Finalising and Implementing the BEPS Agenda

Program

Monday 17 November

8:30 Registration. Coffee and pastries

9:00 **The BEPS project**
Pascal Saint Amans, OECD
Richard Vann, Sydney University. *A stocktake of work to date and an assessment of the future*

10:30 Morning tea

11:15 Miranda Stewart, ANU. *Themes of abuse and the digital economy in BEPS*
Jacques Sasseville, OECD. *Commentator*

12:15 Lunch

1:15 **Actions 8, 9, 10, 13. Transfer pricing**
Mitchell Kane, NYU. *Labor rents and 'developing' countries: Where's the BEPS?*
Michelle Markham, Bond. *Commentator*

2:15 **Action 4. Interest and base-eroding payments**
Chloe Burnett, Sydney University. *Arm's length interest - close to hand*
David Duff, University of British Columbia. *Toward a comprehensive approach to base erosion through the deduction of interest expenses*

3:15 Afternoon tea

3:45 **Action 2. Hybrid instruments and entities**
Graeme Cooper, Sydney University. *Co-ordinating inconsistent choices: hybrids*
John Prebble, Victoria University of Wellington. *Commentator*

4:45 **Action 11. Evidence**
DP Sengupta, Principal Consultant, National Institute of Public Finance and Policy, India. *Base erosion and profit shifting - an Indian perspective*
Wei Cui, University of British Columbia. *A critical review of proposals for destination-based income taxation*

7:00 Dinner

Tuesday 18 November

8:30 Coffee and pastries

9:00 **Actions 1, 7. PE issues**

Antony Ting, Sydney University. *The politics of BEPS - What does Apple's international tax structure reveal?*

Dale Pinto, Curtin University. *A preliminary analysis of the potential options to address the tax challenges raised by the digital economy*

10:30 **Actions 6, 15. Treaties**

Jacques Sasseville, OECD. *Abuse of tax treaties*

Lyn Redman, Greg Woods, Australian Treasury. *Commentators*

11:00 Morning tea

11:30 **Actions 12, 13. Information**

Diane Ring, Boston College. *Transparency, disclosure and developing countries*

Craig Elliffe, University of Auckland. *Commentator*

12:30 Lunch

1:30 **Action 14. Dispute resolution**

Jonathon Spencer, ATO. *Improving tax treaty dispute resolution – Lessons from Australia*

Micah Burch, University of Sydney. *Commentator*

2:30 **BEPS implementation and national interest issues**

Andrew Mills, ATO. *Some Thoughts on Implementing the BEPS Agenda in Australian Law*

David Pearl, Treasury. *BEPS - A policy adviser's perspective*

3:30 **BEPS and developing countries**

Caroline Malcolm, Counsellor to the Director and Deputy Director, CTPA

Carmel Peters, IRD NZ. *Commentator*

4:30 Close

BEPS: A stocktake of work to date and an assessment of the future

Richard Vann, University of Sydney

The details of the individual actions of the OECD/G20 BEPS Action Plan will be discussed at the various sessions of this conference so this paper will consider the broader issues of the project, using some examples from the various actions. At the outset it should be noted that a great amount has already been achieved in building consensus within and beyond the OECD even when the opposition appeared very strong. The following comments are not meant to detract from that achievement, but rather encourage the OECD to continue to think further about some of the longer term issues thrown up by BEPS – already the OECD may be taken to be suggesting in the case of the digital economy that BEPS is but one stage on the road to change in the international tax system.

It may well be that many of the ideas raised are simply not feasible given the negotiation dynamics within the relevant BEPS working group and the many and diverse country interests that need to be accommodated but at the very least outsiders will want to understand what those dynamics are and why they make various possibilities not feasible within the BEPS project.

Provisional nature of outputs to date

The 2014 deliverables have a standard Foreword which makes clear that all of them, though agreed, are only provisional pending further work in 2015 (which was expected because of their interactions with the various Actions to be dealt with in 2015). It is also stated that all of these Actions require more work, in other words they are all in some sense incomplete. Further the reference to tax sovereignty which has featured in the G20 communiqués is repeated, that is, no country is legally bound by what is decided in the BEPS process to date and maintain their freedom of action to a large extent both legally and practically.

