Base Erosion, Profit Shifting And the Future of the Corporate Income Tax

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INTRODUCTION

The Organisation for Economic Co-operation and Development (OECD) is an international economic organization, currently comprised of 34 member countries, whose mission is to stimulate economic growth and world trade, thus improving the economic and social well-being of people across the globe. Founded in 1961, the OECD traces its roots back to the Organisation for European Economic Cooperation, which was designed to administer the Marshall Plan for the recovery of European economies after World War II. By recognizing and taking advantage of the interdependence of their economies, the OECD helps member countries achieve mutual gains from mutual cooperation in economic matters.

Ultimate decision-making authority at the OECD rests with a “Council,” which provides oversight and strategic direction for the OECD. The Council includes one representative from each member country, as well as from the European Commission. Meetings of the Council are chaired by the OECD Secretary-General, and decisions are made on a consensus basis.

Representatives of OECD member countries (along with representatives from countries with “Observer” status) meet in specialized committees to discuss and implement new ideas across a broad range of subjects, including economics, trade, science, employment, education and financial markets. Currently, there are approximately 250 committees, working groups and expert groups.

The work prescribed by the Council is carried out by the Secretariat, which is headquartered in Paris and consists of approximately 2,500 professionals, including economists, lawyers, scientists and other specialists. The Secretariat supports the activities of the committees.

The OECD’s work on tax matters is conducted within the Committee on Fiscal Affairs (CFA), and covers the full panoply of domestic and international tax issues. The CFA is assisted in its work by the Centre for Tax Policy and Administration, which provides technical expertise and support. Unlike the role of the World Trade Organization in setting binding rules in the trade area and imposing sanctions for violations of those rules, the OECD has no enforcement powers

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with respect to tax rules; it is primarily a standard-setting organization, promulgating guidelines and best practices that become implemented through domestic legislation or treaties only to the extent they are persuasive. Nonetheless, the CFA has been quite influential with respect to tax issues. The OECD Model Tax Convention on Income and Capital (the Model Tax Convention) has become the foundation for a broad network of tax treaties across the world, and the OECD Transfer Pricing Guidelines (Guidelines) have become the model for domestic transfer pricing legislation in all OECD countries and in most non-OECD economies. Although the CFA’s work is conducted by the Secretariat and government officials from member countries, input from other stakeholders is solicited at regular meetings with representatives from business, trade unions and non-governmental organizations. Standing committees for input from business and labor consist of the Business and Industry Advisory Committee (BIAC) and the Trade Union Advisory Committee (TUAC), respectively. Input is also generally sought through publication of discussion drafts on the OECD website and open requests for comments.

The mandate of the CFA recognizes the importance of coordinating rules of taxation in a world of economic interconnectedness and increasing globalization, and the threat to cross-border investment posed by the possibility of double taxation — where returns on investment are taxed twice, both in the country of investment (source) and in the country of residence of the investor. Similarly, the OECD Model Tax Convention helps avoid the specter of double taxation by establishing clear rules for taxing income and capital, and by providing rules for allocating taxing rights between residence and source countries, with residence countries generally being responsible for eliminating double taxation in cases of competing taxing rights. Likewise, the Transfer Pricing Guidelines recognize the threat of economic double taxation that may arise from disputes between tax administrations regarding the determination of arm’s-length pricing for cross-border transactions between associated enterprises.

Thus, with that goal in mind, for a number of years the CFA has conducted important work and issued significant guidance in all major areas of taxation, with a particularly prolific output over the past decade. The Model Tax Convention was most recently updated in 2010, with the next update scheduled for 2014. It is constantly reviewed to reflect new thinking and recent developments. A number of issues have been under examination recently, including clarifications to the permanent establishment concept (Article 5), issues of interpretation of the “beneficial owner” concept under Articles 10, 11 and 12, and possible improvements to the mutual agreement procedure (Article 25).

Similarly, in the area of taxation of multinational enterprises, the Transfer Pricing Guidelines are continuously reviewed and updated. New guidance on comparability and profit methods resulted in major revisions to Chapters I-III of the Guidelines in 2010. Work on providing guidance for the transfer pricing issues surrounding business restructurings began in 2005 and ultimately led to the addition of new Chapter IX, covering transfer pricing issues related to business restructurings, to the Guidelines in 2010. A multi-year project resulted in 2008 in a report providing guidance on the attribution of profits to permanent establishments. In 2011, work began on an examination of the transfer pricing aspects of intangibles, as well as an important project to simplify the substantive transfer pricing rules and administrative practices. Recognizing that transfer pricing has become a global issue, in 2012 the OECD organized its first annual meeting of the new Global Forum on Transfer Pricing, which brought together transfer pricing experts from almost 90 countries. Additionally, the OECD examined the transfer pricing and permanent establishment issues surrounding the emergence of new business models enabled by the widespread practice of doing business over the Internet ("electronic commerce," or "e-commerce") in its final report in 2002 titled “Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce?”

Recognizing that globalization and the liberalization of cross-border investment pose significant problems for tax administrations acting by themselves, the OECD has also conducted significant work on international tax cooperation. Work in this area includes the Harmful Tax Practices Project, which was begun in 1998 to promote standards to encourage an environment where fair tax competition can take place. This work resulted in the formulation of standards on transparency and exchange of information, as well as annual assessments of progress regarding implementation of the standards. Important work has also been done to fight aggressive tax planning and corruption, to increase cooperation between tax and anti-money laundering authorities, and to facilitate tax collection assistance.

1 Resolution of the Council on the Mandate of the Committee on Fiscal Affairs [C(2008)147 and C(M/2008)20, item 285](1)(b)(2) (The CFA shall “promote communication between countries and the adoption of appropriate policies to prevent international double taxation and to counteract tax avoidance and evasion.”).

2 Recommendation of the Council on the determination of transfer pricing between associated enterprises [C(95)126/Final] (noting “the fundamental need for co-operation among tax administrations in order to remove the obstacles that international double taxation presents to the free movement of goods, services and capital between Member countries”).
The OECD’s work on aggressive tax planning aims to help tax authorities identify and respond to tax risks, and to share country experiences and responses in dealing with aggressive tax planning. The goal is to enable countries to identify new schemes more quickly, and to provide countries with the tools to modify their risk management strategies and develop successful legislative or administrative countermeasures. The Aggressive Tax Planning Directory collects information on such schemes, how they were identified, and the responses from government. Recent projects in this area have provided significant guidance on a range of issues, including reports on Addressing Tax Risks Involving Bank Losses (2010), Tackling Aggressive Tax Planning through Improved Transparency and Disclosure (2011), Corporate Loss Utilisation through Aggressive Tax Planning (2011), and Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues (2012).

For a number of years, then, the OECD has been thoughtfully addressing all of the most important tax issues of the day, with a focus on increasing cross-border trade and investment through minimization of double taxation, but also working to prevent tax evasion and tax planning that is deemed inappropriate. In the aftermath of the 2008 financial crisis and the 2010–2012 Eurozone sovereign debt crisis, however, there is increasing concern that governments are losing substantial corporate tax revenue because of sophisticated tax planning aimed at shifting income to low-tax jurisdictions. The issue has become highly politicized, and as budgets for social services are cut and austerity measures contemplated, non-governmental organizations and the mainstream media have reacted to complex tax issues through sound bites and demagoguery, attacking (without defining) “aggressive” tax planning, demanding (without defining) that all multinationals pay their “fair share” of taxes, and accusing multinationals of tax planning that is “immoral,” while acknowledging its legality. There have been few accusations that multinationals do anything other than legally reduce their taxes within the rules set out in every country in which they do business. That, however, is exactly the point to some observers; questions have been raised regarding whether the existing tax rules, designed in an era of lower economic integration and characterized by more reliance on fixed assets and equipment, have kept pace with a rapidly globalizing economy characterized by a high degree of economic integration, global supply chains, a greater ease of doing business across borders without physical presence through e-commerce, and increasing reliance on intangibles and services as value drivers.

