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## **Former Treasury Official Expects OECD's BEPS Project Will Improve, Not Jettison, Existing International Tax Rules**

*Former Treasury Associate International Tax Counsel David Ernack, who joined PricewaterhouseCoopers in February after eight years with the government, met with BNA reporter Kevin Bell April 11 to talk about the direction of the Organization for Economic Cooperation and Development's project on base erosion and profit shifting. Ernack, who was Treasury's principal staff attorney for transfer pricing matters and represented the United States as a delegate to the OECD Working Party No. 6, predicted the BEPS project will result in improvements to existing international tax standards rather than radical changes. Questioned about a common criticism of transfer pricing, the former official said he is untroubled by the fact that related parties engage in transactions that rarely take place between independents. The synergies that exist in a related group, he said, "are the reason why multinational enterprises exist and oftentimes can operate more efficiently than unrelated parties can."*

### **Subjective Determination**

**BNA:** The BEPS report says there is a growing perception that governments lose substantial corporate tax revenue because of companies moving profits to jurisdictions where they are taxed at lower rates, and expenses to where they are relieved at higher rates (21 *Transfer Pricing Report* 1025, 2/21/13).

Is this an accurate perception?

**ERNICK:** That's a difficult question to answer; the answer really depends upon your point of view. The first part of the BEPS report takes a look at the available data to try to determine if BEPS is really a problem, and if so what is the magnitude. But their conclusion is that the data do not support a solid conclusion that BEPS is widespread.

It also depends on how you define BEPS. It's important to note that BEPS is intimately tied together with the idea that there is tax competition among countries to attract business, and it's hard to separate the two. That is, you could think about base erosion as occurring because of loopholes that were not intended. But there certainly are also tax incentives that are intentionally created which are a cause of BEPS.

**BNA:** According to the BEPS report, it is difficult to reach solid conclusions about how much BEPS actually occurs, although there is abundant circumstantial evidence that BEPS behaviors are widespread. The report continues that there are several studies and data indicating that there is increased segregation between the location where actual business activities and investment take place and the location where profits are reported for tax purposes.

Does the problem of base erosion and profit shifting actually exist?

**ERNICK:** Whether there is a problem comes back to the question of whether you believe the results that can occur when the rules of any international tax system are followed are intended or unintended. And that's always going to be a very subjective determination.

Some commentators believe that the U.S. international tax system is riddled with loopholes that were not intended to allow base erosion. Others would point out that the United States has the highest corporate tax rate among OECD countries and a worldwide system of taxation, and that the only way that can be maintained in a world where the clear trend is toward much lower rates and a territorial system is with relief valves that al-

low the base to be narrowed. Some would say the rules were designed to be porous.

But in the end, it probably doesn't matter whether BEPS actually exists. The report refers to stories in the popular press and concludes that there is a growing perception that governments lose substantial corporate tax revenue because of BEPS. To the extent there is that perception, the OECD will have to act to produce a report that addresses those concerns.

### Intellectual Property

**BNA:** Have the domestic rules for international taxation and internationally agreed standards, including the transfer pricing rules, kept pace with the changing global business environment characterized by the increasing importance of intellectual property as a value driver?

**ERNICK:** Certainly the international tax rules have been changing significantly in recent years in response to changes in the global economy. We've seen that in the U.S. with all the changes in the past decade in our international tax rules, and in the work that the OECD and member countries have been doing in that same time period. But no matter where we are now, the rules can never be static; there will always need to be changes and a tension around whether or not that occurs fast enough.

### Arm's Length an 'Easy Target'

**BNA:** Some nongovernmental organizations have faulted the arm's-length principle. Can you comment on their criticisms?

**ERNICK:** I think the arm's-length standard is an easy target, but some of the recent criticisms seem rather facile. A lot of weight is placed on the arm's-length standard in our international tax system, and I think in most cases it works well. But there will always be individual examples where it doesn't seem to work so well, especially if you don't do a close examination of all the relevant facts and circumstances.