Looking across the entire BEPS agenda, it was likely that some parts were going to be easier than others, with the consequence that the deliverables have had to some extent to fudge responses. It is likely to be easier to get countries to agree to things that are basically about collecting and disseminating information (transfer pricing documentation and country-by-country reporting) or to agree on overcoming tax planning which leads to tax being paid nowhere (hybrids) – though even in both these cases consensus was not easy as it turned out. It might even be easy to get countries to agree to fix up some of the problems that treaties are alleged to have created such as switching off CFC rules (treaty abuse). On the other hand it is likely to be hard to get countries to agree to things which constrain their ability to use their tax systems to attract investment (harmful tax practices) or to agree to give up their tax base to some other country (the country of location of customers in relation to the digital economy).

Hence it is not surprising that the OECD has had mixed success in achieving the outcomes indicated in draft documents released earlier this year or in completing the 2014 Actions. To think of this as a failure, however, is probably wide of the mark. The amount of detail that has been agreed is surprising in its breadth and depth and the political momentum and commitment to finish the BEPS agenda on time has been reaffirmed on more than one occasion.

Nor should it be forgotten that BEPS is only one part of a three-pronged G8/G20-OECD tax and tax-related agenda, including also establishing automatic exchange of financial account information as the international standard (now agreed by the G20 to start by 2018 at the latest) and disclosing the ultimate beneficial ownership of legal entities (to which the G8/G20 commitment on progress continues with more promised at the Brisbane G20 November meeting).

Which is a dilemma for the OECD. Not only does it have to contend with this other large workload, in 2015 it has to finish the unfinished part of its 2014 work as well as complete the 2015 work. Our politicians tended to give the impression in September 2014 that, with deliverables on 7 out of 15 actions, the work was more or less half complete. A more accurate estimate would be one third of the work is (provisionally) complete. The fate of the BEPS project really depends on the work to be finalised in 2015. The project was always a big ask of the OECD and as time passes, the amount of work seems to grow rather than decrease. No doubt the necessary deliverables will be delivered in 2015 but to what extent they represent a real consensus will be the critical question.

Policy

The policy underlying BEPS is to keep the corporate income tax as the main tax on business profits and to align the location of taxable profits of a firm with its activities. This directly or indirectly explains the various actions which are largely substantive in content, though in some cases they are reactive to failure by countries to align profits with activities (potentially parts of Actions 2-4 and perhaps 5 and 14 – see below) or procedural to provide evidence to tax administrations that BEPS is occurring in specific cases (the transparency part of Action 5, and Actions 12-13). Action 11 stands to one side and, perhaps along with Action 1, provides the only direct consideration of data and policy. As written the action reads mainly like a concern with system wide "proof" (data) that BEPS is occurring and the responses to the consultation on Action 11 to date confirm that view.

There is, however, a deeper policy question of whether the corporate income tax is the right approach to taxing corporations or whether it is economically doomed to failure. It is not evident to what extent this question will be raised in the policy discussion under Action 11. It can be argued that, as the 2014 digital economy paper recognises, the returns earned by most companies are a mixture of return to economic rents and return to risk-taking which cannot be observed separately in the real world. The corporate income tax has the virtue of capturing both kinds of return without the need to distinguish them, unlike other alternatives emerging from the economic literature such as explicit rent taxes, and destination based cash flow taxes on returns (which are assumed to all relate) to risk-taking.

There are also more detailed policy issues inherent in all of the substantive action items which are likely to fall between the cracks, because they will not be captured in Action 11 nor other actions items, either because they are put to one side such as the broader nexus questions in the digital economy, or because the content of the particular action is quite prescriptive and invites a response in very specific and concrete terms such as Actions 6-10, which in my view are the crux in terms of positive norms involved in the BEPS project.

For tax treaties, what the basic policy drivers are in terms of treaty abuse or the permanent establishment threshold are rarely analysed in any detail . The OECD work on treaty abuse has suffered historically from the fundamental difficulty in defining the policy problem(s). The current treaty abuse work is largely devoid of explicit policy analysis. The PE threshold likewise has always been very light on explanation (although some attempt was made by the OECD in 2008 in relation to the services PE). Here I will focus on the PE test and transfer pricing as an example of how the detailed proposals may miscarry if policy is ignored.

