the OECD BEPS Report. It makes it clear that it believes that BEPS is a serious problem that needs to be addressed urgently. The Introduction to the Action Plan uses strong clear statements to describe how multinational enterprises exploit "legal arbitrage opportunities and the boundaries of acceptable tax planning" to take aggressive tax positions (OECD, 2013b:8):

> These developments have opened up opportunities for **MNEs [multinational enterprises] to greatly minimise their tax burden.** This has led to a **tense situation** in which citizens have become more sensitive to tax fairness issues. It has become a **critical issue** for all parties (emphases added).

It then declares (OECD, 2013b:8) that governments **are** harmed, individual taxpayers **are** harmed, and businesses **are** harmed. The Action Plan further states (OECD, 2013b:10) that a "**bold move** by policy makers is necessary" in order to prevent "global tax **chaos**" (emphases added).

This approach is in contrast with the initial OECD BEPS Report which stated that "it is difficult to reach solid conclusions about how much BEPS actually occurs. Most of the writing on the topic is **inconclusive**, although there is abundant **circumstantial** evidence that BEPS behaviours are widespread" (emphases added) (OECD, 2013a:15).

Although a detailed analysis is not made of the fifteen Actions, it is useful to consider the nature of these actions. Rosenzweig (2014:1077) describes the OECD Action Plan as an "immense challenge, [taking] on such issues as the digital economy, hybrid mismatches, treaty abuse, intangibles transfer pricing, and information sharing. The only common element among them seems to be that they involve international tax".

Ault, Shön and Shay (2014:275) provide a summary of the Actions as follows:

- rules for the digital economy;
- prevention of double non-taxation;
- alignment of economic activity and taxation;
- tax transparency and dispute resolution; and
- efficient and effective implementation.

The complexity of these tax issues (each individually extensive, and almost inconceivable to be targeted as one) must cast doubt on the success of the OECD Action Plan. Rosenzweig (2014:1077) describes that "dealing with all these issues at once might appear at first to be a fool's errand, especially since each one has proven so difficult to deal with in the past". However, he then argues that if these difficulties are because the issues are "inexorably intertwined [then] addressing them as part of a comprehensive overhaul not only makes sense, but could also prove crucial to BEPS's ultimate success". This is a logical argument. However, it is worrying that one of the fundamental factors to the success of the OECD Action Plan is the cooperation of countries. It is highly doubtful whether the OECD countries, let alone *all* the countries in the world, will be able to achieve consensus on *all* of these issues.

Boidman and Kandev (2013:1017) argue that the OECD BEPS project has “unprecedented political context”, and that each of the Actions “has previously been the object of exhaustive attention by the OECD” (Boidman & Kandev, 2013:1018). They do not believe that any fundamental changes will come from the OECD BEPS project, because most of the substantive actions are in areas where OECD countries already have well established and fine-tuned policies developed over decades, and other action items are “too controversial to see any movement” (Boidman & Kandev, 2013:1032).

3.4 Definition of BEPS in studies referred to in the OECD BEPS Report

Although the OECD BEPS Report “does not define BEPS exhaustively but rather describes the main characteristics of this notion” (Boidman & Kandev (2013:1018), it does include a chapter providing what it deems “an overview of the available data”. It is useful to understand what these underlying studies examined.

Annex B of the OECD BEPS Report provides a brief summary of each of them, and this will not be repeated here. However, it is important to understand the objective of these studies, and their link, if at all, to BEPS. It will be shown that many of these studies, which arguably form the foundation for the entire OECD and G20 BEPS project, in fact do not purport to investigate BEPS, and many achieve contradictory results.

The OECD BEPS Report groups the studies into the following categories:

- **Data on country corporate income tax revenues.**

  This section of the OECD BEPS Report concludes that “further analysis would be required to distinguish the particular factors **increasing** the corporate income tax base in each country” (emphasis added) (OECD, 2013a:17). This is a very interesting observation that appears to be forgotten in the rush to achieve the deliverables of the OECD Action Plan. The underlying presumption of BEPS is that multinational enterprise profit shifting *erodes* the tax base, and yet the OECD itself concludes that the corporate tax base is *increasing*. This strongly supports the argument, discussed further in Chapter Four, that the nature and extent of BEPS can only be confidently determined by analysis at the micro-level of intra-company transactions.

- **Data on foreign direct investments**

  This brief section in the OECD BEPS Report provides a summary of data about foreign direct investment (FDI) flows. It concludes that further analysis could provide useful insight into the use of low or no tax countries in conduit structures. However, it implicates these low-tax regimes in BEPS by highlighting data such as "in 2010 Barbados, Bermuda and the British Virgin Islands received more FDIs (combined 5.11% of global FDIs) than Germany (4.77%) or Japan (3.76%)" (OECD, 2013a:17). Statements such as this imply that low or no tax regimes (particularly tax havens) are enabling BEPS by providing opportunities for multinational enterprises to engage in profit shifting.

- **A review of recent BEPS studies**

  The OECD BEPS Report implies that the studies included in its report provide evidence about BEPS. The description of the report declares that "this report presents studies and data available regarding the existence and extent of base erosion and profit shifting". These are grouped into studies on:

  - effective tax rates of multinational enterprises;
  - data from taxpayer returns; and
  - other analyses of profit shifting.

The remainder of this chapter contains an analysis of what these "BEPS studies" actually investigated and how, or if, they related to BEPS. The OECD BEPS Report (OECD, 2013a:61) quite definitively declares that they "attempt to demonstrate the existence of BEPS behaviour, or the absence of such behaviour". However, after describing the studies on effective tax rates of multinational enterprises, the OECD Report (OECD, 2013a:63) concludes that

> It is questionable whether any of the foregoing studies provide conclusive evidence that BEPS behaviours are prevalent. In fact **none of these studies identifies data specifically related to BEPS** and the differences or similarities in ETRs [effective tax rates] observed in the studies could well be attributable to factors other than BEPS (emphasis added).

3.4.1 Studies using effective tax rates

Avi-Yonah and Lahav (2012) analysed effective tax rates of the largest 100 United States multinationals and compared them with the largest 100 European Union multinationals. They did not investigate the existence or extent of base erosion or profit shifting. Rather, they were trying to assess whether United States multinational enterprises were disadvantaged by a higher United States statutory tax rate. They concluded (Avi-Yonah & Lahav, 2012:383) that "U.S.-based multinationals do not face a tax-induced competitive disadvantage in competing against EU-based multinationals".

The paper by Yorgason (2009), as its name ("*Collection of data on income and other taxes in surveys of U.S. multinational enterprises*") implies, is simply a collection of data on taxes on multinational enterprises with a presence in the United States. This data was "collected as part of larger surveys that gather financial and operating information from multinational enterprises, basically, statistics on the activities of multinational enterprises" (Yorgason, 2009:1). It presents effective tax rates of multinational enterprises broken down into three categories; namely United States parents; United States affiliates of foreign enterprises; and foreign affiliates. These show that "the effective average income tax rates for foreign affiliates (about 14 percent) is only half that for U.S. affiliates and is much lower than that for their U.S. parents". Yorgason (2009) did not attempt to interpret this data, but indicated how other studies may use it. He did not investigate BEPS, but simply presented data on corporate effective tax rates.

The goal of the extensive study by Markle and Shackelford (2011:34) was to "compare the effective tax rates of all publicly-traded companies around the globe", in order to understand whether domicile substantially affects a multinational's total worldwide taxes (which, they concluded, it does). As a United States National Bureau of Economic Research paper, they unsurprisingly take an American point of view, with a more subtle objective being to investigate the international competitiveness of United States domiciled multinational enterprises. They took a broad approach of trying to understand tax competition between countries, and in particular whether United States based multinational enterprises are disadvantaged by high United States tax rates, or whether they can use "BEPS behaviours" to undo tax differences between countries. They concluded (Markle & Shackelford, 2011:5) that

> Even though many firms reportedly engage in increasingly aggressive international tax planning with transfer pricing, hybrid entities and other tax avoidance strategies, they apparently are unable to completely undo the differences in tax law across countries. Consequently, many countries continue to collect large sums of corporate income taxes from multinationals even though tax havens and other low-tax countries exist.

This study is one that specifically mentions the ubiquitous "BEPS behaviours" described in the OECD BEPS Report. They identify transfer pricing, hybrid entities, intracompany financing, and favourable repatriations as mechanisms to shift income from high-tax to low-tax countries. However, it is also one of the most important studies to conclude (Markle & Shackelford, 2011:33) *against* the idea of a BEPS "problem" (at least from a United States perspective):

> The findings in this study may hasten the development of U.S. tax reform by showing that **U.S. multinational ETRs [effective tax rates] are among the highest in the world** ...Moreover, if territorial taxation further lowers the taxes on Japanese and British multinationals, then the **U.S. may be forced to provide some tax relief for its multinationals** to maintain some level of international tax competitiveness (emphases added).

The OECD BEPS Report then refers to studies by "campaigners and lobbyists" (OECD, 2013a:62), who tend to have a sensational style. The first such report (McIntyre, Gardner, Wilkins & Phillips: 2011) calculated the United States effective tax rate (United States current tax divided by United States profits) of 280 Fortune 500 United States companies. Their stance is clear: "Today corporate tax loopholes are so out of control that most Americans can rightfully complain, "I pay more federal income taxes than General Electric, Boeing, DuPont, Wells Fargo, Verizon, etc., etc., all put together". That's an unacceptable situation" (McIntyre *et al*, 2011:1).

The conclusions that McIntyre *et al* (2011) draw from their calculated effective tax rates appear to contradict the more academic studies already discussed above. They state (McIntyre *et al*, 2011:10) that "it turns out that the corporate lobbyists' assertion that United States taxes are higher than foreign taxes is wrong. In fact, in most cases just the opposite is true". Their paper has a very significant political focus, with the blame for alleged low United States corporate tax being placed on corporate political lobbying for tax breaks. It does not seem to emphasise multinational enterprises' worldwide aggressive tax strategies (which are mentioned, but are certainly not the focus of the report). Rather it focuses on the domestic (United States) tax laws that create alleged low United States corporate effective tax rates. McIntyre *et al* (2011:2) boldly declare that

> There is plenty of blame to share for today's sad situation. Corporate apologists will correctly point out that the loopholes and tax breaks that allow low-tax corporations to minimize or eliminate their income taxes are generally quite legal, and that they stem from laws passed over the years by Congress and signed by various Presidents. But that does not mean that low-tax

> corporations bear no responsibility for their low taxes. The laws were not enacted in a vacuum; they were adopted in response to relentless corporate lobbying, threats and campaign support.

It appears that this and other "Citizens for Tax Justice" reports have several flaws[3] and it is surprising and significant that the OECD has chosen to include it in its formal analysis of BEPS studies. While it certainly examines "base erosion", this analysis is very narrowly focused on United States corporate tax, with an aggressively negative approach to multinational enterprises. A succinct summary of their position is (McIntyre *et al*, 2011:6): "the enormous amount they [multinational enterprises] did not pay was due to the hundreds of billions of dollars in **tax subsidies** that they enjoyed" (emphasis added).

As sensational as this report may be, it is a reminder that base erosion is not only a result of profit shifting by multinational enterprises. The report presents company by company notes over 24 pages detailing the "reasons" for their low taxes, and summarises these reasons into four categories (McIntyre *et al*, 2011:11): accelerated depreciation, stock options, industry specific tax breaks, and offshore tax sheltering. These "reasons" for alleged low corporate tax rates in the United States are reminders that the concept of "BEPS" must be considered objectively when making policy changes. Corporate tax base erosion can occur in many ways, and addressing aggressive tax planning by multinational enterprises should not be done in isolation.

A similar report was prepared by The Greenlining Institute (Kang & Ngo, 2012) (who are described on their website as working "to bring the American Dream within reach of all, regardless of race or income"). The title of their report gives an indication of the style and conclusion of their research: "*Tech Untaxed: Tax Avoidance in Silicon Valley, and How America's Richest Company Pays a Lower Tax Rate than You Do*". They analysed 30 "high-tech" companies on the Fortune 500, and found these companies in 2011 kept US$429 billion in offshore (non-United States) accounts, and calculated an average three-year effective tax rate of 19.1%. They conclude that "American technology companies achieve these low tax rates by moving and keeping hundreds of billions of dollars in profits offshore", and that "evidence of profit shifting is seen in the ballooning cash corporations stash offshore" (Kang & Ngo, 2012:9).

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[3] See Council on State Taxation. 2014. Updated Citizens for Tax Justice Report Misleads Policymakers and The Public; Also Michel, N.J. 2004. Anything but Avoidance: Citizens for Tax Justice's Blundering Corporate Tax Report.

The OECD BEPS Report (OECD, 2013a:62) describes the Greenlining Institute Report as concluding that the large amounts of foreign retained earnings are "a clear indication of profit shifting practices put in place by United States-based MNEs [multinational enterprises]". Two examples of these profit-shifting activities are described by Kang and Ngo (2012:14-15). The first, briefly referred to, is the now infamous Google Double Irish/Dutch Sandwich model[4], while the second, explained in detail, is the use of "contract manufacturing". While these profit shifting strategies are certainly typical of the "BEPS behaviours" described in the OECD BEPS Report, it should be noted that the Greenlining Institute Report blames a variety of other United States specific characteristics for encouraging these profit shifting activities. These include deferral of foreign income, repatriation tax holidays, the receipt of government contracts, and the use of tax havens.

A few comments on the inclusion of the Greenlining Institute Report in the OECD BEPS Report are necessary because of its non-academic and sensationalist style. Its entire argument is based on the assumption that low effective tax rates are proof of profit shifting. It makes little attempt to explain the difference between accounting profit and taxable income. It also simply presents the effective tax rates that it calculated (as cash taxes paid divided by accounting income). There is no attempt to statistically explain the reasons for the effective tax rates being lower than the statutory rate. The Greenlining Institute Report and the Citizens for Tax Justice Report (McIntyre *et al*, 2011) are the only studies out of the many referred to in the OECD BEPS Report to both specifically investigate low tax rates of multinational enterprises, and thereafter conclude that it is a problem. It is significant that they are both from the "campaigners and lobbyists" faction, and, it is submitted, they do not help the credibility of the OECD BEPS campaign.

