

BEPS MONITORING GROUP

OECD BEPS Scorecard

This report is published by the BEPS Monitoring Group (BMG). The BMG is a group of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, Tax Research UK. This paper has not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives.

This paper has been prepared by Sol Picciotto, with comments and input from Francis Weyzig, Maria Villanueva, James Henry, Veronica Grondona, Richard Murphy, and Reuven Avi-Yonah, and draws on our previous reports on the OECD BEPS consultation drafts. It aims to evaluate the reports published in September 2014 by the OECD, submitted to the G20 Finance Ministers and Central Bank Governors, on the seven deliverables in the first year of the Action Plan on Base Erosion and Profit Shifting (BEPS). We aim to do so as clearly and succinctly as possible; more detailed comments were submitted by the BEPS Monitoring Group during the year on the specific actions points on which the OECD issued consultation documents or drafts.

A. Our Overall Evaluations

1. Some progress made...

The OECD has made some significant progress on the difficult challenge of trying to reach agreement among 44 countries on serious reforms to the international tax system, although our concerns remain that these are only a patch-up job which some OECD members will then actually use as an excuse to deny the need for true reform.

1. The OECD's determination to reform international tax rules to eliminate 'double non-taxation' is a major change from its previous priorities, although it still falls short of reaching the aim set by the G20 of ensuring that multinationals are taxed 'where economic activities take place and value is created'.
2. The reports they have presented on the seven deliverables in the first year of the BEPS project show that consensus has been achieved on a majority of the issues addressed.
3. Some of the proposals, which can be implemented simply by changes to national law or policy, could be acted on immediately by states, notably those on hybrids.
4. The OECD officials and governmental representatives on the many working parties and task forces, and those in related bodies such as the IMF and the UN Tax Committee, have become aware that they have an unprecedented opportunity and the great responsibility to reconsider and refashion international tax principles for the first time in the 80 years since they were first formulated.
5. The determination with which the project has been addressed has begun to help change the perceptions and attitudes of corporate tax advisers, some of whom may now become more scrupulous.

2. But some unhappy compromises, obstacles and failures...

Nevertheless, there have been some uneasy compromises, and agreement has not been reached on a number of issues raised by these action points, which therefore require further

work even while the OECD begins on the remaining eight action points in the second and final full year of the project.

1. The proposals to combat treaty abuse do not provide one set of model treaty provisions but alternatives, with an attempt to prescribe a minimum, which could make it harder to negotiate treaty amendments quickly and effectively.
2. Some agreements still involve tidying up technical details, as with some aspects of the action on hybrid mismatches.
3. Others are more major, although rapid progress seems expected: these include the highly important issue of the arrangements for access to Country-by-Country reports and the Master and Local Files for transfer pricing documentation; the failure to agree acceptable procedures for access seems to have led some tax administrations to insist on inclusion of some information on internal transfers in the country-by-country reports, which we think confuses the purposes of the two types of report; in our view, the Master File of transfer pricing documentation should be available automatically to any tax authority which considers that it has jurisdiction over the firm.
4. Little progress has been made on Harmful Tax Practices (HTPs), and the failure to agree the specific proposal on economic substance confirms our view that the general approach is toothless and will be ineffective.
5. Although much work has been done in the important area of transfer pricing focusing on the key issue of intangibles, the output so far is still confused and lacking clear direction, which it is hoped will come next year as the BEPS spotlight is focused more sharply on transfer pricing.
6. The key cross-cutting issue of ensuring that international corporate tax rules adequately deal with a digitalized economy will overshadow the work on many of the remaining action points, while also needing further detailed work itself both in parallel with and beyond the BEPS project, especially on the key issue of revising the definition of taxable presence in the permanent establishment (PE) concept.
7. Governments need to begin to align their tax systems in the direction of the reforms indicated by the project, rather than trying to forestall reforms by enacting beggar-thy-neighbour measures of the kind that the BEPS project is designed to eliminate; equally, those which have already enacted such measures should cease to block progress on provisions which would require their elimination. There should be an end to the hypocrisy of loudly proclaiming a determination to reform international rules while quietly enacting national measures which run counter to the movement towards effective coordination.

3. Fundamental problems remain...

1. A project led by the OECD even with participation of other G20 countries is still an unsatisfactory way to agree global tax rules, and the underlying problem still remains that the Action Plan aims to patch up existing rules rather than re-examine their foundation.
2. The views of states not directly involved in the process, especially the poorer developing countries which are more dependent on corporate tax revenues, need to be taken into account much more directly, and we will carefully scrutinize the OECD proposals to address this which are promised.