### BASE EROSION AND PROFIT SHIFTING

#### Background and Context of OECD BEPS Project

Against this background, in 2012 the OECD began a comprehensive project to address the relevant tax issues and to design new rules to prevent “base erosion and profit shifting.” The G20 group of finance ministers and central bank governors from the 19 most developed countries plus the European Union (EU) has been a firm supporter of the work, stating in their Leader Declaration of June 9, 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.”). The G20 again noted its support for the OECD work in November 2012, and on November 20, 2012, the OECD announced that it would provide a progress report in the beginning of 2013, addressing whether the existing tax rules have kept pace with changes in the economy, “particularly when applied to the increasingly digital economy, or whether there is a need for different solutions.”

The OECD took its first step to address these issues on February 14, 2013, with the release of a 90-page report, Addressing Base Erosion and Profit Shifting (February BEPS Report). The report is a comprehensive evaluation of the existing international tax rules. It considers base erosion and profit shifting (BEPS) to be a “serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike.” The report begins by analyzing the data and studies available regarding the existence and magnitude of BEPS. Interestingly, the OECD concludes that with the data that is currently available, “it

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3 Final Communiqué of G20 Finance Ministers Meeting, Nov. 5–6, 2012, Mexico City (“...We also welcome the work that the OECD is undertaking into the problem of base erosion and profit shifting and look forward to a report about progress at our next meeting.”) A Nov. 5, 2012 joint statement from the United Kingdom, Germany, and France also urged the G20 to support the OECD work on BEPS.

4 Base erosion and profit shifting has become the issue of the day in international tax circles; in addition to the OECD work, a host of other actors have also instituted projects to address similar issues. See, e.g., the EU Action Plan on Tax Evasion and Avoidance, the UK Public Accounts Committee Report on Taxation of MNEs, the French Report on Taxation of the Digital Economy, the BRICS’ Communiqué on Prevention of Cross-Border Tax Evasion and Avoidance, and the Australian specialist Reference Group on Taxation of MNEs. In the U.S., the President’s Framework for Business Tax Reform echoes similar themes (noting that “income-shifting behavior by multinational corporations is a significant concern that should be addressed through tax reform.”).
is difficult to reach solid conclusions about how much BEPS actually occurs.”

After addressing the available studies and data, the February BEPS Report then describes recent changes in the economy and the impact they have had on global business models, as well as the influence of tax competition on corporate taxation. The report provides an overview of the key principles underlying the taxation of cross-border activities, as well as the opportunities for BEPS that these principles create. The report also includes an analysis of several corporate structures the OECD views as highlighting a number of corporate tax planning opportunities that present opportunities for BEPS, even though they are in compliance with existing laws. The report notes that there is a need to re-address the balance between source and residence taxation, and concludes by promising to develop an “action plan” to address what it views as the six “key pressure areas”:

- International mismatches in entity and instrument characterization including, hybrid mismatch arrangements and arbitration;
- Application of treaty concepts to profits derived from the delivery of digital goods and services;
- The tax treatment of related-party debt-financing, captive insurance and other intra-group financial transactions;
- Transfer pricing, in particular in relation to 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;
- The effectiveness of anti-avoidance measures, in particular GAARs, CFC regimes, thin capitalization rules and rules to prevent tax treaty abuse; and
- The availability of harmful preferential regimes.

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5 The report nonetheless also claims that “it is evident from a number of indicators that BEPS is indeed taking place, and it poses a threat in terms of tax sovereignty and of tax revenue.” February BEPS Report at 47.

6 Although the OECD has regularly stated publicly that the BEPS project is not a “[U.S.] business bashing exercise,” any doubts that the project is animated by concerns over tax planning engaged in by U.S. multinationals are erased by the examples provided in Annex C, which borrows heavily from the 2010 Joint Committee on Taxation Transfer Pricing report.


OECD Action Plan on BEPS

The highly anticipated Action Plan on Base Erosion and Profit Shifting (Action Plan) was released on July 19, 2013. The Action Plan begins by noting the many ways in which globalization has benefited national economies, and the salutary effects it has had in creating jobs, fostering innovation, and reducing poverty. However, immediately thereafter the Action Plan notes that corporations have also become more globally integrated, and it asserts that multinationals which have engaged in acceptable tax planning under the existing rules have harmed governments, individual taxpayers and businesses by “minimizing” their tax burdens. The Action Plan notes, somewhat inconsistently, both that it is “much easier for businesses to locate many productive activities in geographic locations that are distant from the physical location of their customers” (presumably the productive activities are located in low tax jurisdictions) and that businesses “reduce their tax burden by shifting their income away from jurisdictions where income producing activities are conducted . . .”

The Action Plan proposes a timeline for the work to be completed that can best be described as ambitious. It states that governments need time to complete the required technical work and achieve consensus, yet also states that rapid progress will be made. It sets out a two-year time frame in which it is contemplated that most of the work described in the Action Plan will be completed.

The OECD will continue its consensus-based approach in conducting the BEPS work. Interested G20 countries that are not OECD members are invited to participate in the project as “Associates,” meaning they participate on an equal footing with OECD member countries, in return for which they are expected to associate themselves with the final conclusions reached.

The technical work will be done by the “subsidiary bodies” of the CFA (the working parties, which are below the CFA and which have traditionally performed the technical work in their areas of expertise, which is then generally submitted to the CFA for approval). OECD working parties generally meet two or three times per year at regular intervals; however, be-
cause the BEPS work is expected to be completed so quickly, new ways to find consensus are envisaged, including through the use of subgroups of working party delegates working remotely to develop solutions which will then be sent to the full working parties for approval. Consultation with non-governmental representatives is also contemplated, including with business and civil society representatives, although the “high-level policy dialogue” with commentators will only occur on an annual basis.

The Action Plan continues the themes expressed in the February report. It notes that the “digital economy” (an undefined term) poses particularly challenging issues for international taxation, and that there are fundamental questions regarding how enterprises “add value” in the digital economy. The plan makes repeated references to determining the jurisdiction where value is created. The Action Plan also refers to “frictions” caused by the interaction of different tax systems as leading to potential double taxation, but makes clear that the “gaps” which lead to corporate income being not taxed at all or only “unduly low taxable” are the more pernicious problem. The need for consensus is stressed, without which there is a danger of countries enacting unilateral measures “which could lead to global tax chaos marked by the massive re-emergence of double taxation.” In contrast to the February BEPS Report, the Action Plan disclaims any intent to alter the balance between source versus residence taxation. The goal of the Action Plan is to “better align rights to tax with economic activity.” The Action Plan does not contemplate incremental changes, but rather makes reference to “fundamental changes” and “new international standards.”

Actions to Address Challenges of Digital Economy

Whereas the February BEPS Report made reference to six “key pressure areas,” the Action Plan now divides the proposed work into 15 separate items. Action 1 will address the challenges posed by the digital economy. A dedicated task force will be created to review business models and identify the relevant issues and options. The scope of the work will include permanent establishment issues, attribution of profits, character of income and sourcing rules.

The work on Action 1 obviously is similar in scope to the 1997–2002 OECD e-commerce project. The conclusion reached there was essentially that the existing international tax rules could be adapted to fit changing business models enabled by electronic commerce. Representatives from the U.S. Treasury Department have stated publicly that there is no need for a separate, parallel set of tax rules governing transactions in the digital economy, however that would be defined. The fact that indirect taxation measures will be considered suggests that resolution of the perceived challenges of the digital economy may be achieved through more effective collection of VAT/GST on the cross-border provision of digital goods or services.