In contrast is a study performed by PricewaterhouseCoopers and commissioned by Business Round Table (PricewaterhouseCoopers & Business Roundtable, 2011), described on their website as "an association of chief executive officers of leading United States companies working to promote sound public policy and a thriving U.S. economy". In this study, the effective tax rates of 2000 companies on the 2010 Forbes Global 2000 list were calculated using their company financial statements. These were then presented in various graphical

[4] For an explanation of the Double Irish/Dutch tax strategy see, for example, Loomis, S.C. (2011-2012). The Double Irish Sandwich: Reforming Overseas Tax Havens. St Mary's Law Journal, Vol 43.

formats, but other than a country by country comparison there was no analysis of the reasons for the effective tax rates. The only conclusion drawn by the study is that "the statutory tax rate in the country in which a company is headquartered has an important effect on the company's effective tax rate" (PricewaterhouseCoopers & Business Roundtable, 2011:7). There was no attempt to investigate BEPS.

The final effective tax rate study referred to in the OECD BEPS Report was undertaken by the American Enterprise Institute for Public Policy Research (Hassett & Mathur, 2011), which calculated and compared statutory and effective tax rates in the United States with OECD countries. The focus of this study was to consider the impact of tax rates on competitiveness, and it concluded that "the United States is currently underperforming in global tax comparisons" (Hassett & Mathur, 2011:5). Once again, effective tax rates were not used in this study to describe or analyse BEPS, but rather to investigate United States' competitiveness.

3.4.2 Studies using taxpayer returns

The next group of studies use data taken off company tax returns. They are predominantly United States focused, with a few using OECD member country data. It will be shown that, unlike the effective tax rate studies above, most of these studies do indeed investigate different forms of profit shifting. What follows is an attempt to describe the BEPS behaviour being examined in each of the studies.

Grubert (2012:1) found that tax differentials (between domestic [United States] and foreign effective tax rates) "can provide incentives to increase investment abroad, and to shift income through transfer price manipulation, the location of company debt, and other mechanisms". Being understandably United States focused, this paper identifies two major pieces of United States tax legislation to which it attributes the increase in the tax differential, and thus the increase in profit shifting abroad. These are:

> The introduction of the **check-the-box provisions** in 1997, which facilitated the shifting of income from high tax to low tax countries, seems to have accounted for 1 to 2 percentage points of the 5.0 percentage point decline in average foreign effective rates. The "**active finance exception**," which reinstituted deferral for income from active financial business abroad, accounts for about an additional 0.5 percentage point of this reduction" [emphases added] (Grubert (2012:4).

For the purpose of this thesis, it is simply worth commenting that these are two United States specific tax provisions, which facilitate many of the "BEPS behaviours" used by multinational enterprises. The study makes a remarkable claim that profit shifting by United States multinational enterprises would disappear if the United States removed this "deferral" (Grubert, 2012:10):

> Eliminating deferral would remove all tax incentives to locate income and activity in countries with tax rates below the rate in the United States ... The effects of differences in average foreign tax rates would disappear as all worldwide income would be currently subject to the U.S. tax rate. The companies that are in a position to take the greatest advantage of lower foreign tax rates under current law would have **no more reason to shift income or locate activity abroad** than those that cannot, or choose not to, take advantage of lower foreign rates" (emphasis added).

Regarding the specific type of profit shifting occurring, Grubert (2012:39) found support for the hypothesis that research and development based intangibles facilitate income shifting and concluded that "the problems in pricing intellectual property thus create greater opportunities for income shifting". Since the research and development data they used in their calculations was research and development performed in the United States, it indicates that "lower foreign tax burdens increase the shifting of income **from the United States**" (emphasis added).

It must again be emphasised that this was a United States study, using United States multinational enterprise data. The nature of United States based multinational enterprises and the nature of the United States tax provisions combine to create United States specific profit shifting opportunities. Other countries should consider examining micro-level research and development data from their locally based multinational enterprises in relation to their domestic tax laws to consider whether profit shifting via research and development intangibles is a concern. Other countries should also consider whether their domestic tax laws contain similar provisions to the United States tax provisions that are being held as enabling BEPS. It may be found that BEPS is not as big a "problem" for some countries as it is for the United States or other high-tax OECD countries.

McDonald (2008) has a narrower focus on United States income shifting from transfer pricing. He spends considerable time explaining the concept of transfer pricing, and how the inherent subjectivity of pricing transactions between related parties may facilitate income shifting. He specifies intangible property cost-sharing arrangements as being a type of arrangement which increases the risk of profit shifting, and states that by using cost-sharing arrangements "multinational companies may effectively achieve the transfer of valuable intangibles to offshore locations for less than the full value required by U.S. law" (McDonald, 2008:8).

While McDonald's (2008) econometric results support the hypothesis that multinational enterprises engage in profit shifting through non-arm's length transfer pricing, he cautions against this interpretation (McDonald, 2008:19): "these results do not in themselves necessarily point to transfer pricing abuse as the underlying cause of the inverse relationship between tax rates and profitability". He further warns that "the results of this analysis are not determinative, and should again be interpreted with some caution" (McDonald, 2008:21).

As an overriding caveat (and one which all BEPS researchers should observe) he draws attention to the fact that his study uses aggregated company level data, and warns (McDonald, 2008:8) that

> Whether and the extent to which there may be income shifting from non-arm's length pricing of intercompany transactions sometimes **can only be definitively determined at the very detailed level of the particular transactions** under review, rather than at the level of a single company within a multinational group (emphasis added).

Not one of the studies in the OECD BEPS Report has used transaction-level data to identify or measure corporate profit shifting. This should be an important project for countries before they decide on their response to BEPS.

Grubert (2003:1) also investigated profit shifting behaviour by United States multinational enterprises, and attempted to discover "how opportunities for income shifting vary by type of company and how it affects their behaviour". His basic premise is that "intercompany transactions provide the opportunity for income shifting" (Grubert, 2003:224), but he focused only on "nonfinancial" transactions between affiliates, such as the purchase and sale of goods or the payment of royalties. His results show (similar to McDonald - who based his study on Grubert 2003 - but without McDonald's caveat) support for the hypothesis that industrial research and development intangibles account for a large part of income shifting.

The report by the Unites States Government Accountability Office (2008) did not make any recommendations, and its objective was "simply to provide information on both average effective tax rates and the location of U.S. MNC [multinational company] business activity" (Unites States Government Accountability Office, 2008:5). It appears that this report was not attempting to analyse BEPS, but rather to provide information for further use in understanding how United States and foreign tax regimes influence United States multinational enterprise decisions "regarding how much to invest and how many workers to employ in particular activities and in particular locations [and] where corporations report earning income for tax purposes".

Heckemeyer and Overesch (2013) were the first in the OECD BEPS Report to clearly have BEPS as the topic of their research. They performed a meta-analysis of 25 studies, and explored the different channels of profit shifting. They found that the dominant channel is transfer pricing and licensing (described as tax-motivated adjustments of related-party transactions), and not inter-company debt (described as corporate financial policy).

Clausing (2011) was the author of another paper specifically studying BEPS, although once again with a United States focus. She investigated the reduction in United States tax revenue (i.e. base erosion) as a result of income shifting, and concluded that income shifting by multinational enterprises causes the United States to lose US$90 billion in revenue (tax). Clausing (2011:584) provides an indirect explanation of profit shifting: "when one considers the potential to shift income, one notes that the **terms and nature of intrafirm transactions** provide the essential method for shifting income" (emphasis added). It is the detail in those transaction terms which defines the extent of the tax revenue lost.

Clausing (2011:1585) also comments on the nature of base erosion in the United States:

> It remains essential to note that the United States also has a **far narrower tax base** than many of our trading partners because of a **plethora of special credits and deductions**. Thus, a lowering of the corporate tax rate should ideally be accompanied by the elimination of many of those **base-narrowing corporate tax provisions** (emphases added).

This again demonstrates how base erosion is not only a function of profit shifting, but also country-specific tax provisions. It also highlights how the United States faces a different BEPS challenge to other countries, and will be approaching BEPS differently. How (or whether) the United States reacts will (for many of its trading partners) determine their own approach to BEPS. Countries should certainly consider whether the unified approach advocated by the OECD is appropriate.

The OECD BEPS Report draws the following four conclusions (OECD, 2013a:20) from its analysis of these "BEPS studies":

- Research indicates that the location of actual business activities and the location of tax profits are increasingly segregated – but this is just *circumstantial* evidence of BEPS.
- Effective tax rates could in principle be used as an indication of BEPS, but in reality they are not able to differentiate between aggressive tax planning and specific government tax incentives (such as a special depreciation, which will necessarily reduce the effective tax rate).
- No effective tax rate studies use the same methodology, and "the available data may simply not be sufficient to indicate the level of BEPS that actually exists" (OECD, 2013a:21).
- The studies have resulted in "very divergent conclusions regarding the level of tax on multinational enterprises and the prevalence of BEPS behaviours" (OECD, 2013a:21).

The last three points appear to conclude the same thing – the available studies (and those on effective tax rates in particular) do not prove the existence or extent of BEPS. There seem to be major conflicting results, which the OECD rightly points out. However, it departs from this cautious attitude in its BEPS Report with a call to urgent action in its Action Plan. This action (especially for the United States, which happens to be the country with the most available studies) will be greatly determined by *which* study is correct – for example, are United States companies subject to too-high or too-low taxes?

This argument can be extrapolated to a South African or Australian perspective. Each will have a different experience of corporate tax base erosion, if at all, and each will experience different forms of profit shifting opportunities depending on the relationship of their domestic tax laws with those of their major trading partners. And correspondingly, each should have a different response.

Finally, Vann (2014:435) summarises the OECD approach to BEPS as "the main objective of the whole beps exercise is thus the protection and restoration of the international corporate income tax base". He explores the idea that the corporate income tax is actually an inefficient tax, that even the OECD (prior to their BEPS campaign) argued should be replaced. It is worth noting his argument (Vann, 2014:436) that because corporate tax is a source-based tax, it is weak in two areas: the source of income can be moved by tax planning without moving the activity; and the activity itself can be moved because capital is internationally mobile.

Although Vann (2014: 441) is "unconvinced that the corporate tax is doomed in theory or practice" it could be argued that the OECD BEPS project, with its itemised list of actions, may be a futile attempt to fix a broken tax. Indeed, perhaps a broader re-examination of the entire concept of a corporate income tax in today's globalised economy is needed.

3.5 Conclusion

This chapter attempted to define and clarify the term "BEPS". It analysed the OECD BEPS Report and Action Plan, and the studies referenced in these reports. It appears that there is no single definition of BEPS, although it is satisfactorily summarised as the international tax planning strategies used by multinational enterprises.

The OECD BEPS Report identifies four key tax areas that together provide the opportunities for BEPS – the mismatch between country tax rules; transfer pricing; leverage; and anti-avoidance rules. While the OECD BEPS Report provides an informative and relatively impartial overview of what BEPS is, the tone of the subsequent OECD Action Plan is much more aggressive. It declares that BEPS is a critical problem that must be urgently addressed by internationally coordinated actions.

The remainder of this chapter then analysed how BEPS has been researched. It found that many of the studies referenced by the OECD BEPS Report did not specifically investigate BEPS. Furthermore, many were inconclusive, or produced contradictory results. It seems that despite the public attention and political action against BEPS, very little is actually known about it.

It is submitted that the OECD Action Plan may have been a hasty overreaction to an issue that needs more research. The next chapter will discuss the extent of the BEPS "problem", and show that attempting to quantify BEPS is a very difficult task. Different countries will be faced with different BEPS opportunities, which should be assessed at the micro-level before developing a response to BEPS. As the next chapter shows, the academic consensus is that profit shifting is smaller than previously believed. Together with the many benefits that multinational firms bring to a country, it will be argued that for some countries it may be better for them to take a cautious approach to BEPS.

CHAPTER FOUR: HOW BIG IS BEPS?

4.1 Introduction

Having argued that BEPS relates primarily to corporate tax minimising strategies used by multinational enterprises, this chapter focuses on the next goal of the research and attempts to analyse how big a problem, if at all, BEPS is. Any responses to BEPS need to take into account the size of the problem, but BEPS encompasses a wide range of legal tax minimising strategies, which are difficult to quantify without knowledge of the transaction-level detail.

This chapter will begin by discussing the conceptual difficulties in measuring BEPS. It is useful to understand the limitations and assumptions of BEPS research before interpreting the current conclusions. It will be shown that one of the biggest conceptual problems in quantifying BEPS is that of the "counterfactual" – what tax revenues would be in the absence of BEPS activity (Dharmapala, 2014:27).

There are various aspects of BEPS that could potentially be measured. These include measuring its incidence (i.e. how many companies are using BEPS strategies), measuring the tax revenue lost through BEPS, or measuring the other non-tax economic consequences of BEPS (such as foreign direct investment flows). The current literature, which will be discussed in this chapter, is generated by two distinct groups, neither of which is able to provide a conclusive estimate of the extent of BEPS.

The first group is the econometric research undertaken by academics and economic research agencies (government or independent), which usually includes a regression analysis of profit against a tax incentive to shift profits (Heckemeyer & Overesch, 2013). These studies generate an elasticity of profits function with respect to the tax incentive, which indicates how companies' reported profits change with respect to changes in the tax incentive. Three recent publications (Dharmapala (2014), Riedel (2014), and OECD (2015a)) have reviewed the literature on the extent of BEPS, and their results will be discussed in this chapter.

The second group includes the reports and publications prepared by social advocacy organisations, such as ActionAid and Oxfam. These types of reports are highly emotive and assertive against perceived unfair behaviour by large corporations, and they often calculate multimillion dollar estimates of the costs of this behaviour. However, their goal is always to generate public support for their cause, and their results are usually not robust (such as grouping tax avoidance together with tax evasion).