The PE test (along with its functional equivalent of creation of a subsidiary in a country) is intended to draw a line between foreign direct investment in a country as opposed to mere exports to a country. The fixed place threshold which bases the test on a fixed presence of some duration in a country was devised in an era when the nature of business meant that some premises were necessary to have a relevant presence and it was sensible to look at single companies as the current complex corporate structures did not exist. The growth of international trade in services has largely undermined the use of fixed premises to express the basic idea (as is recognised in the services PE definition in the UN Model and the OECD Commentary) and the growth of complex corporate structures has rendered the use of single companies an inappropriate way to test presence. The latter is recognised in the use of provisions grouping associated enterprises (which is one of the main proposals of the PE Action 7 discussion paper) but these do not recognise that it is the combined presence in the country of all associated companies whether resident or non-resident that matters, that is, within the country grouping of associated companies whether resident or non-resident should be applied to test presence for the threshold.

With respect to agency PEs the need for this specific test arose from what has come to be called the “at the disposal” test with respect to the fixed place, that is, the premises (presence) had to be those of the enterprise in question, not another enterprise. The agency PE which historically also required a fixed place was designed to ensure that premises of another person were effectively treated as the premises of the enterprise if that other person was dependent on the enterprise (note that the same applies to the services PE and is now discussed at some length in the OECD Commentary). The rewriting of the test in the 1950s by the OEEC to separate the agency test from the fixed place test and to omit the explicit reference to a place finally led to the 2003 OECD view that no enduring presence of the agent in the country was necessary so that exports to a country are much more likely now to be captured by the agency test in contradiction of the basic policy (signing contracts in a country without any other fixed place or other activity there is enough for an agency PE).

The contracting test in the agency PE was an artefact of the usual activity carried on by foreign enterprises in the past of selling things in the country. Now that sales of things in a country (where contracting makes some sense as a test) has been matched or overtaken by provision of services (where it is the provision, rather than the contracting that matters) the agency test misfires in many cases even where the “dependent actor” has some enduring presence but does not contract. The proposed rewrite of the agency test mainly focuses on fixing the contracting side of matters but without getting at the underlying policy. Not surprisingly it has raised concerns for Australian exporters of natural resources.

The suggestion above of looking at the presence of all associated companies in a corporate group in testing whether the threshold is passed would largely solve the "dependent actor" PE issue – the further test would only be necessary for an enterprise which satisfies the presence threshold and is dependent on but not associated with the other enterprise. It would also greatly reduce the significance of the threshold as the presence of a subsidiary would be enough to enliven taxing jurisdiction with respect to all activities of the associated companies in the corporate group undertaken in the country. This kind of discussion about PEs is necessary to establish what the policy of the threshold is. It does not necessarily mean that the recommended fixes have to be applied directly as path dependence has a role to play in how the rules are developed in future. But it is necessary that the policy issues be understood to prevent any rewrite affecting innocent bystanders (which includes collective investment vehicles as well as exporters).

Once the necessary activity threshold has been passed then it is a matter of using transfer pricing to establish the value of all the activities of the associated companies which constitute a corporate group in the country (including those of "dependent actors" of such companies) even if the tax liability is then levied company by company, rather than on a separate entity basis – which brings the discussion to the policy issues of the transfer pricing rules.

The elaborations in the last 20 years of the Transfer Pricing Guidelines and the Attribution Report implicitly assume that the return to companies taxed under the income tax is for risk-taking and so risk has become central in the analysis. The debate about intangibles in particular is, however, mainly about returns to economic rents, which means that much of the transfer pricing analysis miscarries because it is still framed within the return to risk-taking paradigm. Moreover, even if returns are only to risk-taking, it is impossible to really observe where the risk-taking occurs (other than where activities occur) and the adage of the optimal tax literature again applies: it is not possible to tax directly what cannot be observed. The insistence on taking account of facts and circumstances in the transfer pricing guidelines is a case of observing the unobservable and means that the transfer pricing work (putting aside the "special measures") is likely to miscarry at least in part when viewed from the policy level.

