Base Erosion and Profit Shifting: A Roadmap for Reform

OECD

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In this Editorial, the authors explain the context of this special issue of the *Bulletin for International Taxation*. The fundamental premise of the BEPS project is that a coordination of national responses to BEPS can both eliminate double non-taxation and protect against material unrelieved double taxation. The articles in this issue further a dialogue among tax policymakers, taxpayers, advisors and academics that is critical to achieve this objective.

In January 2014, the Max Planck Institute for Tax Law and Public Finance together with the International Network for Tax Research (INTR) hosted in Munich a two-day interdisciplinary conference[1] on the OECD's Action Plan on Base Erosion and Profit Shifting (the "BEPS Action Plan").[2] The conference was attended by scholars in tax law and public finance, practitioners, members of the OECD Centre for Tax Policy Secretariat and country delegates involved in the BEPS project. Speakers prepared papers to frame the discussion of issues raised by action items in the BEPS Report[3] and approaches to addressing those issues. This issue is comprised of papers first presented at the Munich conference.

The BEPS Action Plan, endorsed at the G20 meeting of heads of government in Saint Petersburg in September 2013, sets out 15 "action" items, with varying specificity in deliverable outputs, and an aggressive time line for completion of the actions. A summary chart of the action items, the proposed outputs and the deadlines for completion are provided in Appendix A. The action items may be very generally placed into the following groupings:

- rules for the digital economy (Action 1);
- prevention of double non-taxation (Actions 2, 3, 4, 5, 6);
- alignment of economic activity and taxation (Actions 7, 8, 9, 10);
- tax transparency and dispute resolution (Actions 11, 12, 13, 14); and
- efficient and effective implementation (Action 15).

The international income taxation problems addressed in the BEPS Action Plan are among the most difficult issues confronted by the international tax regime in recent decades. These include: transfer pricing, inconsistent entity and instrument classification, the rise of the digital economy, increasing number and complexity of disputes and the limited effectiveness of existing anti-abuse rules. The OECD, the European Union, the United Nations, other international organizations and their member countries have already devoted substantial efforts to address issues similar, if not identical, to those covered by the BEPS Action Plan.[4] What is different this time?

The BEPS project has acquired urgency from political-level visibility of the failure of cross-border taxation rules to keep up with the realities of modern commerce and finance. The extent of corporate tax avoidance highlighted in legislative hearings,[5] press reports[6] and exposes[7] by non-governmental organizations has prompted public outcries,

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1. The Conference was co-sponsored by the OECD's International Network for Tax Research (INTR), the Max Planck Institute for Tax Law and Public Finance and the Harvard Fund for Tax and Fiscal Policy Research.
2. OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013), International Organizations' Documentation IBFD, also available at www.oecd.org/tax/beps.htm.
3. OECD, *Addressing Base Erosion and Profit Shifting* (OECD 2013), International Organizations' Documentation IBFD, also available at www.oecd.org/tax/beps.htm.
4. A full bibliography of reports on prior efforts to address BEPS issues would run for pages. As one example, the OECD addressed transfer pricing in 1979 its report *Transfer Pricing and Multinational Enterprises*. It published major revisions to the transfer pricing guidelines in July 2010. *See* OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2010), International Organizations' Documentation IBFD. As another example, in 1987, the OECD published *International Tax Avoidance and Evasion, Four Related Studies.* The four studies covered such topics as use of base and conduit companies and countermeasures to the use of tax havens. Proposals included measures to increase transparency and CFC legislation. In 2011, the OECD published *Tackling Aggressive Tax Planning through Improved Transparency and Disclosure*. Many more examples of consideration of BEPS issues could be added to these examples.
5. *See*, for example, US Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Government Affairs Hearing on Offshore Profit Shifting and the US Tax Code (20 Sept. 2012); House of Commons, Committee of Public Accounts, HM Revenue & Customs: Annual Report and Accounts 2011–12, Nineteenth Report of Session 2012–13 (HC 716, 3 Dec. 2012); US Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Government Affairs, Hearing on Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.) (21 May 2013); US Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Government Affairs, Hearing on Caterpillar's Offshore Tax Strategy (1 Apr. 2014).
6. J. Drucker, *Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes*, Bloomberg (21 Oct. 2010); T. Bergin, *Starbucks's continental de-tax café culture*, Reuters (1 Nov. 2012); J. Ford, S. Gainsbury & V. Houlder, *Cadbury: The great tax fudge*, Financial Times (20 June 2013) (Cadbury paid an average of GBP 6.4 million a year in current tax on its ongoing UK operations, despite annual British profits of GBP 100 million and turnover of more than GBP 1 billion).
7. ActionAid, *Calling Time: Why SAB Miller Should Stop Dodging Taxes In Africa* (Nov. 2010).

