Base Erosion and Profit Shifting: A Roadmap for Reform

The Harvard community has made this article openly available. Please share how this access benefits you. Your story matters

<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Citable link</td>
<td><a href="http://nrs.harvard.edu/urn-3:HUL.InstRepos:12366236">http://nrs.harvard.edu/urn-3:HUL.InstRepos:12366236</a></td>
</tr>
<tr>
<td>Terms of Use</td>
<td>This article was downloaded from Harvard University’s DASH repository, and is made available under the terms and conditions applicable to Open Access Policy Articles, as set forth at <a href="http://nrs.harvard.edu/urn-3:HUL.InstRepos:dash.current.terms-of-use#OAP">http://nrs.harvard.edu/urn-3:HUL.InstRepos:dash.current.terms-of-use#OAP</a></td>
</tr>
</tbody>
</table>
Base Erosion and Profit Shifting: A Roadmap for Reform

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 conference1 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 Report3 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 reports6 and exposes7 by nongovernmental organizations has prompted public outcries,

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.
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 in 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.
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 cafe 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).
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 but heads of state. It is difficult to overstated 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. 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. 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 resurface in the course of the BEPS debate and the Action Plan invites increased discipline in relation to preferential tax regimes. 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, 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
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.

...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


Address the tax challenges of the digital economy

Domestic law design

Report

Strengthen CFC rules

Limit base erosion via interest deductions and other financial payments

Sept. 2014

Prevent the artificial avoidance of PE status

Sept. 2014

Neutralize the effects of hybrid mismatch

Sept. 2014

Output(s)

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

Due Date(s)


Sept. 2014/ Sept. 2015

Sept. 2014/ Sept. 2015


Sept. 2015

Sept. 2015

Sept. 2014/ Sept. 2015

Sept. 2014/ Sept. 2015

Sept. 2015

Appendix A

<table>
<thead>
<tr>
<th>No.</th>
<th>Issue and Action</th>
<th>Output(s)</th>
<th>Due Date(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Address the tax challenges of the digital economy</td>
<td>Report</td>
<td>Sept. 2014</td>
</tr>
<tr>
<td>2</td>
<td>Neutralize the effects of hybrid mismatch arrangements</td>
<td>Domestic law design; OECD Model changes</td>
<td>Sept. 2014/ Sept. 2014</td>
</tr>
<tr>
<td>3</td>
<td>Strengthen CFC rules</td>
<td>Domestic law design</td>
<td>Sept. 2015</td>
</tr>
<tr>
<td>4</td>
<td>Limit base erosion via interest deductions and other financial payments</td>
<td>Domestic law design; OECD Transfer Pricing Guidelines (TPG) changes</td>
<td>Sept. 2014/ Sept. 2015</td>
</tr>
<tr>
<td>5</td>
<td>Counter harmful tax practices more effectively, taking into account transparency and substance</td>
<td>Review practices; Expand to non-OECD; Revise criteria</td>
<td>Sept. 2014/ Sept. 2015/ Dec. 2015</td>
</tr>
<tr>
<td>6</td>
<td>Prevent treaty abuse</td>
<td>Domestic law design; OECD Model changes</td>
<td>Sept. 2014/ Sept. 2014</td>
</tr>
<tr>
<td>7</td>
<td>Prevent the artificial avoidance of PE status</td>
<td>OECD Model changes</td>
<td>Sept. 2015</td>
</tr>
<tr>
<td>8</td>
<td>Assure that transfer pricing outcomes are in line with value creation: (i) intangibles and (ii) hard-to-value intangibles</td>
<td>TPG changes; possible OECD Model changes</td>
<td>Sept. 2014/ Sept. 2015</td>
</tr>
<tr>
<td>No.</td>
<td>Issue and Action</td>
<td>Output(s)</td>
<td>Due Date(s)</td>
</tr>
<tr>
<td>-----</td>
<td>----------------------------------------------------------------------------------</td>
<td>-----------------------------------------------</td>
<td>-------------------</td>
</tr>
<tr>
<td>9</td>
<td>Assure that transfer pricing outcomes are in line with value creation: risks and capital</td>
<td>TPG changes; possible OECD Model changes</td>
<td>Sept. 2015</td>
</tr>
<tr>
<td>10</td>
<td>Assure that transfer pricing outcomes are in line with value creation: other high-risk transactions</td>
<td>TPG changes; possible OECD Model changes</td>
<td>Sept. 2015</td>
</tr>
<tr>
<td>11</td>
<td>Establish methodologies to collect and analyse data on BEPS and the actions to address it</td>
<td>Recommendations</td>
<td>Sept. 2015</td>
</tr>
<tr>
<td>12</td>
<td>Require taxpayers to disclose their aggressive tax planning arrangements</td>
<td>Recommendations</td>
<td>Sept. 2015</td>
</tr>
<tr>
<td>13</td>
<td>Re-examine transfer pricing documentation</td>
<td>TPG changes; Domestic law design</td>
<td>Sept. 2014</td>
</tr>
<tr>
<td>14</td>
<td>Make dispute resolution mechanisms more effective</td>
<td>OECD Model changes</td>
<td>Sept. 2014</td>
</tr>
<tr>
<td>15</td>
<td>Develop a multilateral instrument</td>
<td>Report; Develop instrument</td>
<td>Sept. 2014/ Dec. 2015</td>
</tr>
</tbody>
</table>