Accepting as BEPS does that the focus should be on activities the questions then are what is meant by activities in a country in relation to taxing returns to rent and risk-taking, and how can an arm's length test be applied in that setting. These are large issues that I have discussed elsewhere and will leave for now, except to emphasise again that putting aside special measure, the current BEPS work is only partly heading in the right direction (so far is it pushes towards profit splits).

The separate entity part of the separate entity arm's length principle also needs to be thought through given the view above, which is implicit in the BEPS policy stance, that it is the value adding from all activities of associated companies in a country that need to be priced and allocated to that country for taxing purposes, once the threshold is passed. At the moment there are separate principles for PEs and associated enterprises. Clearly a unified set of principles is required. One of the main purposes of the Attribution Report was to unify the principles and that sense headed in the right direction but it sought to move the treatment of PEs in the direction of associated enterprises and elevated dealings to the status of transactions for that purpose. BEPS is focused on activities which implies a move away from transactions and dealings. There is an awareness of the implications of this shift in some of the BEPS intangibles work to date but the current result is an awkward combination of transactions and activities. Path dependence is the reason why the shift is occurring in this way, but the policy goal needs to be kept in view in navigating the transfer pricing rules along that path.

Instruments (and working methods)

The OECD/G20 work to date also indicates the complexity of BEPS and its interactions. The interactions were always recognised, but the complexity arising from the various instruments being used to deliver them has not so far been much highlighted. The instruments are domestic law changes, changes to OECD Commentaries and Guidelines, changes to the OECD Model treaty, the multilateral instrument and in the case of Action 5 the revived Forum on Harmful Tax Practices (FHTP). As an example of this complexity, consider the BEPS work on intangibles. Two Actions, 5 and 8 explicitly feature intangibles, but involve the whole range of delivery mechanisms, being domestic law and the FHTP under Action 5 and potentially the Guidelines, Model treaty and multilateral treaty for Action 8. The related question is what happens as the end of 2015 when the BEPS project is concluded. Will the world return to its previous patchwork of implementing international tax solutions, or will a more coordinated approach be adopted?

One unexpected item in the 2014 deliverable on Action 15 is that the negotiations on the multilateral instrument (treaty) to give effect to some of the BEPS conclusions will now commence in early 2015. Originally the indications were that this negotiation would occur in 2016. The result is that delegates will be negotiating text on 2015 actions which will still be in progress when the negotiations occur (such as changes to the permanent establishment definition, special measures on transfer pricing and international tax dispute resolution), which, along with treaty abuse and a rule on the treaty treatment of transparent entities, are likely to form the contents of the instrument. The message from moving the multilateral instrument into 2015 seems to be that it is expected by the G20 that BEPS will really be finished in 2015 at least so far as establishing the consensus on the new system is concerned, although implementation and follow-up obviously will extend beyond that time.

Once the BEPS work is finished, only two instruments apart from the normal OECD work processes are evident for ensuring that countries honour their agreements to implement BEPS related measures to which they have agreed at the political level, the Forum on Harmful Tax Practices in relation to Action 5 and whichever body is responsible for the multilateral treaty (almost certainly the OECD). Nothing to date like the Global Forum on Exchange of Information for Tax Purposes which has driven the technical work and peer reviews on exchange of information is yet being proposed for BEPS. It is doubtful that the progress on exchange of information would have been made without the Global Forum – the multilateral treaty in that area has only been a convenient mechanism rather than the driver of change. It is thus still possible that BEPS could fail in implementation if no oversight mechanism is put in place at the end of the 2014-2015 work. How long the political attention of the G20 can remain engaged is a related and still open question.