2. The Action Plan aims to remedy flaws without reconsidering the underlying principles of the system, such as the residence-source split. Such reconsideration is unavoidable, as has been starkly shown by the current US difficulties in trying to deal with firms relocating their headquarters abroad ('inversions'). Trying to reassert residence taxation by the home country through a revival of rules on controlled foreign corporations (CFCs), which is on the coming year's BEPS agenda, cannot provide a rational method of taxing firms which are becoming increasingly multinational; today's globalized economy calls for a more global approach to apportioning multinationals' profits.
3. In parallel with and beyond the OECD project, there should be a wider consideration of the issues, involving other organizations especially the IMF and the UN Tax Committee. Instead of trying to usurp the UN, the OECD should support an upgrading of the UN Tax Committee. All states should have full rights of participation in the negotiation of the proposed multilateral convention, which should not be limited to rubber-stamping the outputs of the OECD BEPS project.
4. The underlying cause of BEPS is the separate-entity/arm's-length principle which the OECD itself has increasingly entrenched over the last two decades; it insists on treating the national operations of multinational enterprises as if they were independent of each other, whereas in reality they operate as an integrated whole under central direction. This principle creates a perverse incentive for multinationals to organize themselves as complex corporate groups with often hundreds of affiliates including many formed in convenient jurisdictions to facilitate base erosion and profit shifting.
5. The OECD has a clear mandate from the G20 that international tax rules must be reformed to ensure that multinationals are taxed 'where economic activities take place and value is created'. This evidently requires the abandonment of the separate entity concept and adoption of a different principle which clearly states that multinationals should be treated as unitary firms.
6. The measures to be developed under the Action Plan could be much simpler, more effective, more cohesive and less liable to generate conflicts if they were all aligned towards this clear lodestar.

B. Evaluation of the Individual Reports

1. ACTION 1: ADDRESS THE TAX CHALLENGES OF THE DIGITAL ECONOMY

Nature of the problem:

The digitalization of the economy has made clear the need for new thinking for tax system design. It has accelerated changes in the core profit-generating activities of businesses, enabling restructuring both within firms and between them and contractors, as well as important shifts in relationships between producers and consumers. Moreover, information and communication technology innovations have enabled connectivity and expanded business reach. These trends greatly extend the ability of firms to make profits in countries without themselves having a significant physical presence, and to restructure corporate groups in ways which result in attribution of profits in countries where they would be lightly taxed.

OECD Proposed Solutions

The OECD has accepted that digitalization affects the whole economy, so rules need to be reformed which would not be ring-fenced to a specific sector. It also accepts that this

exacerbates the problems of corporate taxation in a globalized economy. Some necessary reforms should result from work on the specific Action Points, especially on treaty abuse, Controlled Foreign Corporations (CFCs), Transfer Pricing (especially regarding valuation of data and dealing with global value chains), and reconsidering the definition of a PE (e.g. where a firm also has marketing, warehousing or delivery activities). The OECD considers that these should deal with most of the cases which have given rise to public concern, relating to large internet-based companies, since they generally do have subsidiaries in countries where they have significant sales.

However, it also recognizes that there are 'broader tax challenges', particularly relating to collection of VAT in B2C transactions, and as concerns direct taxation questions raised by (i) data collection from customers, (ii) characterization of income from digital transactions, and (iii) the important issue of tax nexus where there is little physical presence. These questions are inter-related, and a framework has been agreed for analyzing them through further technical work. As regards the PE definition, a number of options have been identified, including the proposal for a concept of Significant Presence put forward in the BMG submission earlier this year. The Task Force on the Digital Economy will continue with this work, aiming to conclude in 2015. However, it considers that evaluation of the urgency and scope of further action on this issue should take place only after all the work on the BEPS project is complete.

Our Evaluation

We broadly agree with the OECD's characterization of the issue as being digitalization of the economy in general, and not confined to a specific sector. However, an important aspect which was not sufficiently brought out in the OECD report was the changing nature of producer-consumer relations, which goes much further than simply gathering of data about customers. In our view this necessarily requires a re-evaluation of the traditional Residence and Source concepts and income attribution between them. Re-evaluation of the application of the existing PE concept, under Action point 7, to situations where the firm also has a presence through subsidiaries conducting related activities, is welcome. In our view, this should entail reconsideration of the so-called Authorized OECD Approach (AOA) to the PE. The AOA was agreed relatively recently by the OECD, although it was rejected by developing countries; it has been implemented by protocols to treaties among some OECD countries, most recently (and in our view regrettably) between the UK and Germany.

Nevertheless, this will not be sufficient, and we welcome the proposal to examine the actual PE definition both in parallel with and as a follow-up to the OECD BEPS project. In our view, it relates closely to other issues not included in the OECD project and of particular concern to developing countries, especially taxation of services. Digitalization has significantly increased the ability of firms to shift from discrete sales of physical commodities to more long-term relationships with customers in the form of services, and hence often with little or no physical presence. It is this underlying change that leads to both the problem of characterization and the lack of direct physical presence. For example, an internet-based publisher can service subscribers all over the world using freelance authors in each country to supply local content. It is nevertheless characteristic of services that they generally entail close relationships with clients, often indeed a two-way relationship with significant input from the client. Services firms operating digitally also generally require other local inputs to support their relations with customers, such as payment facilities, business agents and consultants with local knowledge, which may be done by third parties contractually.