Actions to Promote International Coherence of Corporate Income Taxation

The next four action items are grouped under the heading, “Establishing international coherence of corporate income taxation.” Action 2 will involve further work for the development of instruments to neutralize the effects of hybrid mismatch arrangements. The OECD views hybrid mismatch arrangements as problematic because they can be used to achieve unintended double non-taxation by, for example, creating two deductions for only one borrowing, creating a deduction without a corresponding income inclusion, or misusing foreign tax credit and participation exemption regimes. Interestingly, long-term tax deferral

12 Id. at 11.
13 Id.
14 The references to “add value” rather than “create income” are curious, but surely are influenced by the French Report on Taxation of the Digital Economy, as is the discussion of the digital economy being characterized by “the massive use of data (notably personal data)” and “multi-sided business models capturing value from externalities generated by free products.” Action Plan at 10. A July 19, 2013 post on the “OECD Insights” blog continues the attempt to lay the groundwork for the French views on appropriate taxation principles for the digital economy, describing examples such as printing your own airline boarding pass or uploading a video to the Internet as “working for nothing” and “obviously boosting the profits of the companies involved. See http://insightsblog.oecdcode.org/?p=5867. Surfing the Web has thus gone from being merely an addictive time sink to a form of unpaid labor.
16 Id. at 10–11.
17 Id. at 11.
18 Id. at 13.
21 “Double non-taxation” and “stateless income” are terms used by the OECD and others to suggest that some corporate income inappropriately escapes all taxation. That of course ignores the fact that, at least for tax systems which are not fully integrated, as in the U.S., corporate income will generally be taxed at least once at the shareholder level, under the income tax, and perhaps a second time, with an estate tax upon the shareholder’s death. “Less than triple taxation” may be a more accurate characterization.
is now also considered problematic, at least where it results from use of hybrid mismatch arrangements.

The work to combat hybrid mismatch arrangements will involve development of model treaty provisions and recommendations for domestic legislation to neutralize the effect of both hybrid instruments and entities. Because the OECD recognizes that treaty changes could at most only result in denial of withholding tax relief and not, for example, denial of a deduction for interest, changes to domestic law are also envisaged. This could include changes to (1) prevent exemption or non-recognition of payments that are deductible in the payor’s jurisdiction, (2) deny deductions for payments not includible in income, and (3) prevent double deductions. Also contemplated are coordination and tie-breaker rules where more than one country seeks to apply those rules to a transaction or structure.

This action item is obviously one of the most political and emotionally charged; the OECD has made it clear that so-called “stateless income” is unacceptable and is one of the primary targets of the BEPS project. But this is an issue where the “optics” of the problem (multinationals’ ability to structure transactions and internal value chains to achieve “stateless income”) may be bigger than any actual substantive problem. For example, from the U.S. perspective, once a decision has been made to exclude an item from the tax base or provide an exemption or to treat an entity or an instrument a certain way, the U.S. should not care whether another country taxes that item of income or how it treats an entity or instrument.

Moreover, countries are generally very protective of their sovereignty over the design of tax rules and, absent harmonization of those rules across the globe, differences in domestic legislation (including characterization of instruments or entities) are inevitable. It may be a reasonable goal to harmonize the characterization of instruments and entities, but it would require inordinately difficult design and coordination efforts to do so. Correspondingly, application of anti-mismatch rules may result in double taxation, especially where their operation is uncertain, where they are overbroad, or where different countries use different rules.

This is a complex issue and also an area where the OECD has already done a significant amount of work. It will therefore be difficult to achieve rational improvements within one year for suggested changes to domestic rules and two years for proposed changes to the Model Tax Convention. Additionally, several tools are also already available to combat perceived abuses, such as Article 23A(4) of the OECD Model Tax Convention (which relieves the residence State of the obligation to provide relief from double taxation under the exemption method in certain cases) and paragraph 15 of the commentary to Article 1 (providing language for a subject-to-tax provision).

This is also an area where perhaps the need for action is animated by concerns over tax planning engaged in by U.S. multinationals under our check-the-box rule; however, there are differences in entity characterization in other tax systems as well. For example, in 1999 the OECD provided guidance to address common differences in the tax treatment of partnerships among member countries’ tax systems. Hybrid entities are not simply a problem caused solely by the U.S. check-the-box rules — although such rules make avoidance of the CFC rules easier, other countries with weak or non-existent CFC rules and territorial taxation systems do not have the moral high ground on this issue. Finally, this is a not-uncommon situation where member countries are asking the OECD to solve problems that they are capable of addressing with their own domestic rules.

Action 3 is the shortest item in the Action Plan and provides simply that the OECD will design modern controlled foreign corporation (CFC) rules. The Action Plan notes that CFC rules may have beneficial “spillover effects” in source countries (because taxpayers have no or reduced incentive to shift profits to low-tax jurisdictions), but it does not acknowledge restrictions faced by European countries because of European Court of Justice decisions.

Additionally, it will be difficult for the OECD to reach consensus on model CFC rules (each country would have different preferences as to how much it should limit deferral) and unclear why member countries cannot simply enact changes to their domestic rules on their own. Moreover, any proposal to tighten CFC rules should consider the potentially perverse incentives that may result. For example, the Obama administration has included in its budget proposal for the past several years a provision to tax currently existing returns associated with intangibles that have been

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23 Regs. §1.7701-3.


25 See, e.g., Internal Revenue Code §§267(a)(3) and 894(c).

26 See, e.g., Cadbury Schweppes plc v Inland Revenue Commissioners (Case C-196/04) [2006] (holding that the United Kingdom could not impose its CFC rules where U.K. groups had established their business in another European country, which would violate fundamental freedoms provision by establishing different treatment for domestic versus foreign investment).
transferred offshore. The proposal would provide that when a U.S. person transfers an intangible from the U.S. to a related CFC, then certain excess income from transactions connected with or benefiting from the covered intangible would be treated as subpart F income if such income is subject to a low foreign effective tax rate. No such excess income would be treated as subpart F income if the foreign effective tax rate is 15% or more; a partial exclusion from treatment as subpart F income would be provided on a sliding scale if the foreign effective tax rate is between 10 and 15%. For this purpose, excess intangible income would be defined as the excess of gross income from transactions connected with or benefiting from such covered intangible over the costs (excluding interest and taxes) properly allocated and apportioned to this income increased by a percentage mark-up.

The proposal is billed as reducing the incentives for U.S. taxpayers to transfer intangibles offshore to low-taxed affiliates, but a careful analysis of the proposal suggests that might not be the case. A foreign effective tax rate in a CFC of 15% or greater would prevent application of the proposal, and a 15% tax rate for offshore income is still better than the 35% statutory U.S. rate, so the provision may not stop transfers of intangibles offshore, but simply raise the price for doing so. One significant problem with the proposal is that, because it is a subpart F provision, it would apply to penalize only U.S.-parented multinationals. Further, the penalty it imposes would be to raise foreign, not U.S. taxes, because any U.S. company planning to avoid its provisions would generally seek to do so by raising its foreign effective tax rate to the 15% threshold. It is hard to justify creating such an incentive for increased foreign tax payments, unless it is a disguised form of foreign aid. And finally, although this is solely a subpart F provision, the questions it raises regarding the adequacy of and consistency with the arm’s-length standard as a basis for transfer pricing rules should not be ignored.

The fourth item on the Action Plan provides that the OECD will develop rules to limit base erosion via interest deductions and other financial payments. The work here will involve developing transfer pricing guidance for valuing financial transactions, including guarantees, derivatives, and captive and other insurance arrangements. It will also include recommendations regarding domestic law limitations on related and unrelated interest expense and economically equivalent payments, for both inbound and outbound investors.