Many governments, in response to the publicity generated about multinational enterprise tax avoidance, have also held hearings or published reports on corporate tax avoidance and the BEPS project. As could be expected, the approach taken by governments and politicians varies from country to country, just as BEPS has different consequences across different jurisdictions. The response to BEPS in the United States, the United Kingdom, Ireland, Australia and South Africa will be discussed in this chapter, to illustrate the range of political reactions. However, it will be shown that the OECD asserts that BEPS is unquestionably a big problem for all countries, and an urgent response is needed.

Regardless of the extent of lost tax revenue, BEPS also presents a challenge in terms of fairness. This chapter will close with a discussion about the perceived inequality that arises from BEPS strategies, and the difficulties in formulating a response to BEPS in an area dominated by such subjective conclusions. It will be argued that amending the tax legislation to target specific BEPS concerns may be the only legitimate method of preventing BEPS, but any amendments should only be undertaken after considering their other non-tax implications.

4.2 The conceptual problems in measuring BEPS

Most academic studies that attempt to measure elements of BEPS include a section noting the limitations of, and assumptions underlying, their results. The OECD is acutely aware of the problems in trying to quantify BEPS, and specifically included this as an Action (Action 11 – Improving the Analysis of BEPS). It is useful to be aware of these caveats when interpreting the research. It is particularly important when considering media and advocacy group reports, because they are less likely to disclose the limitations of their results.

The conceptual problems can be summarised into the following categories:

- **Database and sampling problems**

The OECD Discussion Draft on Action 11 (OECD, 2015a) highlights the problems with the currently available data being used to research BEPS. Because of the lack of access to transaction level information, researchers make use of aggregated company financial information or tax returns. These databases may have missing financial information, data from entities within a group may be aggregated, or data may be from a non-representative sample, if whole firms are missing from databases (OECD, 2015a:6). Riedel (2014) also notes that country databases may double-count some group financial information.

Most of the studies use European or United States data, which makes it difficult to draw conclusions about other countries and in particular about developing countries. It should be noted that, together with a large body of United States literature, the majority of the media attention is focussed on United States headquartered companies (such as Apple, Google, and Microsoft), and many of the documented tax strategies rely on United States specific tax mechanisms (such as the check-the-box rule, and the United States worldwide tax system discussed in Chapter Three). It is submitted that any country attempting to limit aggressive tax planning by multinational enterprises should begin with an examination of the United States multinational companies operating inside its borders, and the interaction of its domestic tax rules with those of the United States.

- **The relationship between profitability and tax rates**

Underlying most of the research is a regression of profits on tax rates, with the assumption that companies will shift profits from high-tax to low-tax countries. However, BEPS is about the *artificial* shifting of profits away from where the value was created, and Riedel (2014) identifies three other possible factors that may cause a relationship between corporate taxes and profitability:

- companies may have a strategic incentive to allocate high return projects to low-tax affiliates;
- companies may require a higher pre-tax return in order to invest in a high-tax country;
- effort expended, where owner-managers exert less effort the higher taxes rise; and

- other non-tax factors may affect profits across countries, such as worker productivity, public good provisions or market competition.

McDonald (2008:8) provides a guiding *caveat lector* about measuring profit shifting:

> Transfer pricing is intrinsically fact-dependent. Whether and the extent to which there may be income shifting from non-arm's length pricing of intercompany transactions sometimes can only be definitively determined at the very detailed level of the particular transactions under review.

He also warns that while profit shifting found in aggregated data may indeed be supported when the specific transaction is analysed, this does not necessarily imply that non-arm's length pricing is occurring. He provides the examples of a low-tax controlled foreign company (CFC) developing a technology itself for which it earns above-normal returns, while the high-tax CFC only undertakes low-value (and low-profitability) activities; or how a multinational enterprise may invest more in low-tax countries, which translates to higher profitability.

- **The distinction between avoidance and evasion**

Studies that attempt to quantify country or region specific losses due to tax avoidance often do not distinguish between national or international avoidance, or they "[pool] avoidance activities with illegal evasion, filing errors and criminal activity" (Riedel, 2014:5). An example of this is Oxfam (2014) discussed below, which claims to be discussing the OECD BEPS effort, but presents data on a wide variety of other factors, including tax evasion.

- **The counterfactual**

One of the biggest conceptual problems of measuring BEPS is determining the counterfactual – the world without BEPS. The OECD Discussion Paper explains the two-pronged problem (OECD, 2015a:6):

- the first is the question of *what activity* generates profit, and the OECD (2015a) notes that there is no universal acceptance of the answer to this question. Possible alternatives include labour, capital, sales or a combination of these.

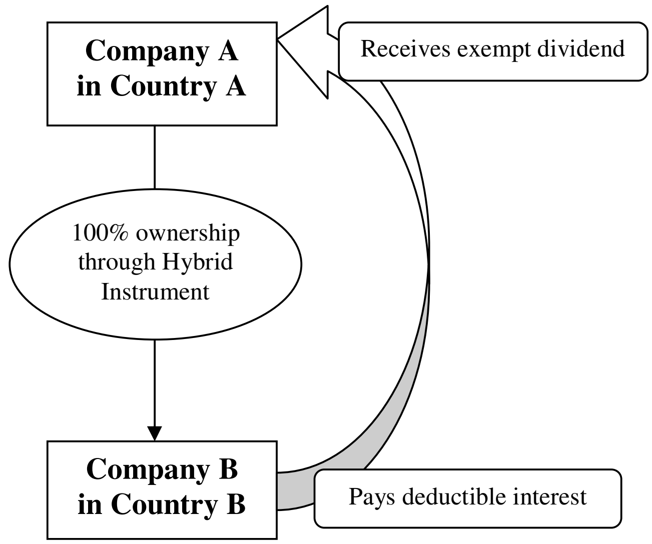
- the next is the question of *where* the profits are generated. The answer is also elusive. For example, if it is argued that labour generates profit, it is still difficult to determine where the labour is located – it could be, for example, in the country with the highest labour cost, or the highest number of employees, or the most full-time employees.

Fuest and Riedel (2010) review studies on multinational enterprise profit shifting out of developing countries and conclude that the measurement of profit shifting raises the difficult concept of "whether a 'true' or 'objective' distribution of profits earned by individual entities of a multinational firm can be identified" (Fuest & Riedel, 2010:3). They argue that

> It is an important characteristic of many multinational firms that the individual entities jointly use resources which could not be used in the same way if they were separate firms. If they could, there would be no reason to create the multinational firm in the first place. For this reason, it is difficult to establish what a profit distribution in the absence of profit shifting would look like.

It is submitted that even if the data limitations were overcome (e.g. researchers had fully transparent transaction level information of profit shifting strategies), there would still be disagreement about the extent of the profits shifted. This is because the underlying profit-creating transaction is occurring between related parties, and it is extremely difficult to establish an arm's length price for trade (especially in intangibles) between related parties.

The following example illustrates the counterfactual problem in measuring BEPS. Consider trying to measure just one transaction - an overly simplified representation of a hybrid instrument, where Company A domiciled in Country A owns 100% of a hybrid instrument issued by Company B domiciled in Country B. The amount paid on the hybrid instrument is treated as tax deductible interest by Company B in Country B, but is received as an exempt dividend by Company A in Country A.



(Own design)

There are many difficulties in trying to quantify the BEPS effects of this situation. The following information, at a minimum, first needs to be obtained:

- Details about the hybrid instrument;
- The amount and timing of the dividend/interest;
- The tax rate applicable to Parent A in Country A, and Company B in Country B (the companies may have negotiated special tax rates other than the statutory company tax rates in each country);
- The tax treatment of the dividend/interest in each country; and
- The tax position of each company – whether they in a taxable income or assessed loss position.

Even if all this detail was available to researchers, the appropriate way to measure this BEPS strategy would still need to be determined. It could be the tax saved in Country B through the interest deduction, or the tax saved in Country A through the dividend exemption, or even the sum of both. Or there may be another measure of the counterfactual – the ownership arrangement that may have been in place if this BEPS strategy (the hybrid instrument) was not available. Perhaps Company B would never have been established, or perhaps the group may have used a third country, with a different tax rate.

This example looks at only one type of simple arrangement between only two companies. In reality, there are countless and much more complicated tax structures set up in many companies (not just multinational groups) across many countries. Trying to measure BEPS on a global scale is clearly not easy, and therefore one must approach any current estimates with a degree of caution.

4.3 Academic literature - what do the studies say?

The term "BEPS" was coined by the OECD in their 2013 BEPS Report. The literature before then did not refer specifically to "BEPS", but instead investigated broader topics such as the correlation between pre-tax profitability and statutory tax rates (such as Grubert (2003); Weichenrieder (2009)) or the effective tax rates of multinational enterprises (such as Markle & Shackleford (2011); Avi-Yonah & Lahav (2012)).

With the OECD BEPS project in progress, more recent papers have reviewed the literature in an attempt to understand and quantify BEPS specifically. Dharmapala (2014) surveys the empirical literature on tax-motivated multinational enterprise profit shifting, with the explicit goal of "describing what is known about the magnitude of BEPS" (Dharmapala, 2014:1). He finds a consensus estimate of a "semi-elasticity of reported income with respect to the tax rate differential across countries of 0.8".

Dharmapala (2014:2) explains that this semi-elasticity means "a 10 percentage point increase in the tax rate difference between an affiliate and its parent (for instance, because the tax rate in the affiliate's country falls from 35% to 25%) would increase the pre-tax income reported by the affiliate by 8% (for example, from $100,000 to $108,000)". However, he explains that even later research, using better data, finds estimates considerably smaller than this consensus estimate.

Dharmapala (2014) notes that there are three apparently contradictory elements relating to the measurement of BEPS. These are the seemingly small estimates of semi-elasticity of tax to profits found in the literature, the "anecdotal evidence" of large profit shifting by multinational enterprises described in the media, and finally the "relative stability over time of corporate tax revenues in major economies". His explanation for these "puzzling" contradictions is that there are significant fixed costs of tax planning, and that "a surprisingly large fraction of MNCs [multinational corporations] do **not** have tax haven affiliates" (emphasis added). He suggests that further research could indicate whether multinational enterprises are already operating "at or near the current legal limits on BEPS" (Dharmapala, 2014:32-33).

Riedel (2014) also reviews the literature on multinational enterprise tax avoidance through profit shifting from high-tax to low-tax countries. She notes that the "descriptive evidence" of BEPS, such as multinational enterprise presence in tax havens and low effective tax rates, must be interpreted with caution, because tax havens "do not only woo firms with low tax rates but often provide good governance institutions, attractive public infrastructure and well developed financial service and labour markets" (Riedel, 2014:2). She also makes the important point that all BEPS research is "necessarily indirect and present no 'smoking gun'" (Riedel, 2014:2) because corporate tax avoidance strategies are not fully transparent.

She finds that although the literature unanimously reports evidence of tax-motivated profit shifting, (i.e. BEPS exists), the quantitative estimates vary widely, from a lower end of 5% to an upper end of 30% of multinational enterprise income shifted to low-tax affiliates. She also notes that even though the estimates vary, the academic evidence is much smaller than that reported by the media. She concludes that it is "too early to draw final conclusions on the quantitative importance of international tax avoidance activities" (Riedel, 2014:7).

The OECD BEPS Project recognises this data and measurement problem, and has included it as Action 11 – Improving the Analysis of BEPS. As part of its work on this Action, the OECD has released a Discussion Draft (OECD, 2015a) that reviewed the currently available data, provided suggestions for developing BEPS "indicators", and called for stakeholder and public comment on these issues. The Action 11 Discussion Draft refers to Dharmapala (2014) and Riedel (2014) as finding evidence of "significant" BEPS activities taking place. It notes that Dharmapala (2014) "does not report a single empirical study not finding some evidence of BEPS" (OECD 2015a:57) and that "over one hundred studies have found the **presence** of BEPS" (emphasis added).

It is submitted that these are trivial findings. The existence, or presence, of tax minimising behaviour by multinational enterprises is surely indisputable. As the late Australian media businessman, Kerry Packer, stated to an Australian government enquiry, "if anybody in this country doesn't minimise their tax they want their heads read" (economicsthemovie, 2013: 1:47:00). The more important question is whether BEPS is of sufficient extent (whether it be in terms of tax revenue losses, other economic effects, or simply unfairness to other taxpayers) to warrant the urgent, timetabled and costly Action Plan proposed by the OECD.

Dharmapala (2014) and Riedel (2014), who presented the two biggest and most recent academic reviews of the extent of BEPS, both conclude cautiously that the estimates of BEPS are small (or at least smaller than previously thought). Despite this, the OECD continues to take the approach that it is very urgent. It is submitted that the OECD has now invested itself so heavily in the BEPS Project that it is unlikely to conclude anything other than a serious problem. Their message is clear - BEPS is a major problem affecting all governments and causing significant losses.

The OECD deals with the consensus academic findings of "small" BEPS, by suggesting that apart from the current extent, policymakers should be concerned about what the "future scale of BEPS would be without internationally-coordinated rules to address BEPS" (OECD, 2015a:56). It declares that "even if BEPS is not widespread now, it could become much more widespread if nothing is done on an internationally-coordinated basis" (OECD, 2015a:71).

This argument should not go unchallenged. Most countries (and certainly all OECD countries) already have (and have had for decades) well-established anti-avoidance rules which specifically target artificial international profit shifting. It is not "easy" for companies to shift profits significantly, and as Dharmapala (2014) argues, the fixed costs of BEPS may mean companies are already at the limit of tax strategies. Given the current level of public and governmental awareness of corporate tax planning behaviours, countries may find that their current legislation is appropriate and the only action needed is an increased scrutiny of the tax affairs of the largest multinationals operating in that country.