We agree that these issues raise challenges going beyond the OECD's BEPS project, but they should nevertheless be addressed expeditiously. If this is not done multilaterally there will be a worsening of unilateral and conflicting measures. This issue seems more appropriate to be taken up through the UN Tax Committee, which is already working on the taxation of services. However, it clearly would need a significant enhancement of the UNTC's resources, and we call on the OECD to cease its opposition to the upgrading of the UNTC and support such enhancement.

2. ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS (HMAs)

Nature of the problem:

The underlying problem is that interest expenses are generally considered as deductible from business profits, so reduce the tax base in Source countries, while tax treaties limit the power to levy withholding taxes at source on interest payments. However, this may apply even if such payments are not taxed as income of the entity receiving them (deduction with no inclusion). Further, companies can organize their financial structure so as to obtain a deduction in two countries (double deduction or 'double dipping'). The Action Plan aims to tackle problems caused by interest deductibility through a number of its action points. Action 2 deals only with where either the entity or the instrument are 'hybrids', i.e. treated differently by the law in the two countries.

OECD Proposed Solutions

The OECD proposes complex provisions on hybrids both for inclusion in tax treaties and for domestic law. The scheme provides that generally the source state would be allowed to refuse a deduction if, or to the extent that, the payment concerned is not taxed by the receiving state; but if it does not do so, the receiving state may tax it. The measures are considered to be complementary, so capable of application without any need for coordination. Some have argued that the recipient should have the primary jurisdiction to tax, but the OECD has decided that the source state should have first bite; rightly, in our view, as it has the stronger incentive to ensure tax is levied. The proposals were cast very widely, affecting entities which are not integrated multinational firms such as investment funds, and did not adequately consider hybrid instruments used for valid reasons such as regulatory requirements for banking (e.g. debt convertible into equity). The OECD has now conceded that such questions need further work.

Our Evaluation

The proposals are complex, yet deal with only one rather specific aspect of the underlying problem. For example, they do not deal with Belgium's notional interest deduction regime providing an allowance for corporate equity, which is left to be dealt with (if at all) as a 'harmful tax practice'. To be properly effective, they would require coordination, at least so that the source state could have adequate information on the tax treatment in the receiving state.

However, in our view, what is needed is a more comprehensive approach to deal directly with the underlying problem of interest deductibility. In practice, multinationals organize their financial structures centrally. The clearest and simplest approach to this basic problem would be to allow each country to limit deductions by treating a multinational's debt on a consolidated basis, and apportion it to entities in each country by an appropriate criterion (such as EBITDA). The details of such an approach could be developed in the forthcoming work on Action Point 4 concerning limitation of deductions, building on provisions which some countries have already adopted in their national laws. If appropriately designed it would provide both a simpler and a more coherent solution to the underlying problem, and one that

would more comprehensively deal with both hybrids and aspects which would otherwise be covered piece-meal by a range of other measures (harmful tax practices, limitation of benefits clauses, transfer pricing provisions on financial instruments, etc).

3. ACTION 5: COUNTER HARMFUL TAX PRACTICES MORE EFFECTIVELY TAKING ACCOUNT OF TRANSPARENCY AND SUBSTANCE

Nature of the problem:

Many countries have been tempted to offer special tax advantages or regimes which in effect work in a beggar-thy-neighbour way, undermining the tax base of other countries. These may facilitate not only profit shifting but also base erosion, since the economic advantages to the countries providing the tax breaks (although they may be significant) are overall less than the taxes lost by the countries harmed. Such practices create a race to the bottom in corporate taxation. Indeed, sometimes countries sacrifice their own tax revenues to stave off threats of relocation by multinationals. For example, the UK 'patent box', enacted to try to keep R&D especially by large pharmaceuticals in the UK, has been estimated to be likely to cost almost \$1b a year.

The OECD initiated a project to try to deal with these 'harmful tax practices' (HTPs) in 1998. It formulated a number of criteria for defining what tax breaks could be considered as 'harmful', and set up an intergovernmental Forum to identify and evaluate relevant national measures. However, the initiative soon ran into political objections, especially from the then US administration, that trying to limit tax breaks infringed the sovereign right of states to decide their own tax systems. It culminated in a report in 2006 which evaluated 47 preferential tax regimes that had been identified as potentially harmful; this found that 18 had been abolished and 14 amended to remove their potentially harmful features, while another 13 were found not to be harmful, as were a number of holding company regimes additionally considered. The only one considered harmful was that of Luxembourg, which the Luxembourg government said it would defend under European law. The HTP project then refocused on information exchange mainly from tax havens, and the work of the Forum on HTPs was effectively suspended.