particularly in Europe, to an extent not seen since before the Reagan/Thatcher period. Prior initiatives to curb international business tax avoidance have been driven largely by bureaucrats and policymakers, and, occasionally, by politicians' search for revenue from politically vulnerable targets, including inbound and outbound foreign direct investment. To have pressure from the public is rare in relation to business tax issues, and the disclosures relating to Cadbury and Starbucks, Apple and Google as well as General Electric, to name just a few examples, have pushed politicians to respond. Political attention has reached not only finance ministers[8] but heads of state.[9] It is difficult to overstate the political significance of G20 heads of state communiqués including BEPS as an issue to be addressed by member countries.

The political "drivers" of BEPS are a symptom of deeper problems with an international income tax regime whose contours were formed in the 1920s and have not changed materially since. International tax rules were largely developed under a bilateral paradigm of a well-developed and extensive residence country taxing system and a source country which fully exercised its taxing rights. This is the paradigm that underlies bilateral income tax treaties. The predominant focus of this regime has been to avoid or mitigate international double taxation.[10] From the beginning, the fundamental division of income between residence and source countries (whether adopted unilaterally or by treaty) has been that the source country has the primary right to tax income from that country and generally will tax business income on a net income basis and impose a withholding tax on interest, dividends, royalties and similar income. The residence country may tax the same income as well, but it commits to mitigate double taxation through allowing a credit for source country tax or exempting the income. The non-discrimination principle generally restricts the source country from treating foreign-owned businesses worse than a source country business.

The bilateral paradigm does not reflect the predominant reality of multinational tax planning today, which routinely involves use of intermediary entities located in tax-favourable countries. While this is not new, as evidenced by long-standing concerns noted previously regarding use of conduit companies and tax havens, use of intermediaries has expanded exponentially as the deconstruction and separation of business processes, both within the same business enterprise and among unrelated business enterprises, has become routine in order to maximize operating, financial and tax efficiencies of multinational enterprises (MNE). Under pressure from public stock markets and private equity fund investors, public and private business enterprises have also changed their orientation to taxation, treating tax like any other cost of business which should be minimized. In addition to devoting resources to compliance with accounting and tax requirements of multiple jurisdictions, multinational businesses devote substantial energy to reducing or avoiding taxes. Aggregate evidence suggests that many non-resource MNEs have been very successful in achieving effective rates of tax well below the nominal or "headline" rate in residence countries.[11]

But MNE behaviour is only one side of the coin. International profit shifting and base erosion envisaged by large business enterprises would be ineffective without countries offering preferential tax rules, including low/no tax regimes for particular taxpayers or income categories and benign provisions on profit measurement. To put it differently: MNE tax avoidance is just the flipside of harmful tax competition. Against this background, the issues raised in the OECD 1998 Report on Harmful Tax Competition[12] resurface in the course of the BEPS debate and the Action Plan invites increased discipline in relation to preferential tax regimes.[13] A case in point is the "Patent Box" which has become fashionable particularly in different EU countries but also outside the European Union. Beyond the patent box issue, the European Commission has committed itself to support the OECD process,[14] addressing good tax governance in third countries as well as trying to employ their own instruments (State Aid, Code of Conduct) in order to abolish the most aggressive tax legislation or fiscal administrative practices used by Member States to attract foreign business.