Hines (2014) puts the "problem" of BEPS into context. He believes (Hines, 2014:443) that the "journalistic accounts of apparently spectacular international tax-avoidance schemes used by multinational corporations ... commonly omit or misrepresent important legal and economic elements, making it difficult to know what, if any, conclusion to draw from them". He further discredits the perception that the extent of BEPS is large in dollar terms. He states that the latest research calculates the elasticity of reported income to tax rate differentials as

0.4, (with even more persuasive research calculating only 0.2). He describes this elasticity as meaning that

> A corporation that is located in a country with a 25 percent tax rate, and that has the opportunity to reallocate some of its taxable income to a country with a 15 percent tax rate, will typically arrange its financial and other affairs to reallocate 4 percent of its income to the lower-rate country (Hines, 2014:444).

He then extrapolates this data to multinational enterprise tax revenue collected by OECD countries and concludes that "even if one were to double, or quintuple, this figure [shifting 2% of income], it would amount to less than 1 percent of tax revenue" (Hines, 2014:444). He concludes with the observation that the evidence (both empirical and anecdotal) is

> Quite consistent with beps being a real phenomenon, but one that is notably small in magnitude and unlikely to undermine the sustainability of government finance ... It is questionable whether radical reforms are justified by the very modest size of the beps problem (Hines, 2014:453).

It could be argued that this particular element of the OECD BEPS Action Plan (Action 11 – Improving the Analysis of BEPS) should have been the starting point of the BEPS project. The OECD itself acknowledges the lack of data. The current approach of attempting to quickly implement internationally coordinated actions targeting international corporate tax legislation may be unnecessary. If research were to show that current tax avoidance legislation is sufficient to contain BEPS to within acceptable limits, then a better approach for any particular country may be to appreciate that BEPS is likely to be occurring, and allocate resources to progressively target the higher risk areas in that country.

4.4 Advocacy groups

While the academic research concludes cautiously, the "activist" groups are a lot more convinced and specific about the extent of BEPS. Oxfam (2014), in its report highlighting how "tax dodging by big corporations deprives governments of billions of dollars" and "corporations must pay what they owe" provides the following estimates (Oxfam, 2014:1):

- African countries lose an average of US$38.4 billion annually through trade mispricing;
- the tax gap for developing countries is estimated at US$104 billion per year;
- Bangladesh loses US$310 million tax revenues because multinational enterprises "siphon off about US$1.8 billion from the country each year" (Oxfam, 2014:6).

These substantial figures are presented in Oxfam (2014) as estimates of multinational enterprise corporate tax avoidance. However, a closer examination of the source of these figures reveals how misleading the report is. For instance, the US$38.4 billion estimate of trade mispricing loss in African countries originates in a report by Global Financial Integrity (2012). In this original report US$38.4 billion is the estimate of average total illicit financial flows from Africa during 2001 – 2010, of which an average of US$24.1 billion is attributable to "trade misinvoicing" (Global Financial Integrity, 2012:11).

While "trade misinvoicing" may initially appear to be synonymous with profit shifting in BEPS, this is not the case. The Global Financial Integrity website defines "trade misinvoicing" as "a form of trade-based **money laundering**" and "a method for moving money **illicitly** across borders which involves deliberately misreporting the value of a commercial transaction on an invoice submitted to customs" (emphases added). They define "illicit financial flows" as "**illegal** movements of money or capital from one country to another". They classify this movement as "an illicit flow when the funds are **illegally** earned, transferred, and/or utilized" (emphases added). Global Financial Integrity (2014) provides the following examples of what illicit financial flows might include:

- a **drug cartel** using trade-based money laundering techniques to mix legal money from the sale of used cars with illegal money from drug sales;
- an importer using trade misinvoicing to **evade** customs duties, VAT, or income taxes;
- a **corrupt public official** using an anonymous shell company to transfer dirty money to a bank account in the United States;
- a **human trafficker** carrying a briefcase of cash across the border and depositing it in a foreign bank; or
- a **terrorist** wiring money from the Middle East to an operative in Europe (emphases added).

Quite clearly, Oxfam (2014) and its accompanying quantification of BEPS, needs to be approached with a degree of scepticism. The above illicit financial flows are most certainly not descriptive of the typical legal BEPS tax strategies used by multinational companies. Even trade misinvoicing, which initially may seem to represent BEPS profit shifting, includes tax evasion, not only legal tax strategies.

Similarly, ActionAid (2013) campaigns against tax havens. In one example in their report, they describe a transaction where "the telecoms giant Vodafone bought a controlling stake in Hutchison Essar Ltd, a large Indian mobile phone company ... for US$11.2 billion" (ActionAid, 2013:10). Because of the complex ownership structure, the sale was in effect a transfer of shares in a Cayman Islands holding company, and could not be taxed by India because it took place offshore. ActionAid (2013:1) claims that this "single offshore transaction deprived [India] of an estimated US$2.2 billion of tax revenues – almost enough money to pay for a year's subsidised midday meals for every primary schoolchild in India".

In another company specific accusation, ActionAid (2013:11) identifies SABMiller in the same sentence as describing maternal and child mortality in Ghana:

> [SABMiller operates a] brewing business in Ghana, west Africa, where despite a growing economy women are still 30 times more likely to die in childbirth than those in Britain, and children are 13 times more likely to die before the age of five. SABMiller's Accra Brewery there sells over £60 million of beer every year, yet booked overall losses between 2007 and 2010, enabling it to pay little or no corporate income tax in most years.

ActionAid (2013:8) are skilled at using emotive descriptors to support their arguments. They claim that

> If developing countries lose the same proportion of their corporate tax revenue to tax avoidance **and evasion** as wealthy countries – almost certainly a conservative assumption – we calculate that recovering this foregone tax, even without adjusting any spending patterns, would raise government spending enough to **reduce child deaths in the developing world by 230 children every day** (emphases added).

While ActionAid (2013) do not provide detailed data on how they calculated these figures, their implication is clear – big corporations and their tax avoidance strategies are at least partly responsible for many problems in developing countries, including child and maternal death.

4.5 Governments

With the outcry by groups such as Oxfam and ActionAid making headlines in the media, several governments have held inquiries into multinational corporate tax avoidance. Some examples of these are described below to show how BEPS is being handled by politicians.

BEPS and corporate tax planning are becoming controversial political topics.

In the United States, the Senate Committee on Homeland Security and Governmental Affairs has held several enquiries into tax avoidance by multinational enterprises. During one such enquiry into profit shifting out of the United States, Senator Carl Levin claimed that

> By routing its activity through Puerto Rico in this way, Microsoft saved over \$4.5 billion in taxes on goods sold in the United States during the three years surveyed by the Subcommittee. That's \$4 million a day in taxes Microsoft isn't paying (Levin, 2012:3).

Similarly, in the United Kingdom, the Parliamentary Public Accounts Committee has made taxation a key focus area, with an emphasis on the tax affairs of multinational enterprises. Unlike the United States senator's pronouncement above, the United Kingdom Committee does not quantify tax revenue losses in absolute terms, but instead has a focus on the "unfairness" of multinational tax avoidance.

In their report investigating Google (Committee of Public Accounts, 2013:EV23), the Chair made the following statement:

> I will ask you this question: if you are a hard-pressed family who pay all their taxes or if you are a struggling business that feels very bullied by HMRC, and certainly hassled by them, how do you think they feel every time they switch on to Google and they are reminded of your rather **devious**—if I may say so—calculated and, in my view, **unethical** behaviour in deliberately manipulating the reality of your business to **avoid paying your fair share of tax to the common good?** (emphases added).

In their previous report (Committee of Public Accounts, 2012), the United Kingdom Public Accounts Committee again voiced their opinion that, while they are fully aware that such tax minimising strategies are legal, they believe they are not fair. During questioning of Matt Brittin, Google Vice President, the following exchange took place, which illustrates many high-tax OECD countries' perception of BEPS:

> *Chair*: So you are minimising your tax even though it is unfair to British taxpayers.
>
> *Matt Brittin*: It is not unfair to British taxpayers. We pay all the tax you require us to pay in the UK. We paid £6 million of tax last year—
>
> *Chair*: We are not accusing you of being illegal; we are accusing you of being immoral (Committee of Public Accounts, 2012:EV40).

This exchange shows how BEPS is a provocative topic that politicians, often with little tax background, have a strong opinion on. South Africa has seen a similar, although muted, reaction from the Minister of Finance, Nhlanhla Nene, in his 2015 Budget Speech:

> Honourable Members, we are also taking further steps to combat financial leakages which **deprive our economy of billions of rands through erosion of the tax base, profit shifting and illicit money flows.** This is the advice I received from Durban businessman, Mr Wolfe Braude, who is with us today: "*Action has to be taken to close **tax evasion loopholes such as transfer pricing, and profit shifting strategies by SA corporates…"*** (emphases added) (Nene, 2015).

This extract shows how even a Minister of Finance can confuse the issues of tax avoidance and evasion, by referring to transfer pricing and profit shifting as tax *evasion* loopholes. It is submitted that, to his public (non-tax) audience, this statement links corporate profit shifting (BEPS) to billion rand tax losses.

However, the body that appears to be overseeing South Africa's response to BEPS is the Davis Tax Committee, which was established in 2013 to review various aspects of the South African tax system, and includes a sub-committee on BEPS. This subcommittee is taking a more measured approach, as reflected in their BEPS First Interim Report (Davis Tax Commitee, 2014), where they stated that

> The BEPS concerns and challenges that other countries such as the UK or USA face may not necessarily be the concerns and challenges that South Africa faces. So there is need for appropriate and customised solutions. Any BEPS remedy from the South African perspective needs to be supported by a fact base that sheds light on how big the relevant BEPS problem is in South Africa, and then legal responses can follow (Davis Tax Committee, 2014:19).

They advocate that "a balance has to be struck" (Davis Tax Committee, 2014:25) between preventing BEPS, and encouraging foreign direct investment and preserving South Africa's international economic competitiveness.

In Australia, the Senate Standing Committee on Economics has held an enquiry into corporate tax avoidance. In questioning three multinational technology companies, Apple, Google, and Microsoft, their approach was to focus on the seemingly low amounts of tax paid by these companies on large amounts of revenue. Although not quantifying lost tax revenues, the enquiry (like the British) concentrated on fairness. The Chair stated:

> I think there are some very legitimate community concerns about how your

> companies are structured and how your companies have engaged in what appears to be—as reported in media story after media story—tax minimisation … We believe, or I certainly believe, that the role of this committee is to explore opportunities that allow us to make sure there is a fair share of tax being paid in the Australian jurisdiction and that it is done in an appropriate way (Economics Reference Committee, 2015).

While many governments have embraced the OECD notion that BEPS is a threat to their country, Ireland's reaction towards BEPS takes a different approach. Ireland, whose tax system has been part of many publicised multinational enterprise tax avoidance structures, is more concerned about the effects of the OECD BEPS *Actions* on Ireland. The Irish Department of Finance (Department of Finance, 2014) released a report called "BEPS in an Irish Context", which, for most part, simply summarises the OECD report, actions, and developments to date. However, it also discusses the impact of BEPS on Ireland, where the focus is not on the effects of BEPS itself, but rather how the OECD BEPS Actions could affect Ireland. In other words, Ireland is certainly aware that it is not one of the BEPS "losers", and that it may be negatively affected by other countries' tax law changes in response to BEPS.

The Irish report stresses that the "BEPS project as a whole, or via any of its individual actions, is not focussed on Ireland's, or indeed any other jurisdiction's, tax rate. The Irish 12.5% rate will not change and is not under discussion as part of the BEPS project" (Department of Finance, 2014:34). It then explains how the BEPS Actions have both positive and negative impacts on Ireland. For example, the value creation actions create "opportunities for Ireland to become a location of choice for groups who wish to bring their intangible assets onshore together with the relevant substance" (Department of Finance, 2014:35). However, it notes that while Ireland is not mentioned in the interim report on harmful tax practices, this area of work "could have an impact on how the Irish tax regime is shaped in the medium term" (Department of Finance, 2014:35). The report concludes that "while the BEPS project offers a lot of positives, there will also be challenges for Ireland" (Department of Finance, 2014:37). The Irish reaction to BEPS seems to be one of supporting the BEPS process while at the same time trying to ensure that the country remains attractive to multinational enterprises.

It seems that not all countries have the same sentiment toward multinational enterprises. However, one thing is clear from these governmental enquiries: each is chiefly concerned with the impact of BEPS on its own country. This is well illustrated by the following opinions of politicians from the United Kingdom, United States and Australia – three important, high-tax OECD members.

The United Kingdom Public Accounts Committee declared that "we are here to guard and follow the public pound— the tax pound—in the United Kingdom (Committee of Public Accounts, 2012:Ev44) and statements were made by members such as, "No, don't befuddle us with that. We really care about the UK, because we think you are not paying the right tax in the UK … I do not get from this interview why Luxembourg is so lucky" (Committee of Public Accounts, 2012: EV33-35).

In the American enquiry, Senator John McCain declared that "for years, Apple has opted to forgo fully contributing to the U.S. Treasury and to American society by shifting profits and circumventing U.S. taxes". He then continues: "For one thing, the very method by which Apple divides the world serves to deprive the United States of substantial revenue. By centralizing worldwide profits outside of the Americas in Ireland, Apple is able to shelter its profits from the U.S. tax authorities" (Permanent Subcommittee on Investigations, 2013:8-9)

A similar sentiment was issued by the Australian Treasurer, Joe Hockey. In his 2015 Budget Speech he declared that "as a result of Tax Office investigations we have identified 30 large multinational companies that may have diverted profits away from Australia to avoid paying their fair share of tax in Australia" (Hockey, 2015).

The message from these governmental enquiries is clear – they are each concerned about the profits being shifted out of their own country. The Australians are not investigating the profits shifted out of the United States, while the Americans are not concerned about the profits shifted out of Australia. While this may be inappropriate given the international complexity of BEPS, it also illustrates the fundamental concept of sovereign taxing rights, and a problem in trying to prevent BEPS. Each country is entitled to set their own tax legislation, and it is natural (whether as a politician, an activist or a citizen) to compete against others. In the case of BEPS, the competition is for tax revenue to flow into your country, not out of it.