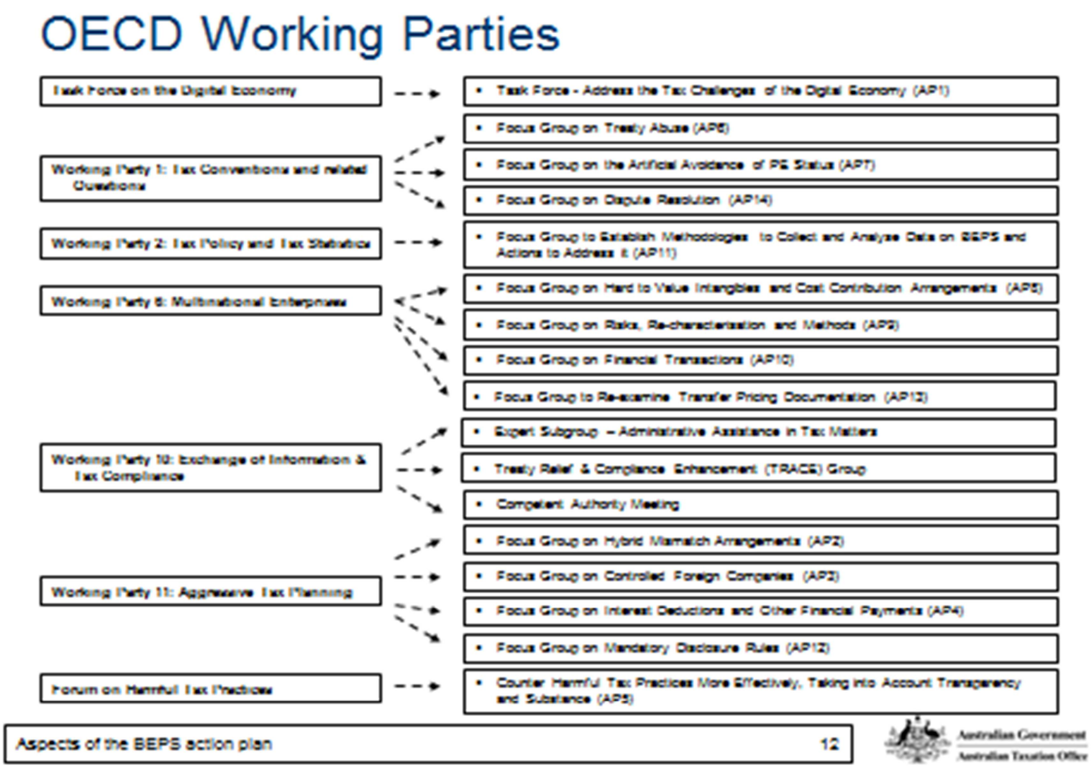
That in turn leads to consideration of why one or other mechanism is chosen for implementing particular actions. In terms of ease of delivery the OECD Commentaries and Guidelines seem the best method since they do not require treaty implementation and are regularly changed by the OECD and largely accepted by countries even though only a form of soft law. At the other extreme renegotiation of existing bilateral treaties based on the OECD Model or negotiation of a multilateral instrument to modify existing bilateral tax treaties is likely to be either a very slow and/or a very contested process. A middle way more generally is to create soft law norms with some peer review process like the FHTP to carry the BEPS work into action.

The 2014 deliverable on the multilateral instrument quotes the multilateral treaty on Mutual Administrative Assistance in Tax Matters as a 'recent success story.' That treaty was opened for signature in 1988, commenced operation in 1995 with five signatures and only had 14 signatures by 2009, after which it took off to become the new international standard for administrative assistance, especially exchange of information, now having 84 signatures and 15 extensions to 'colonies' (including tax haven dependencies of the UK). The success only materialised once the G20 become involved with it in 2009. Even so that is five years ago and the real take-off was only in the last two or three years with the push for automatic exchange of information arising from the current implementation of FATCA by the US. Is it the G20 or FATCA that explains the recent success? While the FHTP is to be revived from its moribund slumber of recent years as a result of BEPS, its history to date shows the difficulty of maintaining momentum purely in soft law terms, without the availability of some hard law framework and ongoing political commitment.

Which raises the questions of why there is little discussion of implementation instruments of specific actions beyond fairly bland reference to domestic law etc and the apparent under-utilisation of the course of soft law guidelines. It is possible that a lot more could be achieved by this approach particularly in relation to Actions 2 and 6-10. Recent history in the form of the 10+ years projects on e-commerce and attribution of profits to PEs may provide the answer. Arguably it was the OECD's refusal pre-BEPS to consider the transfer pricing rules along with the PE threshold for taxing businesses that has largely been to blame for the development of BEPS. The transfer pricing rules have changed beyond all recognition in the last 25 years while the PE threshold has gone largely untouched producing a significant mismatch between them.