The BEPS Action Plan identifies several reasons why base erosion and profit shifting needs to be addressed. With

8. G. Osborne, P. Moscovici & W. Schäuble, *We are determined that multinationals will not avoid tax*, Financial Times, (16 Feb. 2013).
9. *See* Saint Petersburg G20 Leaders Declaration 50 (Sept. 2013) (supporting "the G20/OECD BEPS project" and calling on "member countries to examine how our own domestic laws contribute to BEPS and to ensure that international and our own tax rules do not allow or encourage multinational enterprises to reduce overall taxes paid by artificially shifting profits to low-tax jurisdictions."); Los Cabos Finance Ministers Communiqué 48 (June 2012) ("We reiterate the need to prevent base erosion and profit shifting and we will follow with attention the ongoing work of the OECD in this area.").
10. Professor Ault calls attention to the 1927 Report of the Committee of Experts, which noted "the necessity of dealing with the questions of tax evasion and double taxation in coordination with each other." *See* Report by Committee of Experts on Double Taxation and Tax Evasion 23 (League of Nations 1927). As Professor Ault has also observed, however, "[M]ost of the effort in the ensuing years has been focused more on ensuring relief from double taxation than making sure that double non-taxation does not take place." H.J. Ault, *Some Reflections on the OECD and the Sources of International Tax Principles*, 70 Tax Notes Int'l 1195 (17 June 2013).
11. Grubert and Altshuler report that that in 2006 45.9% of earnings of US controlled foreign corporations that reported positive income and some foreign tax was taxed at a foreign effective rate of less than 10%. H. Grubert & R. Altshuler, *Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax*, 66 Nat. Tax J. 671, Table 3 at p. 699 (Sept. 2013). It seems unlikely that MNEs from countries that largely exempt foreign earnings would pay higher foreign effective rates of tax, but, if so, it is not evident to these observers why that would be the case. For an example of work with non-US data suggesting equivalent responses by German multinationals, *see* J.M. Mintz & A.J. Weichenrieder, *The Indirect Side of Direct Investment* p. 126 (MIT 2010).
12. OECD, *Harmful Tax Competition: An Emerging Issue* (OECD 1998).
13. OECD, *BEPS Action Plan*, *supra* n. 2, Action 5.
14. European Commission, Commission recommendation on aggressive tax planning, C(2012) 8806 final (6 Dec. 2012), available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_fraud_evasion/c_2012_8806_en.pdf; European Commission, Commission recommendation regarding measures intended to encourage third countries to apply minimum standards of good governance in tax matters, C(2012) 8805 final (6 Dec. 2012), available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_fraud_evasion/c_2012_8805_en.pdf.

respect to governments and businesses, the BEPS Action Plan observes:

> Many governments have to cope with less revenue and a higher cost to ensure compliance. Moreover, Base Erosion and Profit Shifting (BEPS) undermines the integrity of the tax system, as the public, the media and some taxpayers deem reported low corporate taxes to be unfair. In developing countries, the lack of tax revenue leads to critical under-funding of public investment that could help promote economic growth. Overall resource allocation, affected by tax-motivated behaviour, is not optimal.
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> [...]
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> MNEs may face significant reputational risk if their effective tax rate is viewed as being too low. At the same time, different businesses may assess such risk differently, and failing to take advantage of legal opportunities to reduce an enterprise's tax burden can put it at a competitive disadvantage. Similarly, corporations that operate only in domestic markets, including family-owned businesses or new innovative companies, have difficulty competing with MNEs that have the ability to shift their profits across borders to avoid or reduce tax. Fair competition is harmed by the distortions induced by BEPS.[15]

Business is also rightly concerned that political pressures to address base erosion and profit shifting will result in uncoordinated solutions that risk substantial increases in disputes and risk of unresolved double taxation. This concern reinforces the wisdom of the 1927 Committee of Experts Report's identification of the intimate link between double taxation and "tax evasion".

The advancing sophistication of international business structuring increases pressures for domestic tax rules to take account of non-taxation or materially reduced taxation of income, particularly in intermediary countries, whether as a source country in relation to potentially deductible payments to intermediary entities or as a residence country in relation to income shifted to an intermediary controlled foreign company. The outcomes of the BEPS Action Plan will likely affect whether countries adopt an "anti-abuse" approach, for example by focusing on related party and "structured" arrangements, or whether more comprehensive approaches will be developed.

Anti-abuse approaches may mitigate costs of transition and limit effects on existing business practices. It may be observed, however, that frequent and ongoing changes to anti-abuse regimes have not proven sufficiently effective. Moreover, the costs of ongoing incremental changes in law in the aggregate may outweigh the burden of a more comprehensive change. Comprehensive change, though, is difficult to design and to implement. The alternatives of anti-abuse and comprehensive solutions need not be mutually inconsistent. The timing also changes matters. The timelines set in the BEPS Action Plan make it very difficult to develop comprehensive changes, but it would be a reasonable approach to strengthen anti-abuse rules in the short term and take appropriate time to reflect on and implement more difficult comprehensive changes. Moreover, preferential tax regimes should be identified and repealed following pressure by the international tax community. Such a staggered approach is already reflected to some extent in the BEPS Action Plan. Moreover, an iterative approach allows time to reveal how developments, such as automatic information exchange and technological advances, might permit administration of more comprehensive proposals that today might not seem feasible.