The notion of addressing limitations on interest deductions through the transfer pricing rules is not new; the OECD did work in this area many years ago and has periodically contemplated updating that work from time to time. That could be difficult work, however; widespread variations of capital structure exist even among companies in the same industry, due to varying preferences regarding leverage and risk, and an “arm’s-length” range of debt could be so large as to not be meaningful. Similarly, determining an arm’s-length rate of interest could be problematic for those companies that have not received a credit rating from a recognized agency. Variations in loan structures and terms could also make interest rate determinations difficult.

For interest rate determinations, rather than trying to determine an arm’s-length rate, companies in the United States frequently elect to use the safe harbor “applicable Federal rate.” And rather than trying to determine an arm’s-length amount of debt to limit interest deductions, the U.S. has instead chosen to rely on the earning stripping rules of Section 163(j), which provide limitations based on a corporation’s debt-to-equity ratio and the ratio of interest deductions to taxable income. Those rules are much simpler to apply in practice than it would be to determine an arm’s-length interest rate; however, perhaps the reluctance of the OECD to use such formulaic rules to limit earnings stripping through related-party loans may be due to the concern that thin capitalization rules are consistent with treaty obligations only when they result in an arm’s-length allocation of profits among related parties.

Action 5 provides that the OECD will counter harmful tax practices more effectively, taking into account transparency and substance. The OECD has been doing work on harmful tax practices since 1998 and is concerned that so much of the tax base has become mobile that eventually rates on such income will be driven to zero. The OECD will review member country regimes, as well as develop a strategy to expand participation to non-OECD economies. It will work to require “substantial activity” for any preferential regime, as well as to include compulsory spontaneous exchange requirements on preferential regime rulings.

This action item is unique in the Action Plan in that it is motivated by concerns regarding actions of governments, not taxpayers. The description of this item also indicates that across-the-board corporate tax rate reductions on certain items of income, such as income arising from intangibles, is also suspect. Thus, the notion of harmful tax practices may be expanded to in-

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27 See Thin Capitalisation; Taxation of Entertainers, Artistes and Sportsmen, Issues in International Taxation, No. 2 (OECD, 1987).
28 Regs. §1.482-2(a)(2).
clude regimes which, although fully transparent and not ring-fenced, nevertheless are viewed as harmful because they do not require value-creating activities to take place within the jurisdiction. Given the increasing popularity of patent box regimes, it will be difficult to reach consensus to prohibit them. And this item may lead to a reexamination of the OECD’s position that a low rate is only one factor in determining whether a harmful tax regime exists, and is not by itself determinative; there may be an attempt to establish a minimum acceptable tax rate. It will be difficult to define what “substantial activity” will be required in order to qualify for any preferential regime, but this continues the theme throughout the Action Plan that actual people and the amount of important functions they perform in any location is important. Finally, the proposal to require the spontaneous exchange of preferential regime rulings is part of the idea of combating perceived abuses through increased disclosure.

**Actions to Adapt International Standards to Changes in Global Value Chains**

The next five items on the Action Plan are grouped under the heading, “Restoring the full effects and benefits of international standards.” The sixth action item deals with preventing treaty abuse. It is intended to clarify the policy behind tax treaties and the criteria for entering into them, to develop limitation on benefits provisions, and to develop recommendations for domestic rules to prevent inappropriate treaty benefits.

This is another area where the OECD sees double non-taxation as a primary concern. Yet the commentary to the OECD Model Tax Convention makes it clear that tax treaties are designed to eliminate double taxation:

> The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons. It is also a purpose of tax conventions to prevent tax avoidance and evasion.\(^{29}\)

It is not explicit that treaties should not enable double nontaxation, although that could possibly be covered by the reference to preventing tax avoidance.

The abuse of treaties the OECD has in mind involves the use of treaties by residents of third countries, not a party to the treaty, which are nonetheless eligible to receive benefits (such as reduced withholding rates) under the treaty. The work in this area will likely involve improvements to the existing options for preventing treaty abuse in the Commentary to Article 1, including provisions directing treaty partners to apply anti-abuse provisions of domestic law,\(^{30}\) subject-to-tax provisions,\(^{31}\) anti-conduit provisions,\(^{32}\) provisions aimed at entities benefiting from preferential tax regimes,\(^{33}\) provisions aimed at denying the benefits of the Convention with respect to income that is subject to low or no tax under a preferential tax regime,\(^{34}\) provisions that have the effect of denying the benefits of specific Articles of the convention that restrict source taxation where transactions have been entered into for the main purpose of obtaining these benefits,\(^{35}\) and provisions designed to protect a Contracting State from having to give treaty benefits with respect to income benefiting from a special regime for certain offshore income introduced after the signature of the treaty.\(^{36}\)

In observing the evolution of the BEPS project, it is interesting to note that the Action Plan makes no mention of enacting general anti-avoidance rules (GAARs). The February BEPS Report specifically mentioned using GAARs as one of the most effective anti-avoidance measures. Instead of utilizing GAARs, however, the U.S. favors (and consistently includes in its bilateral tax treaties) a strong limitation on benefits (LOB) clause, which generally prohibits third-country residents from obtaining treaty benefits, such as reduced withholding rates. For example, under such a clause, a foreign corporation would not be entitled to a reduced rate of withholding under the treaty unless it is able to demonstrate that a certain minimum percentage of its owners are citizens or residents of the U.S. or the treaty partner country. LOB provisions are effective and administrable; GAARs are generally subjective rules whose applicability may not be clear in many situations, leading to significant uncertainty in tax planning. For whatever reason, most countries other than the U.S. have not included strong LOB provisions in their treaties. Perhaps that explains the reason some countries had initially been in favor of using GAARs; it may be potentially much easier for a country to enact a GAAR than to renegotiate all of its bilateral tax treaties.\(^{37}\) The absence of proposed work on use of GAARs in the Action Plan, however, takes them off the table.

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\(^{29}\) Commentary to the OECD Model Tax Convention, Art. 1, ¶7.

\(^{30}\) Id. at ¶¶9–9.6.

\(^{31}\) Id. at ¶15.

\(^{32}\) Id. at ¶17.

\(^{33}\) Id. at ¶¶21–21.2.

\(^{34}\) Id. at ¶21.3.

\(^{35}\) Id. at ¶21.4.

\(^{36}\) Id. at ¶21.5.

\(^{37}\) The multilateral instrument to make changes to many tax treaties at once, discussed under Action item 15, may not be a satisfactory way for a country to modify all its treaties at once to include an LOB provision, because the countries that are partners to
The goal of Action 7 is to prevent the “artificial” avoidance of permanent establishment (PE) status. Commissionerate arrangements are specifically in the sights of the OECD, which considers that companies use these arrangements to replace structures where a local subsidiary had acted as a distributor in order to shift profits out of the country where sales take place without any substantive change in functions. The work here will also involve review of “specific activity exemptions” (i.e., the exceptions in Article 5(4) of the OECD Model Tax Convention for storage and display, preparatory and auxiliary and similar ancillary activities). The OECD believes that multinationals are “artificially” fragmenting their operations among multiple entities to qualify for these exceptions to PE status. The Action Plan also contemplates a review of the related profit attribution issues.

The target of this work overlaps significantly with Action Item 1, regarding issues arising from the digital economy. The concern involves foreign companies doing a substantial amount of business with local customers over the Internet, but without physical presence that would satisfy the PE threshold and allow the country where sales are taking place to impose its corporate income tax. These are the same issues that were examined in the 2002 e-commerce report. The action Plan also contemplates a review of “‘artificially’ fragmenting their operations among multiple entities to qualify for these exceptions to PE status. The Action Plan also contemplates a review of the related profit attribution issues.