The EU began a parallel process on HTPs based on a Code of Conduct, also aiming to evaluate preferential tax measures according to a number of criteria, including whether they relate to non-residents, are ring-fenced from the domestic market, are granted 'even without any real economic activity and substantial economic presence' in the state concerned, involve rules for profit determination which depart from internationally accepted principles, and involve rules lacking transparency, including where they are relaxed administratively in a non-transparent way. The application of these criteria has been done for some fifteen years by an intergovernmental Group working in a rather non-transparent way. It had some success at first, greatly assisted by the activation by the European Commission of its legal powers to challenge some such measures if they could be considered to be state aids. The Code Group managed to identify and list potentially harmful measures, evaluating them and specifying the harmful ones which should be phased out. Subsequently, states became more sophisticated in devising measures which could fall outside the criteria, particularly the 'innovation box' or 'patent box', which offers a low tax rate for royalties from intellectual property. The Group failed to agree that this was incompatible with the Code. This encouraged other countries also to adopt such a provision, notably the UK, and such a measure is now under active consideration by others even outside the EU e.g. Switzerland. The EU Council of Ministers has agreed to re-evaluate criterion (iii) relating to economic substance, while urging that this be done in conjunction with the OECD BEPS project. The OECD must also find solutions which are compatible with EU law, i.e. which do not involve states treating foreign

companies in ways which might be considered discriminatory. It must also find a way to persuade non-OECD and non-G20 countries to fall into line. The original 1998 report included a discussion of 'defensive measures', i.e. sanctions. It rightly pointed out that it is difficult for an individual country to take such measures, since the targeted activity can simply move elsewhere, so it suggested that 'a multilateral approach is required and the OECD is the most appropriate forum to undertake this task' (para. 138). However, this suggestion was so controversial that it was quietly forgotten.

OECD Proposed Solutions

The BEPS project action point 5 entails revamping the Forum. However, it seems that a new review of HTPs was begun in 2010, some results of which are given in this report. Of 30 regimes reviewed, 9 have been found not harmful, 6 are still under review, while 15 concern innovation incentives, which would need to be considered under the revamped approach. Work on this issue was done in secret, attempting to insulate it from business pressures, but as a result also hindering public debate. Progress has been slow, evidently due to a sharp conflict and extended debates over the 'innovation box'.

The report proposes criteria on Transparency, requiring states to make available to each other their administrative rulings, based on a procedure for 'spontaneous' information exchange, a legal basis for which already exists in tax treaties. Hence, this should begin immediately.

Most of the time has been taken up with defining the criteria for 'harmful', especially in relation to 'substantial activities, and as applied to the patent box. The discussion has focused on a proposal to apply an 'economic nexus' approach to deal with the 'substantive activities' issue especially in relation to 'innovation boxes'. This has been opposed apparently by a small group of states, from the OECD (Luxembourg, the Netherlands, Spain and the UK). There is no consensus, and hence no agreement, on this point. However, we understand that the OECD has a legal opinion from the European Commission, supported by its own advice, that the 'economic nexus' concept could be compatible with EU law.

Our Evaluation

In many ways this issue goes to the heart of the dilemma posed by the approach adopted by the G20 and the OECD to the BEPS problem. The mandate from the G20 to reform tax rules to ensure that multinationals are taxed according to 'where economic activities take place and value is created' necessarily entails closer coordination of tax rules. Hence, it could be said to involve limits on state sovereignty, which the G20 has also said should be preserved. Yet without such closer coordination states have been losing their power to tax multinationals effectively.

The proposals on greater transparency are long overdue. However, they rest on weak foundations, since they largely rely on self-reporting by states. We nevertheless hope they will prove effective. No doubt some states have been encouraged to accept this need by the legal proceedings commenced by the European Commission against Ireland, Luxembourg and the Netherlands.

The proposed approach of defining criteria for HTPs and evaluating measures as they are proposed or adopted is toothless, so will be inadequate. This has been shown by the previous experience. The EU project had a little more success than the OECD's, largely because the EU's Code procedure is backed by the European Commission's legal powers to challenge state aids. The OECD procedures lack sanctions, especially since the suggestion in the 1998 report of 'coordinated defensive measures' was buried, and has not been resuscitated in this report. Furthermore, the OECD would need to extend its monitoring to non-G20 countries, such as Singapore or the UAE, over which it has even less effective power. Relying largely

on voluntary cooperation, this approach becomes a game in which the participants judge each other's conduct, under rules which they have more incentives to relax than to strengthen. Participation in the Forum helps countries learn from each other how to design new and more ingenious tax breaks.

Within the limitations of this approach, the proposed approach to 'economic nexus' adopts a subtle solution to defining 'substantial activities'. It aims to deal with the problem that this is not a binary question but a relative one. It is a matter of whether the profits attributed are reasonably related to the actual economic activities and value created. The same issue underlies other Action Points, e.g. treaty abuse, transfer pricing, etc. However, as with the scheme for dealing with hybrids, the proposed rules would be highly complex, yet provide at best a partial solution. It remains to be seen whether the inability to overcome the objections of a few states even to this proposal can be overcome without reviving the possibility of concerted counter-measures. If difficulty has been experienced in reaching agreement under this approach on special regimes such as the patent box, solutions will be impossible for low-tax regimes of a general character already in force in some states and under consideration in others.