Whichever approaches are ultimately adopted from the important BEPS Action Plan discussion drafts that already have emerged, and those that will come, the fundamental promise of the BEPS project is multilateral coordination of country responses. This is a highly significant objective; compromise and deferred implementation of proposals requiring technical development and business adaptations is appropriate to achieve a coordinated outcome. At the end of the day, it is important that the efforts to eliminate double non-taxation do not themselves result in material unrelieved double taxation and the attendant burden on cross-border activities.

While the pressures to address BEPS are indeed different from the past and justify urgency, the difficulty of the issues has not diminished. Indeed, along with the complexities of modern businesses and economies, the technical difficulties of addressing BEPS issues have increased as well. Though the BEPS Action Plan calls for outputs to be complete by December 2015, the work of implementation of actual legislation will take far longer. Moreover, as with any significant legislative endeavour, ongoing dialogue among tax policymakers and administrators, affected taxpayers, advisors and academics is critical to achieve high quality legislation. Decisions that seem wise at one stage of the process may be discarded at another and proposals rejected at one stage, with re-working or as a result of technological advances, sometimes may be found the best available alternative at a later stage.

The papers presented at the Munich conference and in this issue have been and will continue to be useful resources for policymakers and their technical staff as they work through the intricacies of rules to flesh out the BEPS Action Plan and, subsequently, to attempt to implement the proposals through legislation. Referring to the categorization set out above, articles in this issue touch on all the major categories except the development of a multilateral instrument.

Professor Walter Hellerstein's contribution, "Jurisdiction to Tax in the Digital Economy: Permanent and Other Establishments", underscores the importance of administrative concerns in designing rules for taxing the digital economy, in particular, aligning assignment of the tax base with the ability to enforce collection of the tax in the jurisdiction to which the base is assigned. Professor Hellerstein reminds us that "tax administration is tax policy,"[16] a lesson that tax policymakers ignore at their peril.

The preponderance of the articles in this issue addresses avoidance of double non-taxation. Two papers address

15. OECD, *BEPS Action Plan*, *supra* n. 2, at p. 8.

16. Professor Hellerstein attributes this observation to M. Casanegra de Jantscher, *Administering the VAT* in: *Value Added Taxation in Developing Countries* p. 179 (M. Gillis, C.S. Shoup & G.P. Sicat eds., World Bank 1990) (emphasis in original).

hybrid mismatch or what is known to planners as tax arbitrage. Professor Jürgen Lüdicke's article, "'Tax Arbitrage' with Hybrid Entities: Challenges and Responses", provides a deep review of the formidable technical challenges of designing approaches to the use of hybrid entities so as to account for legitimate timing differences and avoid double taxation. Stephen Edge, in "Base Erosion and Profit Shifting: A Roadmap for Reform – Tax Arbitrage with Hybrid Instruments", outlines the broader context in which use of "hybrid instruments" occurs and in which any solution must operate. Edge supports targeted rather than expansive approaches to these issues. Professor Johanna Hey observes, in "Base Erosion and Profit Shifting and Interest Expenditure", that interest-related issues cross multiple action items in the BEPS Action Plan. Her paper provides a review of the issues posed by the deductibility of interest, a breakdown of existing measures taken to limiting excessive deductions, the legal constraints on potential changes and a thorough review of policy options.