The target of this work overlaps significantly with Action Item 1, regarding issues arising from the digital economy. The concern involves foreign companies doing a substantial amount of business with local customers over the Internet, but without physical presence that would satisfy the PE threshold and allow the country where sales are taking place to impose its corporate income tax. These are the same issues that were examined in the 2002 e-commerce report. Providing digital content or services over the Internet, however, does not differ in any meaningful way from a situation where a local country customer places an order over the phone or through the mail for tangible goods to be delivered from a foreign provider with no physical presence in the country of sale; in neither case would it be appropriate for the local country to consider that the foreign provider had enough nexus to impose its corporate income tax. Nonetheless, it is not unlikely that some OECD member countries will advocate for some sort of “economic presence” test, or for a services PE clause. Finally, the reference to doing further work on attributing profits to permanent establishments is curious, as the OECD recently completed (in 2010) a major multiyear project to give just such guidance. It would be strange to alter that guidance in any significant manner so quickly, but perhaps there is pressure by some countries simply to do something to allow for more profits to be attributed to a PE.

The next three action items are efforts to “[a]ssure that transfer pricing outcomes are in line with value creation.” The OECD states its concern that multinationals have been able to “misapply” the arm’s-length principle to separate income from the economic activities that produce it in order to shift it into low-tax jurisdictions. The OECD believes this is done by transfers of intangibles for less than full value, the over-capitalization of low-taxed group companies, and from contractual allocations of risk to entities in low-tax jurisdictions in transactions that are unlikely to occur between unrelated parties. The OECD explicitly rejects formulary apportionment as a basis for new transfer pricing rules, and yet indicates a willingness to adopt rules that are inconsistent with the arm’s-length principle.

Action 8 will address those concerns by adopting a broad definition of intangibles, designing rules to ensure that profits from intangibles will be allocated in accordance with “value creation,” developing “special measures” for hard-to-value intangibles, and updating the existing guidance on cost contribution arrangements.

Shortly after the Action Plan was released, the OECD also released a Revised Discussion Draft on Transfer Pricing Aspects of Intangibles (Revised Discussion Draft) (July 30, 2013). The Revised Discussion Draft makes good on the promise to adopt a broad definition of intangibles; it employs a negative definition, essentially defining an intangible as anything that is not a physical asset or a financial asset. Adopting a broad definition of intangibles, however, is unlikely to combat any perceived transfer pricing abuses; as the Revised Discussion Draft notes, the label attached to a particular transaction is not important, the key consideration is whether a transaction conveys economic value, no matter what it is called. Transfer pricing is about amount, not categorization, so whether or not a transaction is classified as a transfer of intangibles, a transfer of tangibles, or the performance of services should not matter for determining the arm’s-length price of the transaction. Adopting a broad definition of intangibles is likely to simply lead to more disputes and double taxation, as countries search for novel intangibles and assign high value to them.

The Revised Discussion Draft also sheds light on how the OECD believes it can ensure that profits from intangibles are allocated in accordance with “value creation,” and to prevent separating income from the “economic activities” that produce it. Viewed through the lens of the authors of the Revised Discussion Draft, value is apparently created by performing certain “important functions,” such as design and control of research and marketing programs, management and

40 Revised Discussion Draft, ¶40.
41 Id. at ¶36.
control of budgets, control over strategic decisions regarding intangible development programs, important decisions regarding defense and protection of intangibles, and ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible.42 Being the legal owner of an intangible by itself does not qualify for entitlement to any of the return from the intangible; the legal owner of the intangible can reap all the rewards from the intangible only if it also performs and controls all important functions related to creating and maintaining the intangibles, and provides all assets and bears and controls all risks related to development, enhancement, maintenance and protection of the intangible.43

Due to the ease with which intangibles and risks may be transferred across national boundaries and the difficulties of pricing those things in the absence of reliable comparables, OECD member countries have recently expressed misgivings with the traditional “functions, assets, and risks” model of transfer pricing. Too much emphasis was believed to be placed on “mere” ownership of intangibles and other assets and assumptions of risks. The Revised Discussion Draft makes clear that certain “important functions” are to be given special significance and will be a key consideration in pricing related-party transfers of intangibles.44 That model of determining compensation based on important functions harkens back to the Article 7 (of the Model Tax Convention) paradigm for attributing profits to a permanent establishment by reference to “significant people functions” and “key entrepreneurial risk-taking functions.”45 Importing the Article 7 standard into Article 9 is problematic for many reasons, most importantly, on a conceptual basis, because it leads to a type of circular process similar to an “infinite loop” in computer programming, as the Article 7 analysis was predicated on applying the Article 9 transfer pricing rules “by analogy.”46 Additionally, Article 9 generally respects contractual allocation of risks and ownership of intangibles as long as the transaction has economic substance; making certain “important functions” paramount turns that model on its head and represent a significant movement toward allocating profits based on where workers are located, perhaps on the basis of headcount or payroll expense. While the OECD rejects formulary apportionment in name, the substance of the proposal in the Revised Discussion Draft is a significant movement in that direction. The consequences of such a move are beyond the scope of this paper, but should be fully considered, both for transfer pricing implications and for consistency with other international obligations. For example, it appears to have escaped notice thus far that adherence to the arm’s-length standard may not be solely a “soft law” obligation arising from adoption of the OECD Transfer Pricing Guidelines but may be an enforceable commitment under World Trade Organization agreements.47

As for developing “special measures” for hard-to-value intangibles, the Revised Discussion Draft retains (in ¶¶198–205) the existing language in the Transfer Pricing Guidelines that would allow tax administrations to adopt rules similar to the “commensurate with income” (CWI) provision of the Section 482 regulations in the United States.48 The CWI rule requires that consideration for a transfer of an intangible between related parties must be “commensurate with the income attributable to the intangible.”49 Essentially, the CWI rule allows for an ex post valuation; regardless of whether the pricing of the intangible was arm’s-length at the time of the transfer, consideration is also given to the actual profits realized as a result of the transfer.

In the years since its enactment, debate has been ongoing about whether the CWI rule is consistent with the arm’s-length standard, as unrelated parties would not have access to the subsequent profit history of the intangible after the date of transfer. Regardless of the outcome of that debate, it is hard to see how any other “special measure” could be created by the OECD which could be more powerful than the existing grant of authority to adopt CWI provisions. Mak-

42 Id. at ¶¶79–80.
43 Id. at ¶¶74 and 89.
44 Id. at ¶¶75 and 79.
46 See id. at ¶10 (“[T]his Report has been based upon the principle of applying by analogy the guidance found in [Article 9] for purposes of determining the profits attributable to a PE”).
47 See Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, Agreement Establishing the World Trade Organization, fn. 59:

The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm’s length. Any Member may draw the attention of another Member to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions. In such circumstances the Members shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of Members under GATT 1994, including the right of consultation created in the preceding sentence.
48 See Regs. §1.482-4(f)(2)(i).
49 Id.
ng transfer pricing adjustments based on actual profit experience is the ultimate weapon, although perhaps its lack of actual application in practice by the IRS in the U.S. suggests it is too powerful a tool to have much practical application.

Finally, Action 8 also promises to update the existing guidance on cost contribution arrangements (CCAs) in Chapter VIII of the Guidelines. It is likely that that work will not involve development of significant new guidance, but rather will consist of simply importing any new guidance from the final update of the intangibles chapter into the CCA chapter of the Guidelines.

Action 9 commits the OECD to preventing BEPS by multinationals transferring risks among, or allocating excessive capital to, group members. The OECD will also develop new transfer pricing rules or “special measures” to ensure that “inappropriate” returns cannot be achieved solely by contractually assuming risks or providing capital. The theme of aligning returns with “value creation” continues, although that term is left undefined, and the work will be coordinated with the proposed work on interest expense deductions and other financial payments.