The reason for this outcome is probably the way in which the OECD traditionally worked in silos, with treaties in WP1, policy in WP2 and transfer pricing in WP6. Although attempts were made in the previous e-commerce work of the OECD to work across the silos this was largely unsuccessful, as it was entirely unsuccessful in the attribution project. By contrast the BEPS project recognises the need for a whole-of-OECD approach – that a coordinated set of measures are necessary. But old habits seem to die hard. WP6 is unable to see sufficient flexibility in rewriting the guidelines to overcome the many problems that the previous rewrites of the guidelines have created without special measures, other than more of the same. Hence the hard option of the multilateral instrument in several important respects can be seen as a way of overcoming the caution or perhaps the inability to see a way forward in the soft law route in the traditional work silos of the OECD, even though they have largely operated with soft law for many years. This silo issue may have resurfaced in the BEPS PE discussion draft for Action 7. That action includes attribution of profits to PEs (as the policy discussion above suggests it should). The discussion draft indicates the degree of coordination necessary across Actions 4, 7, 8 and 9 but concludes, subject to that coordination, that current work "has not identified substantial changes that would need to be made to the existing rules and guidance concerning the attribution of profits to a permanent establishment if the proposals included in this [discussion draft] were adopted." The overall impression is that WP1 does not want to tread on the toes of WP6 or WP11 (on aggressive tax planning) despite the necessity of interaction.

Apart from coordination issues there is a further complication arising from silos – the problem of "too many cooks spoiling the broth." The following slide borrowed from a recent ATO presentation by Andrew Mills and Mark Konza to an IFA branch meeting indicates that no less than seven OECD related bodies are involved in the BEPS work.



This in fact understates the number and the issue, for example, the Forum on Tax Administration is also involved in the work on dispute resolution and the UN Tax Cooperation Committee has work underway on services (including a possible article on technical services and/or cyber-based services and revision of UN transfer pricing guidance). The existing OECD bureaucracy in the Centre for Tax Policy and

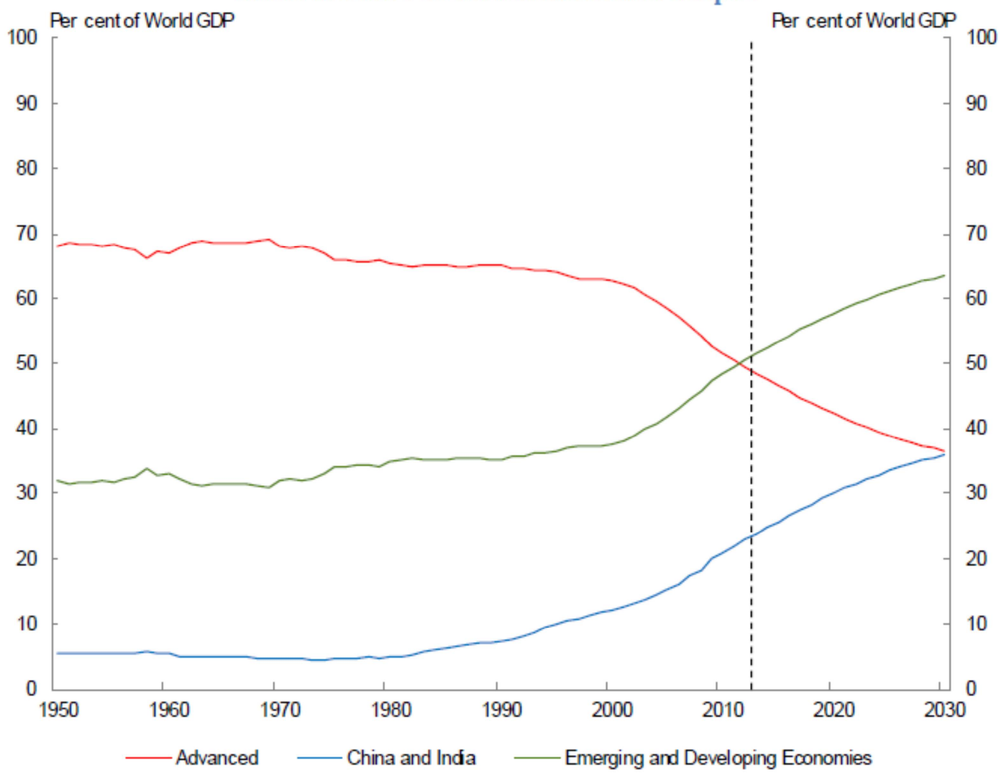
Administration is clearly the main coordination mechanism and will be put to the test in the next year as the various strands of work are brought together.