4.6 Measuring fairness

Human nature plays a large role in taxpayer behaviour, and should be mentioned in any discussion on BEPS. Kruger *et al* (2012:1), begin their textbook on tax planning by noting that

> There may exist a powerful motive to achieve effectiveness in regard to taxation. The reason is to be found in human nature: Most people, at the best of times, dislike paying tax; but nothing infuriates them more than the knowledge that others, in like circumstances, are honestly and legitimately paying less tax.

This emotion was recognised in 1776 by Adam Smith when penning "The Wealth of Nations". The first of his four cannons of taxation is equality, namely that "the subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities" (Smith & Wight, 2007:536). It is this principle of equality which is perhaps the most provocative feature of the BEPS debate because it is not possible to reach an objective conclusion on what the "fair share" of multinational enterprise tax should be. The tax strategies in BEPS are legal. Whether they result in a "fair" outcome rests on the ethical arguments for and against tax avoidance.

The ethics of tax avoidance is a grey area, but one that cannot be ignored in the context of BEPS. There are two broad schools of thought on the topic. The strictly legalistic view is that a taxpayer is morally entitled to minimise his tax so long as he keeps within the letter of the law. The findings in several famous tax avoidance cases are often quoted to support this view. In IRC v Duke of Westminster [1936] AC 1, it was held that

> Every man is entitled if he can to order his affairs so as that the tax attracted under the appropriate Act is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.

Similarly, in Levene v IRC [1928] AC 217, the judge stated that taxpayers "incur no legal penalties, and, strictly speaking, **no moral censure** if having considered the lines drawn by the legislature for the imposition of taxes, they make it their business to walk outside them (emphasis added). And in Ayrshire Pullman Motor Services v IRC [1920] 14 TC 754 it was held that

> No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the

> Inland Revenue to put the largest possible shovel into his stores … [the taxpayer is] entitled to be astute to prevent, so far as he honestly can, the depletion of his means by the Inland Revenue.

Underlying this view is the fact that taxation is imposed by legislation, not by common law, and "there is no principle that allows the court to impose liability on the basis that any of those amounts fall within the 'spirit' of the Act" (de Koker, 2015:§19.1).

In Commissioner v Newman 159 F.2d 848 [1947], Justice Learned Hand stated (although in a dissenting opinion) that

> Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. **To demand more in the name of morals is mere cant** (emphasis added).

Contemporary agreement with these views is found in Boidman and Kandev (2013:1032) who believe that "what Apple or Google is doing in terms of tax planning is nothing wrong or objectionable (in keeping with both responsibilities to shareholders and the rule of law) and that soft or inherently vague notion such as the much abused words "fairness" and "morality" have nothing to do with it". They take this argument further into a discussion of the burden of corporate tax. Their studies show that in Canada, the burden of corporate tax falls almost entirely on employees of corporations through lower wages, a finding which the public, media and most politicians do not appreciate:

> Corporations are fictional legal persons that do not sleep, eat and send their kids to school and hence corporate taxation is merely a proxy for the taxation of corporate stakeholders, such as employees, lenders and shareholders ... Corporate taxes are not borne by the corporation. Real people bear the burden.

However, not all observers agree. The judge in Latilla v IRC [1943] AC 377 did not share these views on the morality (or rather, amorality) of tax avoidance when he stated that "there is, of course, no doubt that they are within their legal rights, but that is no reason why their efforts, or those of the professional gentlemen who assist them in the matter, should be regarded as a commendable exercise of ingenuity or as a discharge of the duties of good citizenship".

Wheatcroft (1955:213) summarises this feeling with a simple anecdote: "If John Smith pays less tax than he should, all the others have to pay more. His "liberty" to avoid tax is an infringement of your and my right to receive a fair contribution from him". Despite being penned six decades ago, Wheatcroft's review of attitudes towards tax avoidance remains relevant. He notes that no matter the ethical opinion of judges in tax avoidance cases, their decisions must be "based purely on legal and technical grounds, and Parliament can expect no discretion or elasticity from the courts in enforcing taxation law".

While judges may be constrained to statute in deciding their cases, public opinion and political lobbying is not so reserved. Where a person's sympathies lie on the issue of morality in tax avoidance will shape their interpretation of BEPS and how big a problem it is. If someone believes that BEPS results in an unfair tax outcome, then, regardless of the dollar amounts of tax revenue lost, they will view it as a big problem.

Unfairness is, of course, subjective. Consider the real tax structure of Starbucks UK, as detailed in the United Kingdom Public Accounts Committee enquiry (Committee of Public Accounts, 2012). The Committee was unhappy with two components of Starbucks UK's tax structure, which they believe resulted in the company showing losses in 14 out of 15 years. The first was a 4.7% (previously 6%) royalty for intellectual property paid by the United Kingdom company to the Netherlands company. The second was a 20% mark-up that the Netherlands company pays to the Swiss company on the purchase of coffee, with a further mark-up when sold to the United Kingdom. On the issue of the royalty, the following dialogue (Committee of Public Accounts, 2012:EV23) took place between the Chair of the Committee, and Troy Alstead, the Global CFO of Starbucks:

> *Chair*: EV23: So how on earth do you then get that 6% or 4.7% is the fair and proper charge?
>
> *Troy Alstead*: And we have 20 arm's-length licensees today, the vast majority of whom make money at that 6% and are rather willing to pay us that price.
>
> *Chair*: I think it is about tax avoidance.

The Chair took further issue with the 20% mark-up, stating "you charge 20% whatever the price is. That is manipulation. It takes money out of the UK that would otherwise be viewed as profit and would be taxed through corporation tax. It is manipulation" (Committee of Public Accounts, 2012:EV47).

The Chair obviously believes that the Starbucks UK structure is unfair. However, it must be asked what she would prefer the alternative to be. In other words, what is the "counterfactual"? Some options could include:

- The intellectual property rights should not be held in the Netherlands (but then where is it fair for them to be held?);
- The royalty payment should be less than 4.7% (but then what is a fair royalty?); or
- The mark up should be less than 20% (again, then what should it be? 10%, 15%, or 5%?).

While the Chair of the Starbucks enquiry may not be happy with the amounts in question, hers is a subjective opinion. In drawing conclusions about the unfairness or otherwise of BEPS behaviour, an observer relies on personal judgement. Fairness is, in most cases, an irresolvable philosophical issue. Therefore it seems that any attempt to change or prevent BEPS must come from amendments to the tax legislation, from where the opportunities for BEPS arise. Clegg and Stretch (2015:§26.1) quote from the English case of Vestey's (Lord) Executors & another v Inland Revenue Commissioners, 1949 1 AER 1108, where the judge declared, "Tax avoidance is an evil, but it would be the beginning of much greater evils if the courts were to overstretch the language of the statute in order to subject to taxation people of whom they disapproved".

4.7 Conclusion

The BEPS project involves a plethora of complex and highly specialised tax sub-issues – value creation; taxing the digital economy; hybrids; controlled foreign companies; multilateral instruments and more. While all of these sub-topics are important issues, many countries (and certainly most developed countries) already have well-developed legislation and tax administrations to deal with the factors that allow corporate tax avoidance to occur. Developing countries may not have such strong tax systems, but this is also nothing new, and many developing countries are actively working on strengthening their tax systems. Most are certainly aware that gaps exist. The size of the gap due to BEPS is still the biggest unknown factor in the BEPS project, and yet any governmental response needs to take some estimate of this magnitude into account.

The conclusion among academic researchers (who tend to measure the elasticity of profits to tax incentives econometrically) is that profit shifting does occur, although the current consensus is that this elasticity is fairly small, and smaller than previously believed. This is in stark contrast to various high-profile social advocacy groups, who report billions of dollars of lost tax revenue due to so-called unfair tax schemes of big multinational corporations.

These emotive reports tend to attract the most media attention, and are thus “front of mind” not only for the public, but also for politicians. The perception that multinational enterprises are employing unfair tax practices and depriving governments of huge revenue is evident in the governmental enquiries discussed in this chapter. While the politicians involved in these enquiries admit that the tax structures under scrutiny are technically legal, the general feeling is that they are morally reprehensible. Of course it should be noted that the countries that appear most concerned are the high tax OECD members such as the United Kingdom. The lower tax countries that are often used in BEPS strategies, such as Ireland, do not seem to share this sentiment.

The OECD appears to have ignored the fact that BEPS does not affect all countries negatively. It chooses not to draw attention to the reality that tax competitive countries (such as Ireland or the Netherlands) may have developed their tax legislation as a means to attract multinational enterprise investment into their country.

With BEPS encompassing such a grey area in terms of the ethics of tax avoidance, it is submitted that the OECD BEPS Project should be raising the issue of tax competition and ethics in corporate tax specifically. These issues should be under discussion in a more focused manner. It seems to be regarded as generally accepted by BEPS commentators that tax avoidance from large multinational enterprises is unethical. However, being unethical is a very different concept to measuring the extent of BEPS in terms of lost tax revenue or other quantifiable economic effects.

If a type of behaviour is deemed unethical, then it is undesirable regardless of its extent. Ultimately, if a government does not like the tax behaviour of the multinational enterprises operating in its jurisdiction, the only valid solution is to amend its tax legislation. However, as Adam Smith recognised more than two centuries ago, taxpayers who are negatively affected by tax laws have every incentive to take their business elsewhere. Smith’s description (Smith & Wight, 2007:552) of two forms of taxation common in the eighteenth century could just have easily applied to BEPS and the tax “problems” created by the modern global economy:

> Land is a subject which cannot be removed; whereas stock easily may. The proprietor of land is necessarily a citizen of the particular country in which his estate lies. The proprietor of stock is properly a citizen of the world, and is not necessarily attached to any particular country. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed to a burdensome tax; and would remove his stock to some other country, where he could either carry on his business, or enjoy his fortune more at his ease.

In designing a response to BEPS, governments should remember that multinational enterprises bring more than tax revenue to a country. It will be argued in the next chapter that a country needs to take a holistic approach to BEPS, and consider the entire economic and social (not only tax) environment in which multinational firms operate. Although changes to the tax legislation could arguably be needed to close specific BEPS gaps, any amendments need to be considered cautiously. Multinational firms have the ability to locate themselves anywhere in the world, and if the extent of BEPS is small, then the costs of attempting to prevent BEPS may not be worth the benefits.

CHAPTER FIVE: A PICTURE OF TWO COUNTRIES – A COMPARISON OF SOUTH AFRICA AND AUSTRALIA WITH REFERENCE TO BEPS

5.1 Introduction

This thesis has shown that BEPS is a global issue, arising because of the relationship, and gaps, between different countries' tax rules. Due to the globalisation of business, most modern economies will be affected by the BEPS strategies employed by multinational enterprises operating in their jurisdiction. However, as discussed in Chapter Four, the extent of BEPS is still unclear. It will be argued in this chapter, using a comparison of South Africa and Australia, that BEPS does not affect all countries in the same way. Each country's response to BEPS will be influenced not just by the tax revenue losses due to BEPS, but by many other non-tax considerations.

This chapter will compare features of South Africa and Australia that may influence their approach to BEPS. It will begin with their relationship to the OECD, which is the organisation driving the BEPS Project. It will then briefly describe the tax system in each country and show that the fundamental principles are similar. It will then compare in more detail the corporate tax data in South Africa and Australia, because BEPS relates to the tax strategies of multinational companies, and the resultant corporate tax losses.

The next section will compare several key economic indicators of South Africa and Australia to highlight major social and economic differences between the two countries. It will be argued that these factors may be more significant in determining an attitude to BEPS than simply tax revenue losses. This will be followed by a comparison of South Africa and Australia's international trade data, particularly the type of products imported and exported by each country, and their import and export locations. This data, with useful graphic visualisations, could be used to indicate in which industries BEPS behaviours are most likely to be found, and where a country should focus its BEPS actions.

South Africa and Australia are useful countries to compare in terms of the impact of, and possible responses to, BEPS. It will be shown that they are similar in several aspects, including the form and function of their tax systems, the major industries supporting their economies, and their involvement in OECD processes. However, there are marked differences between the two countries, most significantly being their level of development, which results in large differences in economic conditions. It will be argued that these types of economic factors will influence a country's approach towards multinational enterprises, and in turn, the actions they take to target BEPS.

5.2 Relationship with the OECD

BEPS is one of the major projects being driven by the OECD. When discussing a country's reaction to BEPS, it is useful to first consider its relationship with the OECD. As Boidman and Kandev (2013:1017) describe: "What is unique about the OECD's BEPS project is its unprecedented political context".

The OECD has 34 members from mostly advanced countries, including Australia. The OECD describes its purpose as to use its "wealth of information on a broad range of topics to help governments foster prosperity and fight poverty through economic growth and financial stability" (OECD, 2015e: Online). However, as the Australian Department of Foreign Affairs and Trade (2015: Online) notes: "the OECD does not have executive or financial powers; it relies on persuasion and consensus". It is this political pressure which it will use to drive the BEPS Project.

South Africa is not a member of the OECD, but is a "Key Partner", along with Brazil, China, India and Indonesia. The Key Partners are "invited to nearly all OECD Committees, are the subject of numerous policy reviews, and are covered in a broad range of the OECD's databases. These arrangements **imply a political commitment** and create a mechanism to develop joint priorities" [emphasis added] (OECD, 2015c: Online). South Africa is an important player for the OECD in Africa. It is described as "the "prime mover" for OECD activities supporting the objectives of NEPAD [the New Partnership for Africa's Development], especially in Southern Africa, on taxation, investment, competition policy and governance" (OECD, 2015d: Online).

Australia is an active member of the OECD, and also held the presidency of the Group of 20

(G20) for 2014. During its presidency, Australia hosted the G20 Leaders Summit in 2014 (Commonwealth of Australia, 2013). The OECD is an active partner of the G20, and at the 2014 G20 summit, the G20/OECD BEPS Action Plan was endorsed (Group of 20, 2014).