The proposal to limit returns that can be achieved by contractually assuming risks continues to reflect the OECD’s discomfort with the Article 9 model of rewarding the assumption and bearing of risk; risk being a mobile generator of value that can be transferred among related parties by contract. But preventing BEPS resulting from transferring risks among group members will be a difficult task. Any principled attempt to restrict the impact of risk allocation on transfer pricing results cannot include a general rule or even presumption that risk transfers among group members should not be given effect for income allocation purposes. Outside of a business restructurings case, risk is not so much allocated or transferred as it is delineated — the quantum of risk being assumed by any member of the group is simply that set out in its contractual relations with other members of the group; there is no natural home for risk in any particular member of a multinational group. Unrelated parties determine the allocation of risks to a particular transaction in a myriad of different ways depending upon their appetite for risk and its effect on their expected return; there is nothing unusual about related parties engaging in that same calculus.

The discomfort with the existing article 9 framework is perhaps most obvious, and most understandable, when risk has been transferred to an entity in a low-tax jurisdiction with few employees or assets and a significant return eventually accrues to that entity. But it will be difficult to prevent “inappropriate returns” from accruing because of contractual allocations of risk, even in that paradigm situation, while still respecting the existing architecture of the international tax system, which generally respects separate entities and contractual allocations of risk. Moreover, unrelated parties that do no more than assume risks and provide capital can earn significant returns, even the lion’s share of profits, and thus similar results should not be ruled out for transactions between related parties. The Revised Discussion Draft merely points to the existing guidance in Chapter IX of the Guidelines, on Business Restructurings, where contractual allocations of risk are generally respected and increased risk is compensated by a commensurate increase in the expected return.50 Perhaps new guidance could be provided on the pricing of risk, but such an exercise would be fraught with difficulty in the likely absence of good comparables, especially given the widely varying terms parties can agree to as part of their transactions. Risk is simply a mobile economic activity that raises fundamental corporate tax issues. It will be difficult to design new pricing or anti-abuse rules that work well to address perceived abuses.

Finally, Action 9 will attempt to prevent BEPS by allocating excessive capital to group members. The OECD notes that this work will be coordinated with the work on interest expense deductions in Action 4; it is not obvious how the two Action Items will differ with respect to this issue (perhaps the answer is that Action 4 is about excessive leverage, while Action 9 may be about excessive funding, whether by debt or equity).

Action 10 will attempt to create rules to prevent BEPS by engaging in transactions that would not, or would only rarely, occur between unrelated parties. It will do this by designing transfer pricing rules or “special measures” (which presumably may be inconsistent with the arm’s-length standard) to (1) clarify the circumstances in which recharacterization of transactions is appropriate; (2) clarify application of transfer pricing methods, particularly profit splits, in the context of global value chains; and (3) protect against common types of base eroding payments, including management fees and head office expenses.

It will be difficult for the OECD to meaningfully address transactions that are unlikely to occur between unrelated parties. Attempting to introduce purely hypothetical unrelated party models to analyze actual related-party transactions represents a fundamental misunderstanding of the arm’s-length principle, which does not force related parties to engage in similar transactions to those unrelated parties would engage in. The arm’s-length principle accepts that related parties, because of their common control,

50 Revised Discussion Draft at ¶85, referring to the guidance on risks in ¶¶9.10–9.46 of Chapter IX of the Guidelines.
can and do engage in transactions that unrelated parties would not. Such transactions are respected, so long as they have economic substance, and the arm’s-length principle merely requires that related parties reach the same prices that unrelated parties would have reached in such transactions.

The existing guidance on recognition of actual transactions undertaken has two prongs under which it may be appropriate to disregard the actual transaction undertaken. The first circumstance occurs when the substance of the transaction differs from its form. The second circumstance arises when the form and substance of the transaction are the same, but the arrangements are different from those which would have been adopted by unrelated parties behaving in a commercially rational manner “and the actual structure practically impedes the tax administration from determining an appropriate transfer price.”

There has been an ongoing debate within Working Party No. 6 at the OECD about what the language of the second part of the test in paragraph 1.65 means and when an “appropriate transfer price” can be determined. One school of thought is that any transaction can be priced, and thus that this part of the test is simply poorly drafted and has no effect. Another view is that unrelated parties simply would not engage in certain transactions (such as a transfer of their “crown jewel” intangibles) and that when related parties engage in such transactions and there is an absence of good comparables to price the transfer, tax administrations ought to be able to simply disregard the transfer. While that view may have emotional appeal, it is hard to see what transaction would be priced if the transaction actually engaged in is disregarded and what the consequences would be when only one jurisdiction involved in the transaction thinks it ought to be disregarded.

The work on clarifying application of transfer pricing methods, particularly profit splits, in the context of the global value chain appears to be an area where further work will be forthcoming; no significant new guidance is provided in the Revised Discussion Draft. The Action Plan also includes a proposal to protect against certain common base eroding payments, and now specifically references management fees and head office expenses as an example of such payments. This is an interesting development, as the work on this issue was originally expected to go in the opposite direction — to make it easier to recognize the legitimacy of expenses for centralized management or other head office expenses. These expenses are frequently the subject of Competent Authority disputes, because some countries will not recognize expenses for centralized services provided to all group members, or will not do so on the basis of an allocation based on a reasonable allocation key, but instead insist upon a separate charge for each separate provision of a service. That is simply not practical for a multinational of any size; the administrative cost of tracking, billing, and accounting for payment for every single transaction in a centralized services arrangement would be all out of proportion to the benefit of doing so. The U.S. services regulations take a much more reasonable approach to this type of situation and allow for shared services arrangements where costs for covered services may be allocated among the participants in the arrangement based on their respective shares of their reasonably anticipated benefits. A reasonable allocation key (such as an allocation based on headcount for human resources services) may be used to divide up the costs of such services. Doing so eliminates unnecessary administrative burdens while still providing for a reasonably close approximation of arm’s-length pricing for the centralized services being provided to group members. The reason why the OECD has now reversed direction and considers payments for the expenses of centralized services to be “base eroding” payments is not obvious; perhaps this reflects the influence of the non-OECD member G20 countries involved in the project, who have traditionally been skeptical of such payments.

**Actions to Ensure Taxpayer Transparency**

The next four Action Items are grouped under the heading “Ensuring transparency while promoting increased certainty and predictability.” This section starts with Action 11, which will establish methodologies to collect and analyze data on BEPS and the actions to address it. It will consist of developing recommendations for gathering data regarding both the scale and impact of BEPS and the effectiveness of actions taken to address it. It will also involve use of new types of data, and developing methodologies based on both aggregate (foreign direct investment and balance of payments data) and micro-level data (from financial statements and tax returns), although the OECD pledges to respect taxpayer confidentiality and consider the administrative costs involved. The deadline for this Action Item is September 2015.

This is perhaps the most unusual part of the Action Plan. In the February report, the OECD asked how big a problem BEPS may be, and engaged in a review of the available data on the subject. The conclusion was that the available data do not actually prove that BEPS is occurring. The report also noted that widespread cuts in statutory corporate tax rates have not

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51 Transfer Pricing Guidelines, ¶1.65.

52 Id.

53 Regs. §1.482-9(b)(7).
actually led to a fall in the corporate tax burden (measured by the corporate tax-to-GDP ratio). Generally, revenues from corporate income taxes as a share of GDP have increased over time, with the unweighted average of revenues deriving from taxes on corporate income as a percentage of GDP increasing from 2.2% in 1965 to 3.8% in 2007.