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**"It's easy to take potshots" at the arm's-length standard "and point out how badly it works in some cases, but the relevant question is always, 'compared to what?' "**

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No one claims that the arm's-length standard works perfectly in practice. But if you want to allocate taxable income of a group among its related entities in a way that aligns with economic income, you really have to price things, to value things. That's not easy, especially for intangibles. There are really no good proxies for economic income you could look to try to shortcut that process.

The common analogy is to reference the Churchill quote regarding democracy as a form of government. He said something to the effect that, 'Many forms of government have been tried, and will be tried in this world of sin and woe, and no one pretends that democracy is perfect, it's actually the worst form of

government—except all those other forms that have been tried from time to time.'

I think that about sums it up when you consider the arm's-length standard as a basis for a transfer pricing system. It's easy to take potshots and point out how badly it works in some cases, but the relevant question is always, 'compared to what?' No one seems to have put forth a credible alternative that would work better.

### Status Quo

**BNA:** OECD officials have said that given the enormous political pressure exerted by the Committee on Fiscal Affairs and the Group of 20, the status quo is not an option (21 *Transfer Pricing Report* 1023, 2/21/13).

What kinds of proposals do you expect to see from the OECD in June? Are they likely to abandon some of the traditional approaches?

**ERNICK:** I don't think there will be radical changes. I don't think fundamental international standards will be abandoned, especially not in such a short time frame; the OECD has made that clear. It will be difficult to get consensus among member countries so quickly. That might affect the level of detail in the next report; it may be more general and just try to give some sense of the direction the work may go in.

There are a range of options the OECD could recommend, but there is really nothing new under the sun; what has been done before will be done again. On several of the issues, like permanent establishment, transfer pricing, and issues related to e-commerce and the digital economy, the OECD has already done significant work at the working party level on exactly the same concerns over the past decade.

Now the issues are being examined again as part of the BEPS project. Will the same conclusions be reached? What has changed so quickly that would justify different conclusions? You would think the earlier work would be instructive, but there are now obviously political pressures and revenue concerns that weren't as acute earlier.

But it's clear that the OECD believes no action is not an option. They can't just say the existing rules are fine and walk away. I think the usual OECD process will be followed, with drafts and an opportunity to comment, although in a much more compressed time frame, and that's good to allow contribution from all stakeholders.

As for actual substantive changes, there doesn't seem to be any appetite for a fundamental reallocation of taxing rights between source and residence countries. But even though it's not a goal, increased source taxation may be a result of any changes, in the sense that the project may reduce incentives to reduce income from source countries.

On e-commerce and digital goods, the OECD has looked at this issue before, in the e-commerce project; it seems clear that there should not be different rules for this sector.

### Hybrid Arrangements

**BNA:** How about proposals on hybrid mismatch arrangements and arbitrage? Are proposals likely in this area?

**ERNICK:** It's not clear on what to do here.

Hybrid mismatch arrangements and arbitrage can be viewed as the normal consequences of differences in domestic law, and may be deliberate in some circum-

stances. Differences among national laws are inevitable in the absence of a harmonized system of worldwide taxation. These include differences of characterization that result in hybrid entities or instruments.

Harmonizing might be appealing, but I think experience shows that there would be complex design and coordination issues if you tried to counter the effect of hybrid mismatches. You could have multilateral coordination driven through the treaty system, but that would be difficult. And anti-mismatch rules may be overbroad and result in double taxation.

### Permanent Establishments

**BNA:** What about changing the PE rules?

**ERNICK:** Its unlikely that agreement could be reached to change the PE threshold.

In any event, the real concern seems to be situations where there is no permanent establishment, but the income earned is also not subject to tax elsewhere.

If you do away with the PE threshold and just start taxing on the basis of sales into a jurisdiction with no further nexus, then that doesn't look like an income tax, it starts to look like a sales or consumption tax.

Even if you change the PE standard, you still have the difficult issue of how much profit to attribute.

### Limitation on Benefits

**BNA:** What about anti-avoidance measures?

**ERNICK:** A general anti-abuse rule might not be the best solution. It would be better to go with modifications to limitation on benefits provisions or beneficial ownership rules. A lot of countries don't even have LOB provisions in their treaties.