In our view, however, the problem of the 'innovation box' should be tackled directly by stating that countries which wish to encourage innovation and R&D should do so by allowing deduction of actual expenditures on people and assets. As the report points out, such 'front end' regimes directly link company expenditures to tax benefits. The proposed 'economic nexus' scheme attempts through its elaborate rules to extend these principles. However, allowing such schemes even subject to an economic nexus requirement would not only be ineffective, but in our view unjustified. If it is considered desirable to offer tax advantages to perform R&D, appropriate tax allowances are an adequate mechanism. The argument that companies deserve even greater contributions from the taxpayer if an investment in R&D generates exceptional income seems hard to justify. Innovative companies derive exceptional profits from the first-mover advantage, but also importantly from patent protection, which is a state grant of a monopoly. To grant on top of this a low tax rate, especially on income which could reduce the tax base resulting from economic activities (including marketing and sales) taking place in other countries, is a direct encouragement for firms to devise BEPS strategies.

More widely, the underlying problem of competition to offer corporate tax advantages can only be dealt with effectively by reforming the substantive rules so that multinationals can indeed be taxed 'where economic activities take place and value is created'. As we have repeatedly pointed out, this entails acceptance of the principle of taxation of multinationals as unitary firms. One of the most important areas in which this principle should be applied is so-called intangibles. To allow firms to 'attribute' income streams to particular intangible 'assets', and apply lower tax rates to such income streams, is simply a recipe to encourage base erosion and profit shifting to continue. The countries which have adopted such regimes should be pressured to end them, if necessary by coordinated counter-measures.

4. ACTION 6: PREVENT TREATY ABUSE

Nature of the problem:

Tax treaties generally restrict the power of source states to tax business profits and to apply withholding taxes on payments such as dividends, interest, royalties or fees. States accept these restrictions in order to attract inward investment, and on the understanding that such payments would be subject to the normal taxation in the recipient treaty-partner state. However, multinationals can take advantage of treaties in various ways to obtain the benefits

of reduction of source taxation without being taxed by the treaty partner, which is an unintended result of tax treaties.

One key method is 'treaty shopping', by setting up intermediary entities in states with appropriate treaties to receive such payments, which can be passed through to low- or zero-tax states, leaving little or no profit in the intermediary entity to be taxed. This is one of the key techniques which creates 'stateless income' which has not been taxed anywhere but is available to a multinational for reinvestment abroad. Some states encourage treaty shopping by offering advantages such as exemption of foreign-source income, while actively negotiating treaties. States which became aware of the problem in the 1970s adopted counter-measures, such as the 'limitation of benefits' (LoB) clause developed and refined over a period by the US. Others have preferred a more general 'main purpose' provision, which is more flexible but also more discretionary.

More widely, countries can try to prevent unintended benefits by enacting anti-abuse provisions. This can be done in national law, but courts may be reluctant to use a general anti-avoidance rule to block the application of a specific treaty provision. It is therefore preferable to ensure that the treaties themselves also include a clear statement of their purposes and objects and an anti-avoidance rule.

OECD Proposed Solutions

The OECD proposes model treaty provisions for both a LoB and a Main Purpose clause. States could choose either or both, but the OECD proposes a minimum standard. In addition, it makes recommendations regarding domestic anti-abuse provisions, and proposes that it should be made clearer that tax treaties are aimed at preventing both double taxation and double non-taxation by inclusion of an appropriate statement in the Preamble of such treaties.

Our Evaluation

In our view, a statement in the preamble in a treaty is too weak, as such statements are rarely used to counter what may seem to be a rational literal interpretation of a substantive treaty provision. Tax treaties need to begin with an article which clearly states that their purpose is to ensure that persons and companies are taxed where their economic activities take place and value is created. The aim of the substantive provisions should be to ensure this. One or more suitable anti-abuse clauses can be helpful, but it is unrealistic to expect them to carry too much weight, especially if the substantive provisions are ineffective. We agree that there are advantages and disadvantages to both the proposed measures, but the failure to agree on a single effective measure is problematic. The targeted LoB provision is detailed and complex, more precise, but therefore offering possibilities for circumvention, while the Main Purpose provision is more flexible and hence potentially comprehensive, but also more discretionary and hence liable to be arbitrary and potentially more prone to abuse. In view of the disagreement, a 'belt and braces' approach seems the only solution, combined with a minimum standard as proposed. Nevertheless, it is not clear that this will reduce the problems posed by either of the alternatives, and combining them could multiply those problems. We nevertheless hope that all OECD and G20 countries will comply with their commitment to adopt suitable provisions promptly, and complement these with spontaneous exchange of information by the residence state on structures to which the anti-abuse provisions may apply.. The G20 faces a larger challenge in trying to ensure wider adoption of these provisions. This is one of a number of issues where closer coordination especially with developing countries is essential, presumably through the proposed Multilateral Convention. If a non-G20 developing country has a strong preference for a specific provision, we suggest that the choice of the developing country should be decisive in determining the type of

provision in its treaties with OECD and G20 partners. Expecting developing countries to have to apply a range of different anti-abuse measures would unnecessarily strain their administrative capacity.