A similar pattern exists for corporate income taxes as a percentage of total taxation. The unweighted average of taxes on corporate income as a percentage of total taxation in OECD countries was 8.8% in 1965, dropped to 7.6% in 1975, and then consistently increased over the years until 2007, when the reported average ratio was 10.6%. With respect to the differences between statutory corporate tax rates and effective corporate tax rates, the report noted that based on the available data, it is “difficult to establish how far the effective rate is below the statutory rate by design (e.g. accelerated depreciation) or because of tax planning.” In the absence of any hard data regarding the size of the problem, or even that one exists, the report nonetheless claimed that “there is abundant circumstantial evidence that BEPS behaviours are widespread.”

Essentially, then, the Action Plan has proposed to undertake a two-year program of work to address a problem for which the existing data provide no solid conclusions surrounding its existence or magnitude. The OECD proposes to assess existing data sources and to identify new sources of data, but that work to determine objectively whether BEPS exists and, if so, its magnitude will be completed only after all the other substantive work to address BEPS has occurred.

The lack of any hard data regarding the size or existence of BEPS that would justify changes to combat it also brings out a fundamental problem with the purpose of the project; namely, the absence of objective factors delineating what is deemed offensive and what is not, and what is deemed “aggressive” tax planning and what is “good,” or at least “acceptable,” tax planning. It cannot simply turn on whether there is low, or even no, taxation in a particular circumstance, which might be due to intentionally created tax incentives or exemptions. No definition is provided for the term “base erosion,” although the term itself implies that it is a pejorative label. That negative connotation is reinforced by the cover the OECD chose for its February BEPS report, of a shoreline apparently intended to evoke images of a sunny, sandy Caribbean tax haven (as opposed to a European tax haven).

“Base erosion” appears to be defined as resulting from unintended “loopholes” in tax treaties and domestic rules; however, the myriad of provisions that could lead to so-called base “erosion” (accelerated depreciation, tax holidays, exemptions from income, nonrecognition provisions, patent box regimes, loss carry-forwards and carry-backs, etc.) could also properly be referred to as “base determination” provisions, in that they are intentionally created incentives designed to attract business to the jurisdiction that enacts them. It is a stretch to claim that legislators, treaty negotiators, and other policy makers have consistently designed tax rules unaware of their consequences and potential for abuse. Regardless, it is impractical at best to ground the definition of “base erosion” and the boundaries of acceptable tax planning on the supposed intent of the rule-makers, however that could possibly be divined. The rules are the rules and, subject to well-established anti-avoidance doctrines (substance over form, sham transaction, step transaction doctrine, business purpose, and similar principles), compliance with those rules should be sufficient. Capricious pronouncements that certain tax planning “schemes” that comply with existing rules are nonetheless “aggressive” or “abusive” serve no useful purpose. In this context, it is also important to remember that many of the issues that have raised concerns as part of the BEPS projects are geared toward the corporate tax strategies of U.S. multinationals. From a U.S. perspective, given that we have the highest statutory corporate tax rate among OECD member countries and are one of the few countries in the OECD still maintaining a worldwide system of taxation, it is not at all clear that the existing measures designed to narrow the base are unintended and need to be “fixed”; the exact opposite conclusion would be more reasonable — the only way such a system can be maintained and provide for any sort of competitive environment is if the rules for determining the base intentionally allow the base to be narrowed.

Action 12 will involve work to require taxpayers to disclose their aggressive tax planning arrangements. The OECD will develop recommendations for mandatory disclosure rules for aggressive or abusive transactions (while considering the administrative costs for tax administrations and businesses). It will use a modular design to strive for consistency but allow for specific country needs and risks. A “wide” definition of “tax benefit” will be used. The work will also involve “enhanced models of information sharing for international tax schemes between tax administrations.”

This Action Item reflects one of the consistent themes of the BEPS project: that, in addition to new substantive rules to address BEPS, perhaps better disclosure of “aggressive” tax planning would lead to both better risk assessment by tax administrations and pressure on taxpayers not to engage in such planning.

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54 “[T]he very meaning of a line in the law is that you may intentionally go as close to it as you can if you do not pass it.” Superior Oil Co. v. Mississippi, 280 U.S. 390, 395–396 (1930).
in the first place. The direction of the work is not known at this point but, as often happens in OECD projects, may end up tracking existing U.S. rules. In this case, that may be rules similar to those under §6011 for the disclosure of certain reportable transactions (reportable transactions being transactions of a type that the IRS has determined as having a potential for tax avoidance or evasion). The wide definition of “tax benefit” may wind up mirroring that in the Section 6011 rules, to include deductions, exclusions from gross income, nonrecognition of gain, tax credits, adjustments (or the absence of adjustments) to the basis of property, status as an entity exempt from federal income taxation, and any other tax consequences that may reduce a taxpayer’s federal tax liability by affecting the amount, timing, character, or source of any item of income, gain, expense, loss, or credit. The disclosure involved here could also potentially follow the model for the reporting of uncertain tax positions required on Schedule UTP. Finally, the work to put in place “enhanced models of information sharing for international tax schemes between tax administrations” could potentially involve something like JITSIC, the Joint International Tax Shelter Information Centre, which aims to deter the promotion of, and investment in, abusive tax schemes by sharing among tax administrations information regarding transactions or structures that they view as risky or inappropriate.

Action 13 will reexamine transfer pricing documentation, with the goal of making it more transparent for tax administrations, but also considering the compliance burden for business. There will also be a requirement for MNEs to report to governments their “global allocation of the income, economic activity and taxes paid among countries according to a common template.” This element is where the so-called country-by-country (CBC) reporting requirements are introduced.

Shortly after the Action Plan was released, the OECD also released a White Paper on Transfer Pricing Documentation, prepared as part of its work on transfer pricing simplification. The goal of that project is to find ways to make transfer pricing documentation more useful to tax administrations and at the same time less burdensome to taxpayers. The White Paper notes that documentation requirements vary significantly from country to country, and that documentation in each country must be tailored to the specific requirements of local country law. It notes that more efforts should be put into creating more uniformity in documentation practice, so that multinationals are not required to prepare different documentation packages for every country in which they do business.

That is indeed a laudable goal, and would result in much simplification and reduction of burden for taxpayers.

What is unusual about the White Paper is that it also introduces the topic of CBC reporting, and discusses how such information might be used by tax administrations as part of their transfer pricing risk assessment. The work on transfer pricing documentation is part of the project to simplify the administration of transfer pricing, yet providing the type of information required under a CBC reporting regime will involve introducing substantial complexity and compliance burdens for taxpayers, all with very little potential to reduce any perceived transfer pricing abuses.

CBC reporting was originally envisaged as being a useful anti-corruption tool, particularly in the extractive industries, with the idea being that if multinationals were required to disclose their cash payments to certain smaller, less developed countries, it would make it easier to track that money to ensure that it was spent on social services for the broader population and did not somehow inure only to the benefit of any particularly powerful political leader or group. For that purpose, CBC reporting can be useful, depending on the ease with which inbound payments can be traced to their ultimate destination.