Professor Mitchell A. Kane undertakes a careful review of the rationale for controlled foreign company (CFC) legislation in "The Role of CFC Legislation in the OECD BEPS Project" and makes recommendations for the appropriate scope of CFC rules in the multilateral context of the BEPS project, relating the application of the CFC rules to the treatment of the payments received by the intermediary CFC in the source jurisdiction. Professor Guglielmo Maisto reviews the intersection of corporate residence rules, CFC legislation and hybrid issues in "Controlled Foreign Company Legislation, Corporate Residence and Anti-Hybrid Arrangement Rules" and makes observations on how proposals to address these action items should be coordinated. Professor Rosanne Altshuler reviews internation competitiveness in the context of identifying harmful tax practices in "Inter-Nation Competitiveness: A Discussion Paper on Base Erosion and Profit Shifting". Her contribution addresses the ill-defined term "competitiveness" and highlights that much remains to be explored in understanding how international tax rules affect a country's welfare. Two of the articles in this issue cover issues relating to the alignment of economic activity and taxation. Our co-author, Munich conference organizer and INTR colleague Professor Wolfgang Schön deconstructs economic and tax law aspects of taxing "risk" in "International Taxation of Risk". By careful analysis of the economics of risk and carefully relating them to how international taxation rules apply to a firm, Professor Schön makes an important contribution and provides direction for how transfer pricing rules may be adapted to cope with the challenges of allocating risk premiums within a multinational firm. J. Scott Wilkie's "Intangibles and Location Benefits (Customer Base)" observes that intangibles "may lie at the heart of any effective recalibration of how international taxation 'rules' and guidance respond to changing patterns and characteristics of multinational and global business and businesses". His article takes a deep dive into the concept of an intangible as a legal construct and as a component of value and draws conclusions for the BEPS work in related areas.

Two papers by academics with expertise in public finance and financial accounting address the issues relating to the potential effects on profit shifting of increased transparency through country-by-country reporting. Maria Theresia Evers, Ina Meier and Professor Christoph Spengel's paper, "Transparency in Financial Reporting: Is Country-by-Country Reporting Suitable To Combat International Profit Shifting?" is sceptical that the benefits of country-by-country reporting will outweigh the costs and favours alternative measures. Professor Jennifer Blouin's "Transparency and Financial Accounting" reviews what can be gleaned about profit shifting today from financial reporting and other data sources and raises issues that should be considered in an enhanced reporting regime.

We applaud the contributions of the scholars and practitioners who have contributed to this issue. For the BEPS project to succeed, it is essential that thoughtful and objective work be undertaken to assist policymakers in addressing the most difficult issues in international taxation. We express our thanks to the OECD, for encouraging this work through the International Network for Tax Research and to the other co-sponsors, the Max Planck Institute for Tax Law and Public Finance and the Harvard Fund for Tax and Fiscal Policy Research, for their financial and logistical support for the conference.

Appendix A

No.	Issue and Action	Output(s)	Due Date(s)
1	Address the tax challenges of the digital economy	Report	Sept. 2014
2	Neutralize the effects of hybrid mismatch arrangements	Domestic law design; OECD Model changes	Sept. 2014/ Sept. 2014
3	Strengthen CFC rules	Domestic law design	Sept. 2015
4	Limit base erosion via interest deductions and other financial payments	Domestic law design; OECD Transfer Pricing Guidelines (TPG) changes	Sept. 2014/ Sept. 2015
5	Counter harmful tax practices more effectively, taking into account transparency and substance	Review practices; Expand to non-OECD; Revise criteria	Sept. 2014/ Sept. 2015/ Dec. 2015
6	Prevent treaty abuse	Domestic law design; OECD Model changes	Sept. 2014/ Sept. 2014
7	Prevent the artificial avoidance of PE status	OECD Model changes	Sept. 2015
8	Assure that transfer pricing outcomes are in line with value creation: (i) intangibles and (ii) hard-to-value intangibles	TPG changes; possible OECD Model changes	Sept. 2014/ Sept. 2015

No.	Issue and Action	Output(s)	Due Date(s)
9	Assure that transfer pricing outcomes are in line with value creation: risks and capital	TPG changes; possible OECD Model changes	Sept. 2015
10	Assure that transfer pricing outcomes are in line with value creation: other high-risk transactions	TPG changes; possible OECD Model changes	Sept. 2015
11	Establish methodologies to collect and analyse data on BEPS and the actions to address it	Recommendations	Sept. 2015
12	Require taxpayers to disclose their aggressive tax planning arrangements	Recommendations	Sept. 2015
13	Re-examine transfer pricing documentation	TPG changes; Domestic law design	Sept. 2014
14	Make dispute resolution mechanisms more effective	OECD Model changes	Sept. 2014
15	Develop a multilateral instrument	Report; Develop instrument	Sept. 2014/ Dec. 2015