5. ACTION 8: ASSURE THAT TRANSFER PRICING OUTCOMES ARE IN LINE WITH VALUE CREATION - INTANGIBLES PHASE 1

Nature of the problem:

Transfer pricing is the area which most clearly reveals the fundamental flaws in the current tax rules. These can be traced to the separate entity/arm's length principle, which implies an unrealistic and unworkable standard, since multinationals only exist because of the benefits of synergy they can obtain by operating in an integrated way. In particular, the use of 'comparables' in establishing standards for transfer prices under the arm's length principle has been shown to be deficient in both theory and practice, due to the integrated nature of multinational firms and their advantages of superior know-how and technology, and economies of scale and scope. Three of the nine substantive points in the BEPS Action Plan aim to deal with aspects of transfer pricing.

For over three decades it has been understood that the major problematic area in transfer pricing involves so-called intangibles, for several reasons. A major competitive advantage of most multinationals is their control of know-how and advanced technology. This generally results from their size and ability to combine large-scale innovative activity, as well as simply to acquire such technology by purchasing rights or teams of innovators. A firm's knowledge or know-how is very much a result of synergy, and it is very hard to value the different contributions of different parts of the firm to that whole. This is so even when such knowledge can take the form of intellectual property, since this concept creates a misleading notion of the nature of innovation or creativity as individualized, episodic and discrete, instead of collective, continuous and cumulative. Today, such research is generally carried out by multinationals through worldwide teams operating in a coordinated way. Furthermore, basic research must be closely linked with product development and marketing, and in fact companies spend far more on these than on research.

This has become an intractable issue because the OECD approach has exacerbated the difficulties created by the separate entity/arm's length principle, by contributing to making a fetish of the concept of 'intangibles'. The innovation and know-how which are the main sources of competitive advantage for companies today essentially flow from the people they employ.

OECD Proposed Solutions

The OECD began to recognize the special problem of intangibles over twenty years ago, but has made only feeble attempts to deal with it. The issue of intangibles is central, and a project begun already in 2010 has finally resulted in a draft revised chapter on Intangibles for the Transfer Pricing Guidelines. The proposals in the discussion draft on Intangibles were long-overdue. They seemed to recognize the need to move away from the fictions of ownership, contract and provision of capital to justify transfers within multinational corporate groups, which have long been a primary source of BEPS. Not surprisingly, the drafts were the subject of a most intensive lobbying effort by tax advisers, many of whom seemed to believe in the reality of the fictions they themselves create. Regrettably, the report seems to have yielded to many of their arguments.

The report presents a new chapter VI on Intangibles for the OECD Transfer Pricing Guidelines which is 66 pages long, plus a 36-page Annex of examples. The core parts of the draft on Intangibles is at this stage treated as provisional, pending the work to be done next

year. Mastering its intricacies will be a daunting challenge for tax officials especially in developing countries, but no doubt continue to provide lucrative work for tax advisers. The draft begins by affirming that '[l]egal rights and contractual arrangements form the starting point' (para. 6.35); but it goes on to say that they 'serve simply as reference points', so must be 'combined with the identification and compensation of relevant functions performed, assets used, and risks assumed by all contributing members' of the corporate group. The discussion of how to evaluate the various ways in which functions, assets and risks may be deployed takes many pages, but makes clear that it is basically a pragmatic factual analysis.

Accepting the starting point of fictitious legal ownership will continue to encourage firms to convert the innovations they generate into potentially highly valuable property rights, and use fictitious transfers to related entities to design complex tax-saving structures. This puts great weight on the methods used to decide the appropriate remuneration for the various 'functions, assets and risks'. Yet here the proposal remains unclear and full of ambiguities, inconsistencies and even contradictions. It states in general terms that 'depending on the specific facts' any of the five accepted transfer pricing methods may be appropriate, and then adds that 'other alternatives may also be appropriate' (para.6.133). However, in discussing the use of comparables it rightly points out that 'intangibles often have unique characteristics' (6.113), and hence that 'the identification of reliable comparables in many cases involving intangibles may be difficult or impossible' (6.143). Furthermore, 'One sided methods, including the resale price method and the TNMM, are generally not reliable methods for directly valuing intangibles' (6.138). The logical conclusion is that the profit split method should be used, but the draft is reluctant to say so, and says little or nothing about how in practice the analysis of "value creation" factors could guide application of profit split.

Our Evaluation

The proposals still refuse to abandon the fictitious concepts of ownership and risk within a multinational. The new emphasis on 'functions, assets and risks' seems only to add further complexity to the detailed factual analyses required, which will add greatly to the burdens of tax administrations. It is nevertheless likely that there will be a further shift in practice to the use of the profit split method. Yet, much more work needs to be done on regularizing and systematizing this method, especially by (i) developing recommendations for common tax accounting standards, and (ii) defining suitable allocation keys. We hope that this can be done in the next phase of the project.