**BNA:** Would increased transparency address the BEPS problem?

**ERNICK:** I don't think country-by-country reporting is the answer; however well that may work as an anti-corruption measure, it has very limited usefulness in addressing transfer pricing problems or base erosion concerns.

### BEPS Trajectory

**BNA:** Where do you think the BEPS project is going?

**ERNICK:** The work of the OECD in the tax and development area may give clues as to where this may be going.

One possibility is increased use of withholding taxes. But this may not be a good idea because withholding taxes are generally a barrier to trade and investment.

Note also that the foundational documents of the European Union require the member countries to eliminate withholding tax on related-party interest, royalties, and dividends.

In terms of transfer pricing, the OECD has said they want to protect the consensus around the arm's-length standard, but it needs to be improved in order to be maintained as the international standard, and that formulary apportionment is not the answer (21 *Transfer Pricing Report* 1098, 3/21/13).

Maybe more attention could be paid to the economic substance rules. Some countries would certainly like to make it easier to recharacterize transactions. But that doesn't seem to be a good solution—it's better to deal

with transfer pricing problems through pricing adjustments.

Some countries would also certainly like to move away from the principle in Article 9 that you can allocate risk among entities by contract, and move more towards the Article 7 principle that significant people functions are determinative in allocating profits.

We started down that road at the beginning of the business restructurings project, but quickly realized that that way madness lies. I would shun that approach; it won't be productive. And that's an area where you may want to be careful what you wish for, as the result could very well be to create an incentive to move people and jobs offshore to low-tax jurisdictions.

It's important to note that the request comes from the G-20, so the OECD must find a way to address the concerns of both OECD countries—generally, advanced, developed economies—as well as the non-OECD countries, such as the BRICs. Also, some potential solutions—like changes to CFC rules or withholding taxes—may be limited by constraints imposed by EU rules. It's a very challenging assignment, with not a lot of time to reconcile all the competing interests.

### Holistic Approach

**BNA:** Do you agree that a holistic approach is needed to address the issue of BEPS?

**ERNICK:** Yes, I don't think you can address these issues piece by piece; it has to be a comprehensive analysis.

**BNA:** Should such a holistic approach address the balance between source and residence taxation?

**ERNICK:** I think it's clear that that's not what this project is about. The fundamental concern revolves around issues of double non-taxation. And some countries are not really clear on whether they are a source or a residence country, and that can change over time anyway. I don't know that you'd want to lock yourself into favoring one over the other.

**BNA:** In addition to transfer pricing rules, should such a holistic approach address the tax treatment of intragroup financial transactions, and the implementation of anti-abuse provisions, including CFC legislation?

**ERNICK:** CFC rules will be examined; they've always been considered to be a backstop to the transfer pricing rules. Rules regarding limitations on deductibility of interest will also be examined, to address concerns around narrowing the base. And anti-abuse provisions will be considered, although those are hard to design without being very blunt and subjective.

### OECD-BIAC Meeting

**BNA:** Does it not behoove business to agree to some fixes in order to avoid the specter of unilateral action by some countries?

**ERNICK:** Well, it's not really a negotiation.

I can't speak for business in general, or really for anyone else, so these are just my own personal opinions, but I think business will follow whatever rules are promulgated.

My impression from the OECD-BIAC [OECD's Business and Industry Advisory Committee] meeting I attended last month is that business is very engaged on this project and wants to offer constructive solutions.



Business supports the work and believes that the OECD is the best organization to analyze these issues; it's got deep technical expertise. It's also good at building consensus around solutions.

I think the main concern business has revolves around certainty and uniformity, and that's probably more important than what the actual changes may be. Business wants to know what the rules are, in objective terms, and to have confidence that the same rules will apply across all the jurisdictions in which they operate.

### Dispute Resolution

**BNA:** What fixes to the arm's-length standard could business stomach in order to save it?

**ERNICK:** I really can't speculate; I think any proposed changes would have to be seen first to be evaluated. And there would likely not be a monolithic view; different industry sectors would have different concerns.