The BEPS Action Plan asserts that the success of the BEPS Project is dependent on cooperation between countries. The OECD, as the driver of the project, will be looking to its members and partners for support and impetus in directing tax reform. Both South Africa and Australia may therefore feel pressure to act. Australia, as the host of the 2014 G20 summit, made public pronouncements about its support for the BEPS Project, including the following by then Prime Minister Tony Abbott (Abbott, 2014: Online) in his closing press conference:

> Now, we absolutely want companies to pay their fair share of tax and we want them to pay their tax in the jurisdictions where their profits are earned. This is particularly important for emerging and developing economies and **we're taking concrete and practical steps** to achieve this. It's about the countries of the world, the people of the world, receiving the tax benefits that are their due and it's needed so that governments can fund the infrastructure and the services that people expect and deserve (emphasis added).

South Africa, although not as prominent as Australia in OECD/G20 matters, does have a reputation as the economic gateway to Africa (Draper & Scholvin, 2012). It is also the only African key partner of the OECD (which has no African members), and the only African member of the G20. It would be reasonable to expect the OECD to be looking to South Africa to drive BEPS actions not only in South Africa, but throughout the rest of Africa.

5.3 General tax system

The tax systems in South Africa and Australia have many similarities. At a fundamental level, South Africa and Australia both have a residence basis of taxation. This means that residents of that country are taxed on their worldwide income, while non-residents are only taxed on income from a source within that country.

Australia's residence provisions are found in section 6-5(2) of the Australian Income Tax Assessment Act 1997 ("ITAA 97"), which states:

> If you are an Australian resident, your assessable income includes the ordinary income you derived directly or indirectly **from all sources,** whether in or out of Australia, during the income year (emphasis added).

For non-residents, section 6-5(3) of the ITAA 97 then applies:

> If you are a foreign resident, your assessable income includes:
> (a) the ordinary income you derived directly or indirectly **from all Australian sources** during the income year; and
> (b) other ordinary income that a provision includes in your assessable income for the income year on some basis other than having an Australian source (emphasis added).

South Africa has very similarly worded provisions. The South African Income Tax Act, No. 58 of 1962, defines gross income as:

> (i) in the case of any resident, the **total amount**, in cash or otherwise, received by or accrued to or in favour of such resident; or
>
> (ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person **from a source within the Republic** (emphases added).

In terms of BEPS, these general residence/source rules mean that, in both South Africa and Australia, resident companies are taxed on their worldwide income, while non-resident companies are only subject to tax on their income from a source within that country. Both countries, with their residence basis of taxation, will therefore be similarly exposed to BEPS strategies. Both should be paying attention to their specific source rules, particularly in terms of their major bilateral tax treaties, to ensure income shifted out of the country is not being left untaxed.

The composition of total tax revenue is also similar in South Africa and Australia. For 2012, South Africa's three largest components of tax revenue were personal income tax (34%), Value-Added Tax (VAT) (26%) and company income tax (20%) (National Treasury & South African Revenue Service, 2014). In Australia, for the 2012-13 tax year, the three largest contributors to tax revenue were individuals (50%), companies (20%) and Goods and Services Tax (GST) (15%) (Australian Taxation Office, 2015a). The share of company tax is very similar for both countries at 20%. However, while South Africa has a greater proportion of VAT, Australia has a greater proportion of personal income tax.

Individuals in both South Africa and Australia are taxed on a sliding rate scale. The individual maximum marginal tax rate is currently 41% in South Africa (South African Revenue Service, 2015a), and 45% in Australia (Australian Taxation Office, 2015b). Both countries tax companies at a flat statutory rate, which is currently 28% in South Africa (South African Revenue Service, 2015b), and 30% in Australia (Australian Taxation Office, 2015c).

South Africa imposes VAT at 14% (South African Revenue Service, 2015c), and Australia imposes GST at 10% (Australian Taxation Office, 2015d).

These similarities in tax structure are mirrored in the functioning of each country's tax administrations. Taxation in South Africa is administered by the South African Revenue Service (SARS), and it is generally considered to have an efficient and well-developed tax system. The OECD describes South Africa as having a "well balanced and administered tax system [that] underpins a sound fiscal position" (OECD, 2015b:2), and it was ranked 19th out of 189 countries in terms of the ease of paying taxes (World Bank & PricewaterhouseCoopers, 2015).

Taxation in Australia is administered by the Australian Taxation Office (ATO), which is a highly regarded tax agency. In fact, South Africa's own Pravin Gordhan, former Minister of Finance and Commissioner for SARS, stated that "the ATO is highly regarded amongst its peers around the world and in many instances has been the world leader both in terms of thought processes, strategic leadership, and, indeed, implementing those in day to day practice" (D'Ascenzo, 2015:3). Australia was ranked 39th in terms of the ease of paying taxes (World Bank & PricewaterhouseCoopers, 2015).

The basic tax systems in South Africa and Australia are therefore fundamentally similar. Both have a residence basis of taxation, similar types and rates of taxes, and a similar composition of total tax revenue. With both countries having well developed tax administrations, it could be expected that their tax offices implement similar approaches to BEPS. As BEPS relates primarily to *corporate* tax minimising strategies, the next section will describe further details of the South African and Australian corporate income tax.

5.4 Company income tax

The statutory company income tax rate in South Africa is 28%. Company income tax collections for the 2013/2014 year totalled nearly R180 million, which was 20% of total tax revenue and 5.2% of GDP (National Treasury & South African Revenue Service, 2014). It was the third largest component of tax revenue, after personal income tax and VAT.

Australia has a 30% company income tax rate. For the 2012-2013 tax year company tax accounted for 20% of total tax revenue, and 5.2% of GDP. Company tax collections were A$64.530 million, the second largest contributor to total tax revenue after personal income tax (Australia Taxation Office, 2015a).

These company tax contributions to total tax revenue for South Africa and Australia are high compared to OECD averages. The average OECD company tax rate for 2015 was 25%, and Table 1 below provides a comparison of several tax statistics across South Africa, Australia and the OECD.

Table 1: Selected tax statistics for South Africa, Australia, and the OECD average

2012	**Total Tax Revenue as % GDP**	**Corporate Tax as % GDP**	**Corporate Tax as % Total Taxation**	**Corporate Tax Rate**
South Africa	24.9%	5.2%	19.9%	28%
Australia	27.3%.	5.2%.	18.9%.	30%
OECD average	33.7%.	2.9%.	8.5%	25%

Sources: OECD (2014c); National Treasury & South African Revenue Service (2014)

South Africa and Australia both have a lower share of total tax revenue as a percentage of GDP compared to the OECD average. However, both countries have higher company tax rates and the share of company tax is similar across both countries – much higher than the OECD average.

This relatively greater dependence on the corporate income tax could have two alternative effects on each country's perception of BEPS. A large share of company tax to total tax revenue may imply that the tax lost through BEPS is of greater significance than countries with a lower share of company tax. South Africa and Australia may therefore be expected to take greater action against BEPS to protect their relatively important corporate tax base.

However, an alternative argument is that a greater reliance on corporate tax may make a country hesitant to take action that discourages multinational companies from operating within its borders. Together with the uncertainty surrounding the measurement of BEPS, South Africa and Australia could instead be expected to take a more cautious approach to BEPS. It is submitted that the approach taken will depend on the economic and social factors discussed in the next section, and not simply on company tax levels.

Behind these high-level company tax statistics is, however, an interesting feature of the composition of South African and Australian company taxpayers. In South Africa for the 2012 tax year, of the total 625,808 company taxpayers, only 299 companies had taxable incomes exceeding R200 million, and these companies were liable for 58% of all company income tax assessed (National Treasury & South African Revenue Service, 2014).

In Australia, the composition of company taxpayers is similar. The 2012-2013 tax statistics from the Australian Taxation Office (ATO) show that of the 854,745 total company tax return lodgements, only 1090 "very large" companies (defined by the ATO as total business income greater than A$250 million) accounted for more than 60% of net tax (the amount of tax owed for the income year) (Australia Taxation Office, 2015a).

This is a very similar corporate tax structure to that of South Africa. Both countries have a relatively high company tax rate, along with a relatively high reliance (compared to the OECD average) on company tax, and yet both have a small number of very large taxpayers that account for a large share of company tax revenue.

The concentration of large company taxpayers suggests a simple strategy for targeting BEPS – an increased audit focus by the tax authority on those few companies. This argument is supported by the work done by Davies, Martin, Parenti and Toubal (2014) who examined tax avoidance in France through transfer pricing to ten tax havens. They found that only 450 French multinational enterprises were responsible for more than 90% of intra-firm exports to those tax havens. They conclude that "by appropriately targeting enforcement, a significant increase in revenues may be achieved at a small cost" (Davies, *et al*, 2014:21).

Of course, the *legal* nature of BEPS suggests that increased enforcement by the tax authorities would not necessarily uncover prohibited tax strategies – the typical BEPS tax structures used by multinational enterprises are legally sound. However, while increased vigilance may not by itself prevent BEPS, it could serve as a mechanism to uncover gaps in the tax law and allow the tax authorities to become aware of the strategies being used by multinational firms in their country. This could drive legislation change where necessary, but the costs of increased enforcement would first have to be considered.

While the tax fundamentals, and specifically the corporate tax structure, in South Africa and Australia, is similar and suggests a similar response to BEPS, the two countries differ markedly in terms of socio-economic factors. These non-tax factors discussed in the next section may have a more important influence on the country's reaction to BEPS than the corporate tax revenue losses from BEPS.

5.5 Economic indicators

South Africa, with a Gross National Income (GNI) per capita of US$6,800, is classified as a developing country by the World Bank. Australia, in contrast, is a high income developed country with a GNI per capita of US$64,680. Together with a relatively low GNI/capita, South Africa faces high unemployment and inflation, with latest statistics for 2014 showing a 25.1% unemployment rate together with inflation of 5.8%. By comparison, Australia has only 6% unemployment and 1.4% inflation (World Bank, 2015).

South Africa's last measured (2011) Gini index was 65, while Australia's (measured in 2003) was 34. The Gini index measures the extent to which the distribution of income among individuals or households deviates from a perfectly equal distribution (World Bank, 2015), with zero representing perfect income equality and 100 representing perfect inequality. According to World Bank estimates of the Gini index (World Bank, 2015) out of 149 countries with estimates, South Africa was the second worst country in the world in terms of income inequality, while Australia ranked 52nd.

In addition to social inequalities, South Africa and Australia differ greatly in terms of the size of their economies. Australia's net trade in goods and services was (-)US$8.8 billion (composed of exports of goods and service of US$294.7 billion and imports of goods and services of US$303.5 billion). South Africa's net trade in goods and services was (-)US$6.5 billion (composed of exports of goods and service of US$109.3 billion and imports of goods and services of US$115.8 billion) (World Bank, 2015). Despite a similar *net* trade figure, Australia's export and import of goods and services is nearly three times that of South Africa. This indicates a much greater volume of international trade, and thus greater exposure to potential BEPS transactions.

The size difference between the two economies is again evident in their foreign direct investment figures. The World Bank estimates inflows of foreign direct investment for Australia at US$50.982 million and for South Africa at US$5.740 million (World Bank, 2015). The difference in scale of these foreign direct investment inflows (Australia has nearly ten times the inflows of South Africa) could affect their BEPS response. South Africa arguably has less capacity to take aggressive anti-BEPS actions that may reduce multinational investment into the country.

These indicators help describe the relative economic and social positions of Australia and South Africa. Despite having similar tax systems, they have vastly different economies. It is submitted that a country's economic performance may affect its perception of multinational enterprise activity within its borders, and thus its response to BEPS. South Africa, a poorer developing economy with a high degree of income inequality and high unemployment, will perhaps be more likely to tolerate BEPS behaviour in order to maintain international investment in the country. Australia, with its stronger and richer economy, may feel confident to take more aggressive steps against BEPS.

5.5.1 The BEPS dilemma

Multinational enterprise investment in a country is generally regarded as having positive effects. The OECD recognises these benefits, and encourages international investment. In particular, the OECD believes that multinational enterprises "through job creation, human capital development, efficient capital distribution, and technology, knowledge and skills transfers – have significantly contributed to development and economic growth of both home and host countries" (OECD, 2014b:1). It is these benefits which South Africa will be cautious of losing if its BEPS actions deter multinational enterprises from investing in the country.

This caution would not be unfounded. Merlo, Riedel and Wamser (2015) investigate how anti-avoidance legislation affects the location decision of multinational enterprises. Their results, using German multinationals, indicate that thin capitalisation rules and transfer pricing documentation requirements reduce a country's probability of attracting subsidiaries of multinationals. They conclude that while these anti-avoidance provisions may reduce profit shifting, they could cause "high-tax countries [to] lose out in terms of real investment and employment, which may, in consequence, exert detrimental effects on national welfare"

(Merlo *et al*, 2015:23).

Durst (2014) also examines this trade-off between taxing multinational corporate income and attracting foreign investment in a developing country setting. He argues that the OECD Action Plan, using a "mixture of anti-avoidance measures" is "technically sound but politically unfeasible" (Durst, 2014:6). This is because of the pressure of tax competition, and the "fear of losing capital investment to other countries" (Durst, 2014:7).

He believes that developing countries are particularly affected by this dilemma. While developed countries have limited reliance on corporate income tax (due to a higher proportion of personal and consumption taxes), they can afford to allow BEPS to slip through. Developing countries, with greater poverty and unregulated markets, have a much greater reliance on corporate tax. This is the case in South Africa, with its relatively high share of company tax compared to the OECD average. It is submitted that South Africa will be faced with Durst's (2014) dilemma of choosing to implement actions against BEPS at the risk of discouraging international investment. Australia, with its relatively wealthy population, strong share of personal income tax, and greater share of international trade and investment, may be more likely to proceed assertively in the international tax arena.