The OECD is also committed to considering 'special measures either within or going beyond the arm's length principle' (Action Plan p.20). So far these seem to be envisaged only for special cases or exceptional circumstances, without any clarification yet of what these might be. The OECD still religiously proclaims its adherence to the totem of the 'arm's length principle, even though this is interpreted as allowing five accepted methods of application which differ widely, and further alternatives are under consideration. The total incoherence of transfer pricing rules remains the most blatant indicator of the crisis of the current system. Unless a better approach can be developed in the next year, the BEPS project would have to be judged a failure.

6. ACTION 13: RE-EXAMINE TRANSFER PRICING DOCUMENTATION AND DEVELOP A TEMPLATE FOR COUNTRY-BY-COUNTRY REPORTING

Nature of the problem:

There are two distinct problems here, both caused by the separate entity/arm's length principle. This principle means that countries are supposed to treat the subsidiaries and branches of a TNC in their country as if they were independent of the others in the

multinational corporate group. The consequence is, on the one hand that tax authorities find it hard or impossible to construct a clear picture of the group as a whole, while on the other they need a lot of information on transactions between group members in order to adjust transfer prices according to the arm's length principle.

OECD Proposed Solutions

The OECD initially confused the two issues, by trying to combine the development of the CbCR template with transfer pricing documentation. The proposals substantially rectify this, by proposing three levels of reporting: (i) a CbC report, (ii) a Master File, and (iii) a Local File. In principle, the first should be a general risk-assessment tool relating to all BEPS issues, while the other two deal specifically with transfer pricing documentation. However, this distinction is unfortunately not made fully clear in the report. First, implementation is proposed by means of a revised section in the Transfer Pricing Guidelines, although some phrases are added stating that the CbC report might also be useful for other BEPS issues. Secondly, it seems that some countries, especially non-OECD G20 members, would like to include some transfer pricing documentation as part of the CbC reports. This is apparently because they find it difficult to obtain such information otherwise.

A 'model template' for the CbC report has been agreed, to provide an overview of the multinational as a whole broken down by jurisdiction giving aggregate data by jurisdiction on (i) revenues (separating those from related and unrelated parties), (ii) profit/loss before income tax, (iii) income tax paid (cash), (iv) income tax accrued in current year, (v) stated capital, (vi) accumulated earnings, (vii) number of employees, (viii) tangible assets (non-cash). It also requires a listing of all constituent entities in the multinational group together with their jurisdiction of incorporation and residence and main business activities. Separate annexes describe the information which should be included in the Master File and Local files. The Master File requires information in five categories: (i) the MNE group's organisational structure; (ii) a description of the MNE's business or businesses; (iii) the MNE's intangibles; (iv) the MNE's intercompany financial activities; and (v) the MNE's financial and tax positions. The Local File would provide more detailed information relating to specific intercompany transactions.

The report envisages that all reports would be delivered to tax administrations. Tax administrations are required to take 'all reasonable steps to ensure that there is no public disclosure of confidential information (trade secrets, scientific secrets, *etc.*) and other commercially sensitive information' in any of the three levels of reporting.

Work has not yet been completed to agree the procedures for filing and access by tax administrations to any of the three levels of documentation. Options under consideration apparently include direct filing to all administrations where there is a taxable presence, central filing with automatic access or sharing, filing with the parent's authority and sharing via information exchange, and technological solutions. Reaching agreement on these procedures is expected to take a further three to four months.

Our Evaluation

The formulation of a template for country-by-country reporting is a major achievement, on which we congratulate all those involved. We hope that the political commitment will continue to be strong enough to ensure effective implementation.

In our view the CbC report should be regarded clearly as separate from transfer pricing documentation. It is very unfortunate that some, especially developing countries, experience such problems accessing information on related-party transactions that they consider that it should be included in the CbC report. This is no reason to confuse the two. Instead, there

should be a strengthening of the requirements for transfer pricing documentation, especially the Master File, and particularly of the mechanisms for access by tax authorities. We hope that this can be done, and that it will result in full consensus on the CbC report template, to provide a general overview of every multinational's worldwide presence.

The report still leaves open the key issue of access. In view of the very general nature of the information required by the CbC report template, there seems no valid reason why these reports should not be published. The report rightly stresses the need for tax authorities to preserve strict confidentiality of information which may be commercially confidential. However, the CbC report as now designed would not normally include such information. Publication should therefore be the norm, subject perhaps to allowance for exceptional cases. There is widespread public interest in such greater corporate transparency, which has led to mandatory publication requirements especially in the EU and the US of such reports in specific sectors (extractive industries and financial services). Finally, this data would constitute an invaluable information resource, which should be treated as public domain. At present, corporate data, even if they originate from state legal requirements e.g. for publication of company accounts, are in practice extremely difficult to access. Hence, both researchers and even government bodies such as tax authorities, are dependent on private providers of data-bases. This is particularly damaging to developing countries, both because of the high cost of subscriptions, and because the coverage of developing countries in such databases is poor. The G20 should take a lead in making this important standard a worldwide expectation, and ensure that the data is publically available to support corporate transparency and facilitate tax enforcement everywhere in the world.