One area of agreement in transfer pricing, however, involves the resolution of disputes through the mutual agreement procedure process. There seems to be an across-the-board view that the process needs improvement. Whatever the rules are, when disputes inevitably arise, there should be a timely, efficient mechanism for resolving them. More widespread adoption of mandatory binding arbitration clauses in tax treaties would be welcome.

**BNA:** Does business believe that the current international tax rules work?

**ERNICK:** I can't speak for business in general, but my impression is that business has the same impression that tax administrations do: some things work well, some things need improvement. And certainly there is the thought that if you look at the system as a whole, no one in their right mind would have set out to design a system like the current one.

There is also the view that if tax reform is done right, including reform of the international tax rules, everyone can be better off. But broadening the base is really only one component of tax reform.

### Transfer Pricing

**BNA:** The BEPS report lists six key pressure areas, including transfer pricing. Transfer pricing is listed in the context of 'the shifting of risks and intangibles, the artificial splitting of ownership of assets between legal entities within a group, and transactions between such entities that would rarely take place between independents.'

Should the OECD transfer pricing guidelines be changed to address these issues?

**ERNICK:** Even before the BEPS project started, Working Party 6 was already examining these very same issues, in the context of the work on Chapter 6 of the transfer pricing guidelines on intangibles, and had looked at them as well in the context of business restructurings and the addition of new Chapter 9.

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But I don't know what it means to refer to the 'artificial' splitting of ownership of assets between legal entities within a group. Is there an entity that should always own assets in a group? Is that the parent? As long as you respect separate legal entities, you have to allow for transfers of assets among entities, and there is no objective standard regarding where they should be.

Similarly, I'm not following the concern around transactions between such entities that would rarely take place between independents. Related parties can and do engage in transactions that unrelated parties could not or would not, and there is nothing inherently wrong with that. Indeed, some would say that the synergies arising from those types of transactions are the reason why multinational enterprises exist and can often times operate more efficiently than unrelated parties can. A family, operating with common interests and goals, will generally work together better than a group of individuals with no common bond.

But the goal of the arm's-length standard is not to require related parties to replicate the transactions that unrelated parties would, or to mimic their behavior. It is to replicate the pricing that would have been reached if those transactions, whatever they are, as long as they have economic substance, had been engaged in by unrelated parties dealing with each other at arm's length.

### Valuing Risks and Intangibles

**BNA:** In your view, are there specific areas where the current guidelines produce undesirable results from a policy perspective?

**ERNICK:** You can't point to a particular section of the guidelines as producing undesirable results. The key pressure point seems to be, applying the guidance in the transfer pricing guidelines, can you accurately value risks and intangibles? Those things are inherently difficult to price and very mobile, and they can attract a lot of profits. But I can't see how there are any shortcuts around those difficulties.

**BNA:** Do the current OECD transfer pricing guidelines place too much emphasis on contractual risk allocations rather than the underlying reality of an economically integrated group?

**ERNICK:** I don't think so. In the real world, risk is allocated by contract, and those allocations have meaning. And assuming and bearing risk is rewarded. The underlying difficulty is really about pricing risk, and I think any potential solutions have to focus on that aspect, not on trying to reallocate risk.

### Article 9

**BNA:** Should Article 9 of the OECD Model Tax Treaty be changed?

**ERNICK:** No, at least not until someone comes up with something better.

Even if you wanted to, the arm's-length standard is already enshrined in both the OECD and United Nations Model Tax Conventions, and thousands of bilateral tax conventions.

It's also an obligation under the World Trade Organization rules.

In a sense, we've really passed the point of no return; it's not realistic to think about transitioning to another standard.

### Controlled Foreign Corporations

**BNA:** Do you think the answer to base erosion is more comprehensive rules on CFCs rather than a major overhaul of the OECD transfer pricing guidelines?