5.6 The Observatory of Economic Complexity – focusing a country's BEPS efforts

The Massachusetts Institute of Technology (MIT) has developed a tool that provides insight into the type of international trade occurring in a country. The MIT Observatory of Economic Complexity (Simoes & Hidalgo, 2011) uses interactive visualisations to portray international trade data. Four of these visualisations are useful in indicating likely BEPS activity in a country. These are:

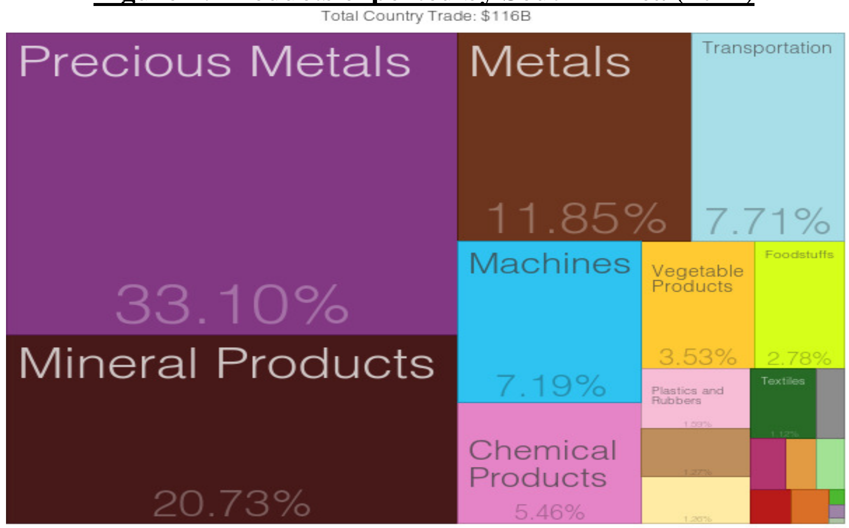
- products exported by a country;
- products imported by a country;
- export destinations for a country; and
- import origins for a country.

International trade (usually between related parties) provides the mechanism through which BEPS strategies occur. For example, in the Starbucks tax structure described in Chapter Four, one of the BEPS concerns was the mark-up applied to the sale of coffee beans between the Netherlands, Swiss, and United Kingdom companies. Using these four simple visualisations it is possible to gain a quick, albeit rudimentary, understanding of the probable BEPS risk areas affecting a country. This could allow the tax authorities to focus their enforcement efforts on multinational enterprises operating in particular industries. It could also suggest which double tax treaties should be reassessed in terms of BEPS gaps.

It should be noted that the trade data used in the Observatory of Economic Complexity tool does not include trade in *services*, which is large area of concern for BEPS. However, BEPS strategies can be applied to physical products as well (such as coffee beans in the Starbucks case), and this tool remains useful for analysing a country's economic relationships.

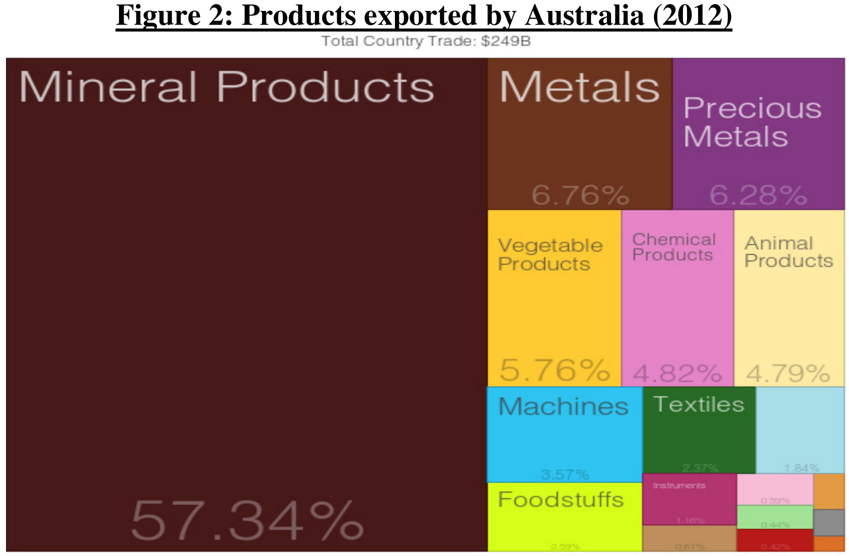
The four visualisations are provided below for South Africa and Australia:

Figure 1: Products exported by South Africa (2012)



Source: Simoes & Hidalgo, 2011

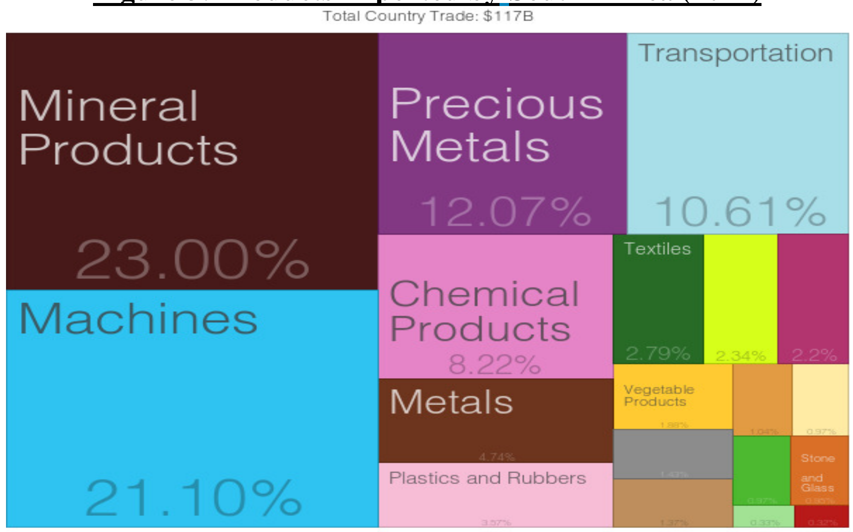
Figure 2: Products exported by Australia (2012)



Source: Simoes & Hidalgo, 2011

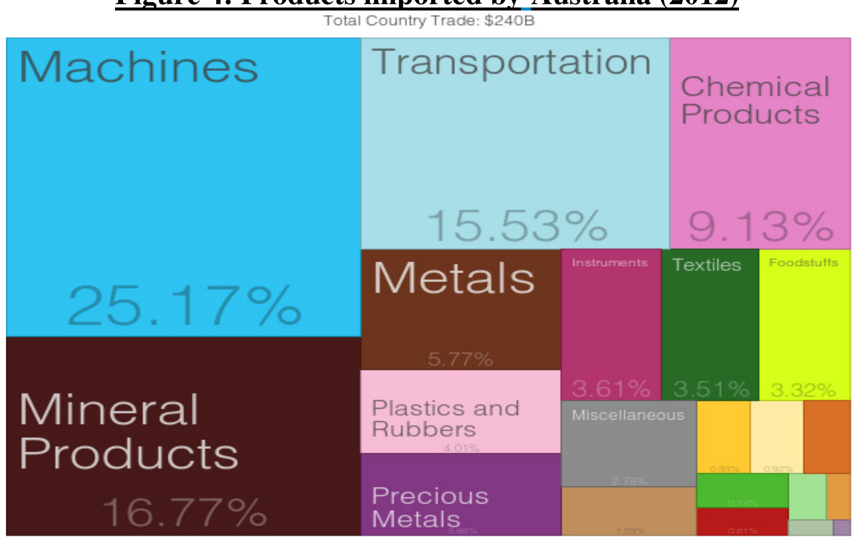
The major exports from South Africa and Australia are very similar. The top three export product categories for both countries are Precious Metals, Metals and Mineral Products. These product categories account for more than 65% of South Africa's and 70% of Australia's total exports. For both countries, the mining industry is a very important part of the economy. Although BEPS behaviours will very likely be found in multinational mining companies, both South Africa and Australia will need to consider the economic effects of any BEPS actions they implement against these companies.

Figure 3: Products imported by South Africa (2012)



Source: Simoes & Hidalgo, 2011

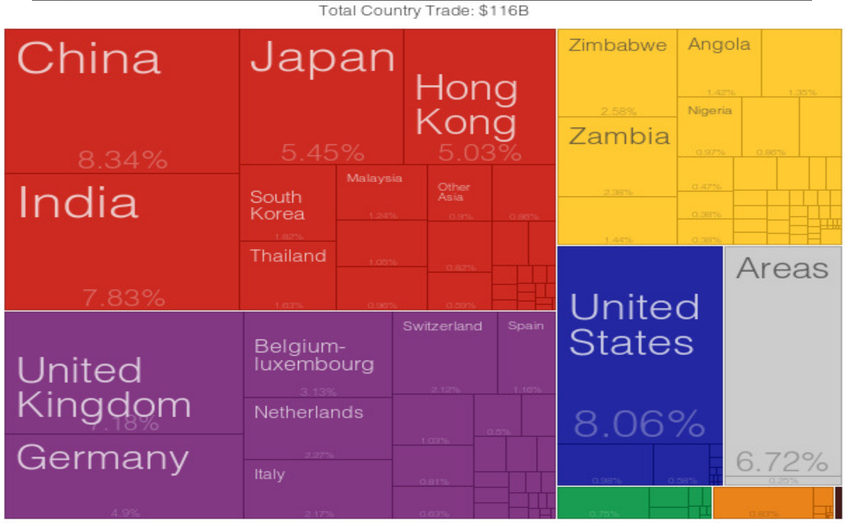
Figure 4: Products imported by Australia (2012)



Source: Simoes & Hidalgo, 2011

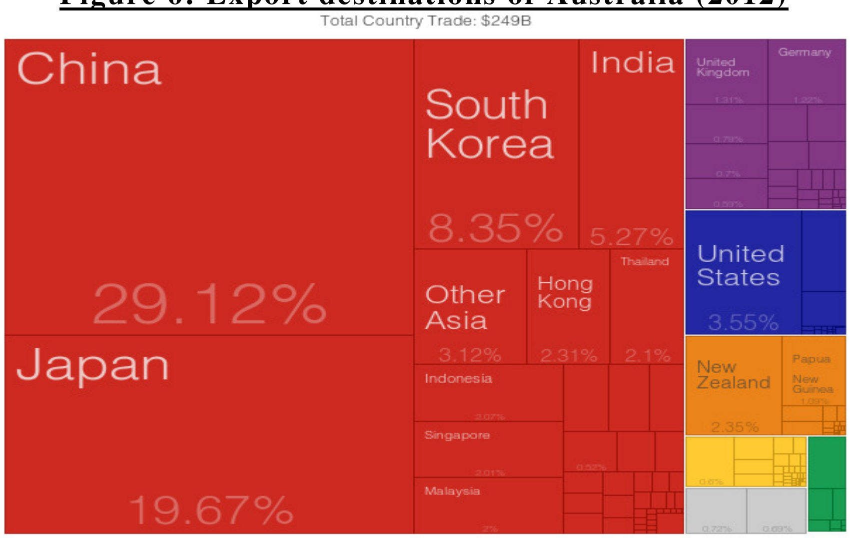
The major imports into South Africa and Australia are also similar. The top two import categories in both countries are Mineral Products and Machines, accounting for over 40% of total imports into both countries. An interesting feature of the imports into South Africa and Australia is the significance of Machines and Transportation, which together make up over 30% (South Africa) and 40% (Australia) of total imports. The products in these categories are likely to be capital assets that qualify for tax allowances. If BEPS is occurring, then it would likely be reflected in overpriced imports, which would feed through to inflated capital allowances, and a corresponding reduction in income tax.

Figure 5: Export destinations of South Africa (2012)



Source: Simoes & Hidalgo, 2011

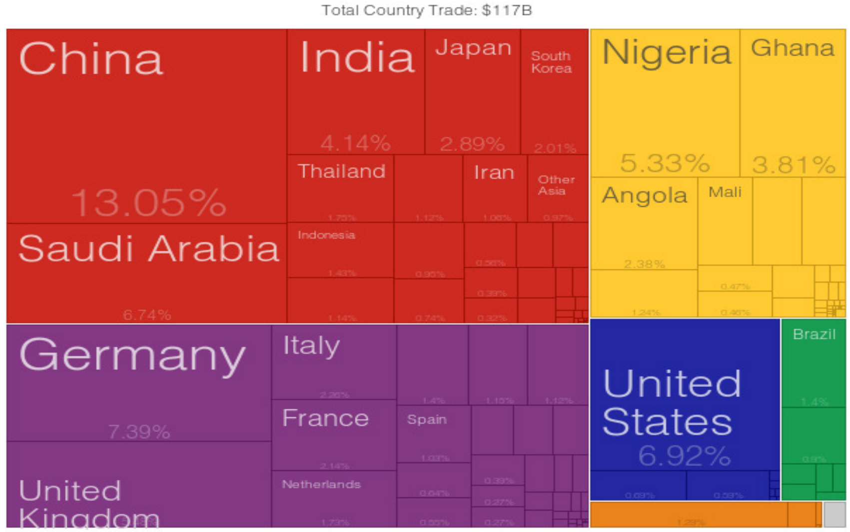
Figure 6: Export destinations of Australia (2012)



Source: Simoes & Hidalgo, 2011

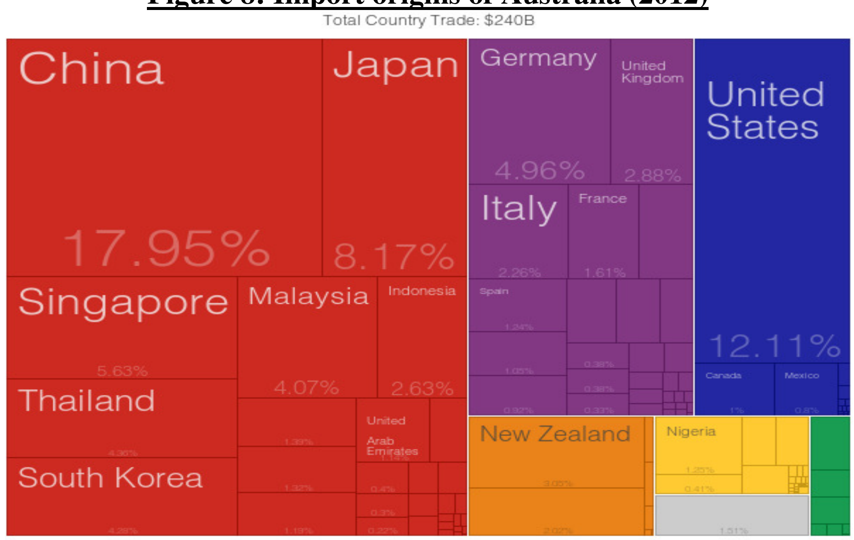
The composition of South Africa's and Australia's trading partners is more varied than the products they trade. South Africa's top five export destinations each share in 7-8% of total exports. In contrast, Australia is heavily reliant on one major export destination – China, which accounts for nearly 30% of Australia's exports. Unlike South Africa's diverse export destinations, more than 80% of Australia's exports go to Asia.