At the same time, tax authorities continue to have an important need for easy access to the information that would be required in the Master File. We hope that the OECD can devise an efficient solution for automatic transmission to every tax authority in which a multinational has a taxable presence. It would be highly unsatisfactory if they had to rely on obtaining this important data through the vagaries of information exchange, which would be time-consuming, and potentially discriminatory. Attention should also be given to improving the mechanisms for a tax authority to easily obtain on request the Local File supplied to another country where it has a demonstrable need.

7. ACTION 15 DEVELOP A MULTILATERAL INSTRUMENT

Nature of the problem

International tax rules are embodied in treaties, almost all bilateral. If a revision to the text of model treaties is agreed (by the OECD or the UN) it can take years for existing bilateral treaties to be renegotiated. In addition, treaty coverage is variable, and many developing countries have few treaties. Changes to the interpretation of existing treaty articles can be implemented more quickly, by amending the Commentary to the model treaty, or by amending other documents especially the Transfer Pricing Guidelines. However, these have only indirect legal effect, although they strongly influence administrative practices, they cannot change the binding legal provisions. In addition, variations in the texts of actual bilateral treaties, of which there are around 3,500 in force, mean that the system is incoherent and full of loopholes.

A multilateral convention could deal with many of these problems, by enabling changes to be implemented more quickly and in a coherent and coordinated manner. However, it poses a number of legal questions, such as whether and to what extent it could override existing treaties, which states would be involved in negotiating the text and eligible to join, and whether states could pick and choose which provisions to accept or would need to sign up to

at least a core package of provisions. Negotiation of such a convention could take some time, presumably starting in 2017 once the OECD project is expected to complete, and even after a text is agreed it would not be binding on any state until it ratifies the convention.

OECD Proposed Solutions

The report cogently explains the reasons why a multilateral convention is desirable, as well as how it would be feasible. It proposes an instrument that would co-exist with the existing network of bilateral treaties, to both modify and add new provisions to them. Such an instrument would apply only where states accepting it already have a bilateral treaty between them. However, the report leaves open the question of whether a dispute-settlement provision could be included which might apply even in the absence of a bilateral treaty. The relationship between such a multilateral instrument and any bilateral treaties concluded subsequently by states is an important issue, which the report states should be decided at the political level. It also identifies a number of other technical issues which it says can be resolved through appropriate drafting, including the use of compatibility clauses and suitable superseding language. Further, it suggests that the scope of such a convention could be expanded subsequently, so providing a method for regular systematic updating of the treaty system.

Two important questions remain. One is the content of the instrument. The report discusses which potential treaty provisions might be considered to be 'multilateral in nature' and those which are rather bilateral and for which 'flexibility can be provided within certain boundaries'. However, it does not clearly explain whether the intention is that the 'multilateral in nature' provisions would also be combined into a core package, requiring acceding states to accept them all. This is particularly important because among the provisions suggested for this group is a multilateral dispute-settlement procedure which would include an arbitration provision 'to provide certainty and resolution of disputes'. The second concerns the arrangements for negotiation. It stresses the importance of broad participation, and envisages a call by the G20 for international conference with a mandate limited in time, as well as scope (to implementing the BEPS Action Plan)

Our Evaluation

The BEPS project offers an unprecedented opportunity to bring coherence and great coordination to international tax rules. To achieve this, a multilateral convention is indeed essential. To succeed, however, would require ensuring that the content of such a convention is both effective and widely acceptable. The BEPS project is hampered because although the G20 includes the world's most powerful states, it excludes the poorest and most needy, who are also relatively more dependent on corporate tax revenues. It is clearly right that all states should be entitled to participate in the negotiation of any multilateral treaty. Nevertheless, by the nature of the process, much of the content of such a treaty would already have been determined.

This may be unavoidable, and hence be acceptable up to a point. However, the key issue to be addressed is to what extent this would be considered a package deal, and if so which provisions would be part of such a package and which might be optional. In this respect, a key question is the dispute settlement procedure, especially if it might involve binding arbitration. This is known to be a red line issue for many especially developing countries. We have two particular concerns. One is that the BEPS project may well result in a highly complex set of rules lacking coherence and likely to generate conflict. This indeed is what leads many to press for a binding arbitration procedure. However, such a procedure is an inappropriate way to attempt to resolve conflicts due to rules which are not themselves clear

and susceptible to different interpretation. Secondly, the present tax dispute settlement procedures are highly secretive and hence lack legitimacy. Any strengthening of these procedures should in the first instance consider how they could be made far more transparent.