**ERNICK:** I don't expect a major overhaul of the transfer pricing guidelines. And as I noted before, CFC rules have always existed to backstop the transfer pricing rules, so it's natural that modifications to those rules may be considered.

That's definitely the way the U.S. has been going recently, with the introduction of the excess returns proposal. But if you go down that route, there is always going to be the trade-off between administrability and overbreadth. Bright line rules are easier to administer, but by definition, they don't allow tailoring to individual facts and circumstances.

**BNA:** What is the current attitude of OECD members towards the idea of enacting stricter CFC rules?

**ERNICK:** It doesn't really solve your problem if you don't have a company from your country at the top of the org chart.

CFC rules will be examined, but will not be a good solution for all countries.

### 'Substantive Operations'

**BNA:** Should the OECD guidelines be changed so that the share of profits associated with substantive operations may not be reduced?

**ERNICK:** It's hard to see how that would be done.

What is meant by 'substantive operations?' If that means operations where significant people functions are performed, then that gets back to the whole debate about whether risks should be rewarded or whether, alternatively, people functions and headcount are determinative.

I don't think importing the Article 7 analysis into Article 9 will solve the problem.

### Action Plan

**BNA:** Work on the BEPS project was recently organized into three clusters—base erosion, jurisdiction to tax, and transfer pricing. The cluster groups are developing an action plan that will be sent to the CFA in June for their approval. Once approved, the action plan will be released for public comment. The BEPS project is on the fast track. What will happen after June?

**ERNICK:** Then the action plan will go to the G-20, and then I think a 12- to 18-month period for further work is contemplated.

As I said, I think the June report will be pretty general; it would have to be a non-consensus document to go into a lot of specifics. That may be possible, since it's

not a final document. But a lot of work will still remain for the OECD after the action plan is released.

**BNA:** Are any areas identified in the BEPS report more susceptible to quick resolution?

**ERNICK:** It's hard to identify issues that can be resolved quickly; these are all difficult issues that people have thought about for a long time.

The only areas where things could be resolved quickly would be the areas where it was agreed not to make any changes, which might be in areas like the PE threshold and changes specifically for the digital economy and e-commerce. But even there, I don't think there will be agreement not to do anything by June; people will still want to at least consider the issue more.

### BRICS

**BNA:** Are the countries of Brazil, Russia, India, China, and South Africa playing an active role in shaping the direction of the BEPS project?

**ERNICK:** I don't have any specific information as to the role of the BRICS countries in this project. The OECD has been making a big effort in general to include them in its work, to try to encourage greater acceptance of it.

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### "I think the interests of developed and developing countries are aligned with respect to transfer pricing issues."

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The request to examine BEPS issues came from the G-20, which includes several non-OECD member countries. So I'm sure that the BRICS countries are involved in the project and that there is a strong effort by the OECD to take account of their views.

**BNA:** How do the perspectives of the OECD members and the developing countries differ on how the arm's-length standard should be improved?

**ERNICK:** Some of the developing countries have obviously said that they believe the guidelines and the arm's-length standard favor developed over developing countries, and that's why the effort was begun at the UN a few years ago to develop a practical manual on transfer pricing for developing countries.

I really don't see it; I think the interests of developed and developing countries are aligned with respect to transfer pricing issues. The real concern is regarding countries with real tax systems versus those with no or very low taxation.

Developing countries also place more emphasis on risk assessment and capacity building in transfer pricing. Improvements in administration of transfer pricing rules would help them a great deal.

Some developing countries are in favor of more emphasis on, and reward to, people functions, as opposed to intangibles or risk bearing. There are also some developed countries that share that view.

**BNA:** Developing countries have taken the position that profits should be taxed where profit-generating activities are carried out, whereas OECD members give greater emphasis to the importance of intangibles in

creating value. How can these two positions be reconciled?

**ERNICK:** I think some OECD member countries would share the view that where the functions are being performed should be determinative. But I don't think either one should be over-emphasized. Intan-

gibles can carry significant value, but so can functions being performed by people. It's always going to come down to a difficult question of how to price those activities and those intangibles at the prices that would have obtained in the open market.