Figure 7: Import origins of South Africa (2012)



Source: Simoes & Hidalgo, 2011

Figure 8: Import origins of Australia (2012)



Source: Simoes & Hidalgo, 2011

China is the biggest import origin for both South Africa (13%) and Australia (18%). The United States is also an important import origin for both South Africa (7%) and Australia (12%). Asian countries account for more than half of Australia's total imports and 41% of South Africa's imports, while European imports are second largest making up 28% of South Africa's and 20% of Australia's imports.

The mining and metals industries are clearly major contributors to the economies of South Africa and Australia. With the majority of international trade occurring in these categories, it would appear reasonable to expect BEPS strategies to be used by multinational enterprises operating in these industries. However, despite trading in similar products, South Africa and Australia's trade partners vary greatly. South Africa has a significant volume of trade with African countries, with the balance of its trade partners fairly evenly spread across the countries of the world. Australia has a very heavy reliance on trade with China specifically, and Asian countries as a whole.

One possible response to BEPS emerges when examining the major trading partners of South Africa and Australia. Two countries appear in the top five export destinations and import origins of both South Africa and Australia – China and the United States. It would appear sensible for tax policy makers in both South Africa and Australia to re-examine their tax treaties with these two countries. This should allow any obvious tax mismatches to be discovered, although the political relationship between the countries will affect how, if at all, tax treaties are amended.

Australia has a very sensitive trade relationship with China, which will possibly overshadow any BEPS responses it would like to take. Australia is unlikely to aggressively modify its China tax treaties. In addition, mining, the major industry in Australia for decades, is facing declining export earnings (Department of Industry and Science, 2015), which may make Australia hesitant to introduce BEPS measures against its mining companies, which are the major exporters to China.

Although China is also South Africa's largest trading partner, it is not to the same extent as Australia. South Africa's mix of trading partners is less concentrated, with a larger share of trade coming from Africa. This makes it more difficult to identify any country-specific BEPS actions that South Africa may take, other than focusing on their top five trading partners. Mining is also an important industry in South Africa, especially as a provider of jobs in a country with high unemployment. Similar to Australia, South Africa's mining industry is struggling (PricewaterhouseCoopers, 2015), and South Africa is also unlikely to take BEPS actions that negatively affect the mines.

The United States has been the focus of much BEPS research. As discussed in this thesis, many of the high-profile BEPS examples (such as Amazon, Google and Starbucks) are American domiciled companies, and several specific tax rules in the United States have been implicated in BEPS strategies. As a large trading partner of both South Africa and Australia, it would seem that analysing the United States and its tax rules and tax treaties would be an important element of their BEPS actions. However, Arnold and Wilson (2014:1) caution:

> Until the United States is willing and able to take the lead on aggressive international tax planning by multinational corporations, the reality is that smaller countries ... should be cautious about making changes to [their] international tax rules that are dependent on other countries making similar changes.

The BEPS dilemma thus remains. The problem facing countries regarding their position on BEPS is summarised by Arnold and Wilson (2014). They note that while the harmful consequences of BEPS are "superficially clear", they argue that for any one country, BEPS analysis is "much more subtle and difficult than the ... list of consequences may suggest". They believe that most countries have a "schizophrenic attitude" to BEPS – wanting to protect their domestic tax bases from foreign multinational enterprise tax planning, but having no desire to prevent their own multinationals eroding other countries' tax bases (Arnold & Wilson, 2014:6).

It is submitted that a country's approach to BEPS should not be simply a function allocated to its tax authority. A thorough understanding of the economic and political landscape is needed before the BEPS Action Plan is adopted. The MIT Observatory of Economic Complexity visualisations help to appreciate the structure of a country's international trade and suggest possible focus areas for BEPS. However, the political nature of international trade relations, and the ambitious OECD call for international cooperation against BEPS, suggests that BEPS should not be approached hastily.

5.7 Conclusion

The term "BEPS" has been explained in this thesis as encompassing the tax minimising strategies used by multinational enterprises, usually including profit shifting strategies that artificially shift profits out of high-tax countries to low-tax countries. With the increase in trade between countries as multinational enterprises expand across the world, it is reasonable to expect that every country with an open economy will be affected by BEPS through the tax planning activities of the companies operating in its jurisdiction.

While most countries will be exposed to some degree of BEPS, their perception of BEPS and their responses to it will vary. This chapter argued that the actions that a country takes against BEPS, despite it being a “tax” problem, will depend on much more than simply the tax effects of BEPS. A comparison of South Africa and Australia was used to illustrate how economic, political and social elements of a country will influence its treatment of multinational enterprises, and thus its BEPS actions.

South Africa, as a relatively poor developing country with high unemployment, but a well-developed tax system, may be less likely to implement aggressive anti-BEPS measures against multinational enterprises. These large businesses are often major contributors to jobs and growth in a developing country. South Africa could be willing to forgive BEPS behaviours (which are, moreover, difficult to measure and may not even be of concern to a particular country) in favour of encouraging multinational investment into the country.

Australia, however, is a much larger, developed economy with greater involvement in the OECD. With richer individuals contributing a large share of tax revenue, and much larger shares of international trade and foreign investment than South Africa, Australia may not feel as reliant on multinational enterprises for development of its economy. Together with political pressure to act, Australia is more likely than South Africa to take assertive anti-BEPS measures.

Using visualisations from the MIT Observatory of Economic Complexity, it was argued that a country may be able to direct its BEPS actions towards its major BEPS risk areas – the products and countries that are a key part of its international trade. The mining and metals industries were identified as accounting for a significant volume of imports and exports for both South Africa and Australia, who both also enjoy significant trade with China and the United States. While multinational enterprises operating in these industries and countries likely account for a large proportion of BEPS behaviours, it was argued that the BEPS actions taken will be shaped by each country’s relationship with its major trading partners, as well as with the businesses in its major industries.

CHAPTER SIX: CONCLUSION

The major goal of this thesis was to critically analyse the term BEPS, and assess its extent. A secondary goal was to perform a comparative analysis of BEPS in a South African and Australian context. It was found that BEPS fundamentally relates to international corporate tax planning, and perhaps more specifically, to where the ethical line is drawn between tax avoidance and tax evasion. The BEPS tax strategies employed by multinational enterprises are legal – they take advantage of legal arbitrage opportunities (or, loopholes) between the different tax systems in which they operate. However, the impetus for the BEPS project seems to be driven by the public perception that multinational enterprises are not paying their "fair" share of tax. This thesis argued that because of the complexity of understanding and measuring BEPS, and its economic and political setting, countries should be cautious in their approach to BEPS.

As a starting point in defining BEPS, Chapter Two examined the composition of a country's tax base, and explained that tax base erosion results in the loss of tax revenue for a country. The tax strategies used in BEPS result in the loss of *corporate* tax revenue. However a country's full tax base includes the variety of taxes imposed in that country. In South Africa and Australia, the three top components of tax revenue are the individual income tax, the company income tax, and the consumption tax (VAT in South Africa, and GST in Australia).

The erosion of a country's tax base can be caused by many factors other than BEPS, and to any of its tax bases. Some examples provided in Chapter Two include outright tax evasion, exchange rate fluctuations, interest rate policies, and even emigration. In fact, many countries knowingly erode their tax bases through the use of tax policies such as free trade zones, tax holidays, and special deductions and exemptions. It was argued that before responding to BEPS, a country should understand (and measure) all of its tax bases, as well as the causes of their erosion. This would enable a country to assess the relative significance of BEPS against other forms of tax base erosion.

Chapter Three then attempted to define BEPS. The term gained public recognition after being the subject of the OECD's BEPS Report and BEPS Action Plan. However, despite much negative media attention and political indignation, the term BEPS is not specifically defined by the OECD. Very generally it can be described as the tax avoidance strategies used by multinational enterprises. However, as discussed in Chapter Three, these strategies are many and varied, and are the result of various interacting and complicated features of the international corporate tax field.

These features are discussed in Chapter Three, along with an analysis of how BEPS is described by the OECD BEPS Report and Action Plan. The complexity of BEPS is summarised by the OECD itself when it states that "it is not any particular country's tax rule that creates the opportunity for BEPS, but rather the way the rules of several countries interact" (OECD, 2013a:44). For this reason, it is submitted that different countries will experience different elements of BEPS, if any. The profit shifting opportunities present in a particular country will depend on its interaction with the tax rules of its major trading partners. It is probable that each country will respond differently to BEPS, which calls into doubt the success of the OECD's internationally coordinated Action Plan.

The chapter further investigated the BEPS studies referenced by the OECD in its BEPS Report. Despite the OECD Action Plan calling for a "bold move" to prevent "global tax chaos" (OECD, 2013b:10), many of the studies produced contradictory results, or were not intending to provide insight into BEPS issues. This lack of research again suggests that the OECD was too hasty in its call for urgent action. It is argued that before implementing actions targeting BEPS, a country should rather seek to gain more information about BEPS and its effects on the country.

The conceptual problems in measuring BEPS were discussed in Chapter Four, which analysed the extent of BEPS. The biggest problem facing researchers is that of the "counterfactual" – what the situation would be without the BEPS tax-minimising strategy being examined. This conceptual issue arises because BEPS tax strategies are legal – they arbitrage mismatches in international tax rules to minimise their tax liabilities.

Nevertheless, the general consensus among academic researchers is that profit shifting is occurring, but is much smaller than previously believed. This is in contrast to many advocacy groups who describe billion-dollar tax losses in highly emotive reports, which ultimately gain more media attention than the staid academic studies. This attention by "journalists, activists and citizens" on multinational enterprises' tax affairs is what Boidman and Kandev (2013:1032) call a "bottom-up dynamic", by people who

> Cannot appreciate that what Apple or Google is doing in terms of tax planning is nothing wrong or objectionable (in keeping with both responsibilities to shareholders and the rule of law) and that soft and inherently vague notions such as the much abused words “fairness” and “morality” have nothing to do with it.

Chapter Four continues with a discussion of the ethics of tax avoidance. Boidman and Kandev (2013) clearly believe that aggressive tax planning by multinational enterprises is ethically acceptable. However, if everyone shared this view, then BEPS would never have become a major OECD project. Multinational enterprises, due to their size, international presence and amount of tax dollars at stake, are now at the centre of what is essentially a tax avoidance issue - what is acceptable, and what is not acceptable, when it comes to arranging tax affairs to minimise the amount of tax paid to governments.

The ethical debate frames the entire BEPS issue, and will certainly affect a country’s response to BEPS. For example, if a government provides for an income tax deduction (such as a 150% research and development deduction to stimulate research and development), then most people would find it acceptable for a company to use that deduction. They would also more than likely find it acceptable for such a company to employ a tax specialist to find and use all the similar available deductions/incentives. In fact every single taxpayer “takes advantage” of their country’s tax legislation, by using the available exemptions and deductions when calculating their taxable income.

It is a subjective task to then determine where this ethically “acceptable” behaviour ends. The BEPS behaviour of multinational enterprises is legal tax planning, except on a much larger international scale than most businesses or individuals can afford. And perhaps many countries would find multinational enterprise tax strategies ethically acceptable when compared to the benefits of multinational activity in a country. It is very important for a country to assess whether BEPS is of sufficient magnitude (qualitatively or quantitatively) to justify adopting the OECD Action Plan.

The benefits of multinational enterprise activity are discussed in Chapter Five, along with a comparison of various economic indicators of South Africa and Australia. These two countries provide an interesting comparison, because although they have a similar tax system, and in particular a similar corporate tax structure, their economies are very different.

It was argued that, because of their well-developed tax systems, and concentration of very large taxpayers a simple BEPS strategy for both South Africa and Australia would be to increase their tax enforcement effort on the largest multinationals operating in their country. However, it was then argued that South Africa, a developing country, is more likely to overlook BEPS behaviours in recognition of the benefits that multinational enterprises bring to a country. Australia, a richer country with much greater international trade exposure, may feel less reliant on multinational enterprises and be less likely to tolerate BEPS behaviours.

However, an analysis of South Africa and Australia's international trade data suggests that their actual response to BEPS will be difficult to predict. Visualisations from the Observatory of Economic Complexity (Simoes & Hidalgo, 2011) portrayed South Africa's and Australia's major imports, exports, and trading partners. These industries and trading partners account for a large degree of each country's international trade, which arguably provides the opportunities for BEPS. It was argued that a suitable response for South Africa and Australia would be to focus their BEPS efforts on multinational enterprises operating in these important industries, and on their tax treaties with their major trading countries. However, the political complexity of international trade relations, and a country's natural inclination to protect and promote its own industries, complicates their efforts to address BEPS.

BEPS is conceptual problem that will not be easily addressed with 15 timetabled actions. It is an evolving area that tax policy makers will deal (and have been dealing) with over time. Countries should be careful of targeting tax legislation affecting multinational firms without fully appreciating the advantages they may bring, other than tax revenue. They should also consider the actions of other countries, as BEPS is by its very nature dependent on the interacting tax laws of different countries. At the very least, the OECD BEPS Action Plan, and any estimates of the extent of BEPS, should be approached with a degree of caution.

It is submitted that a reasonable approach for any country to take would be that expressed by the Chairman of the Tax Committee of the Business and Industry Advisory Committee to the OECD (OECD, 2012: Online), who stressed

> the seriousness of issues relating to base erosion and profit shifting for both governments and business, and emphasized the need to address such issues within a **neutral and predictable** transfer pricing framework and in a way that will **encourage innovative activities and economic growth** (emphases added).

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