For transfer pricing purposes, however, CBC reporting has very little relevance for identifying any perceived abuses. To make a transfer pricing adjustment requires a detailed facts-and-circumstances analysis of whether a particular transaction or group of similar transactions achieves arm’s-length results. CBC reporting involves a much broader analysis, looking at the countries where a taxpayer has it sales or other potential attributes (like employees or physical assets) and where a taxpayer reports its profits and pays taxes. The OECD believes that information of that type can be a useful tool for transfer pricing risk assessment. It will not be, at least if taxpayers are still required to price transactions based on the arm’s-length standard, because the risk assessment contemplated by examining the information provided by a CBC reporting regime consists of determining whether the taxpayer’s distribution of profits around the world is the same as it would have been if a formulaary apportionment system had been used to allocate profits. Such information will provide no principled basis for making a transfer pricing adjustment (under the arm’s-length standard) for any particular transaction or group of transactions. At best, it will be

55 OECD White Paper on Transfer Pricing Documentation at ¶41.

56 The OECD provided further insight into its work on CBC reporting with the release, on Oct. 3, 2013, of its “Memorandum on Transfer Pricing Documentation and Country by Country Reporting.”
weak circumstantial evidence that further examination is warranted. But the fact that the proportion of taxes paid in any particular country is not proportionate to the amount of sales, employees, assets, or other factor in that country will not support a transfer pricing adjustment for any particular transaction.

The problem, however, will be that tax administrations (at least those from countries with large consumer markets) will use the information provided by a CBC reporting regime to increase pressure to align taxes paid (or at least taxable profits on which they are based) with the location in which sales occur. While rejecting formulary apportionment in name, the OECD is starting down a path that leads toward allocating profits according to sales. The direction of this issue may not be susceptible to change at this point, however; CBC reporting has gained momentum in EU countries and the G8 also recently reiterated support for the concept.57

Action 14 commits the OECD to making dispute resolution mechanisms more effective. It will address obstacles to solving treaty disputes under the Mutual Agreement Procedure (MAP), including because most treaties lack arbitration provisions and the fact that access to MAP and arbitration may be denied in certain cases.

With this Action Item, the OECD at least recognizes that the likely outcome of its work to develop new rules so quickly will be an increase in controversies with a corresponding increased risk of double taxation. Along with that will come increased pressure on the MAP. It was recently announced that the OECD has launched a new forum designed to improve the MAP.58 The forum will explore ways that competent authorities are hindered in their efforts to resolve cases, including by lack of resources and by structural problems, such as performance metrics or revenue goals.59 That could potentially be a very useful project, as it plays to the traditional strengths of the OECD in enhancing dialogue among countries and building consensus out of disagreement.

Additionally, more widespread adoption of arbitration clauses is imperative. The U.S. experience with its “baseball style” arbitration provision in a limited number of treaties has been tremendously successful, incentivizing competent authorities to moderate their positions and generally guiding them toward agreement before the taxpayer’s right to elect arbitration kicks in.

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57 G8 Lough Erne 2013 Communiqué at p. 1 (“We will work to create a common template for multinationals to report to tax authorities where they make their profits and pay their taxes across the world.”).
59 Id.

Actions to Ensure Swift Implementation

The final action item has its own heading all to itself: “From agreed policies to tax rules: the need for a swift implementation of the measures.” The OECD believes it will need “innovative” ways to implement the conclusions resulting from the Action Plan as quickly as possible. Some changes will be made to member country domestic legislation, while others will involve changes to the Commentary to the OECD Model Tax Convention and the Transfer Pricing Guidelines; other actions may result in changes to the Model Tax Convention itself. The OECD recognizes that most treaties are negotiated on a bilateral basis, over a period of years, and that updating many treaties simultaneously could take a great deal of time. For that reason, Action 15 proposes the development of a multilateral instrument to enable those countries which wish to implement any measures developed under the Action Plan into their tax treaties as soon as possible.

The idea of amending many treaties simultaneously has been discussed since at least 2006,60 and has been characterized, at least by some, as “a solution in search of a problem.” The basic presumption behind the proposal, that tax treaties are not updated quickly enough, is questionable. While some changes recommended by the Action Plan may be correct and may be improvements over existing treaty provisions, that does not necessarily mean that every country which so agrees also believes that it is necessary to implement that change quickly in all or the majority of its treaties. It is also important to recognize that some treaties are more important than others, and that changes are likely to be implemented quickly in treaties with those countries which are the most important trading partners. For smaller, less important treaty partners, the changes may be implemented more slowly, or not at all, without significant adverse consequences. Finally, the proposal for a multilateral instrument also assumes that (1) all countries would be able to agree on language for the provisions of the multilateral instrument and (2) those countries would be satisfied to make those changes on a standalone basis, and not within the normal process of negotiation which occurs during treaty amendments. Both of those assumptions are unlikely to be true, at least from the U.S. experience. First, our bilateral treaty negotiations often result in highly customized language for each treaty provision; even clauses which have the same purpose may have slight, but important, wording deviations from treaty to treaty. Second, some treaty provisions are simply more important to one
country than another. For some provisions, the United States may have an equal interest in making the suggested modification; for others, it may be more important to certain treaty partners than it is to the United States, leading the United States to agree to it with a treaty partner only where another provision is given in concession. It all depends. For those reasons, it is unlikely that the multilateral instrument will gain traction, at least in the U.S., even before considering the difficulties which would be entailed in gaining approval of such an instrument in Congress and eventual ratification.

CONCLUSION

The OECD BEPS project is ambitious, both in terms of the scope of issues it proposes to examine and in terms of the timeframe in which it hopes to develop new guidance. And yet the major topics to be examined pursuant to the Action Plan (particularly transfer pricing, permanent establishment, digital economy, and hybrid mismatch arrangements) are all areas in which the OECD has previously done significant work, particularly over the course of the last decade. It is not clear what has changed so quickly that would require different conclusions to be reached. Reasonable policy decisions have been made regarding complex problems and it is unlikely that new and improved solutions exist which have not been considered previously. The OECD has stated repeatedly since undertaking the BEPS project that the amount of political pressure for change should not be underestimated. It would be unfortunate if that ended up being the justification for making bad policy decisions. And yet given the scope of changes being promised by the OECD, it is also hard to see how the result of the BEPS project could simply be a reaffirmation of the existing rules.

Perhaps the best solution to any perceived BEPS problem is simply to engage in classical tax reform: broaden the base and lower the rates, on a revenue-neutral basis. So far the BEPS project has involved only a discussion of how to broaden the base with no corresponding discussion regarding lower rates. Yet lowering statutory rates could also serve to eliminate incentives to engage in base erosion and profit shifting. Throughout its history, the goal of the OECD in the tax arena has been primarily to prevent double taxation, in order to avoid the threat to cross-border trade and investment it poses. It is important that the work of the OECD in the BEPS project not become geared toward simply raising the most corporate tax revenue possible, but rather that it remain consistent with the stated purpose of the OECD: “to promote policies that will improve the economic and social well-being of people around the world.” That is accomplished by minimizing the tax barriers to global trade and investment and by spending efficiently and wisely.

In that respect, it is also important to remember one fundamental constraint on the scope of potential changes from the BEPS project that may be acceptable on a practical basis, which is the fact that tax competition still exists. Any country making fundamental changes to broaden its tax base must also take into account the effect such changes would have on its business environment and its attractiveness as a destination for investment. The rules of taxation and economics are in some sense as immutable as the laws of physics; a low-tax environment will always attract trade and investment and a high-tax environment will always repel those things. Companies respond to tax incentives, which is why countries have to compete for foreign direct investment on the basis of taxes.61

Finally, although the debate surrounding BEPS is taking place in a highly charged political environment, its potential to solve the problems at which it is aimed is quite limited, at least from the U.S. perspective. Corporate tax receipts in the U.S. have traditionally been relatively small, with the bulk of revenue collected in the U.S. coming from payroll and individual income taxes. Even a large increase in corporate tax receipts is unlikely to make a meaningful contribution toward solving the problems generated by growing entitlement programs. Real reform of entitlements needs to happen in order to address the largest source of budget problems. Immigration reform and trade liberalization also have potential to create economic growth on a scale large enough to ameliorate budget shortfalls. The focus on corporate tax receipts as a potential solution to our budget problems is misguided, and the longer it continues the longer the real problems go unaddressed.