Conversely it can be argued that "the more the better" in terms of establishing as broad a consensus as possible and ensuring buy-in to the outcomes of BEPS by the diverse groups involved. The BEPS Action Plan articulated a broad consultation strategy which is still a work-in-progress as indicated under the next heading. No doubt consideration is being given by the OECD and others to the follow-up strategy for BEPS. It will be critical to the ultimate success or otherwise of the BEPS project.

Non-OECD countries

BEPS is not only about the tax machinations of multinationals. It also is an implicit recognition of the shift in geo-political power away from the old economies as illustrated by the following graph in one of the documents produced by Australia's Treasury in relation to BEPS.

Chart 2: Share of Global Economic Output



Source: Au-Yeung W, Kouparitsas M, Luu N, Sharma D, (2013 forthcoming) Long-term international GDP projections, Treasury Working Paper.
Note: Groupings are based on the IMF World Economic Outlook aggregations. Emerging and Developing Economies includes China and India.

The involvement of the G20 in the exchange of information area from 2009 was probably explained mostly by politics – getting the necessary political support and power to bring tax havens to heel. In the case of BEPS in addition to getting the political support and power to bring another recalcitrant group, the multinationals, to heel, it was also a convenient way to get the major emerging economic powers into the tent. Shortly before BEPS got underway there were signs that the major non-

OECD countries did not accept parts of the international tax consensus, particularly in chapter 10 of the UN transfer pricing manual that was first published in 2012.

The OECD was already taking preventative action against this threat before BEPS. At the same time that the OECD published its pre-BEPS draft on transfer pricing for intangibles in 2012 it also published a draft on safe harbours and material on simplification measures in the transfer pricing area. Although these may have appeared to just be further continuation of OECD transfer pricing work (revising the Guidelines and providing best practice information), in fact it was one of many straws in the wind indicating that China, India and Brazil were flexing their muscles and shaking up international taxation as became more publicly evident when the UN draft manual appeared shortly thereafter.

It is not easy, however, for the OECD to come up with a consistent response to concerns of non-OECD countries because the nature of the problem varies country by country. The China and India views in the UN material in effect adopt the methodology and case-by-case approach of the OECD Guidelines but reach quite different conclusions than those that would be expected in OECD countries and also note the difficulty of finding comparables for developing countries. By contrast the Brazilian approach and one suspects that of many other developing countries seems to be that the fact intensive nature of current transfer pricing guidance and imbalance of expertise between developing country tax administrations and advisers of multinational companies mean that a much simpler method for dealing with transfer pricing problems is necessary in their case.

One can understand China and India not being very comfortable with OECD conclusions when the result is the profits from intangibles end up in tax havens where little or no activity occurs, and not in China and India where a great deal of activity occurs. Hence the BEPS work on intangibles can be seen as much as addressing the specific concerns of China and India as well as dealing with the more general concerns of OECD countries. Indeed the intangibles work released in 2014 deals directly with location specific advantages which have been identified by China as important and more accommodation is implicit in the non-BEPS OECD work on comparables in relation to developing countries.

On the other hand the pre-BEPS push by the OECD to simplify transfer pricing which has to some degree continued into BEPS with the release of the discussion paper on a specific safe harbour for routine non-core services will no doubt appeal to Brazil and like-minded countries. There is, however, inconsistency between transfer pricing simplification and the work on intangibles which has improved previous guidance but at the cost of considerably more complexity and uncertainty.

In relation to BEPS the Action Plan specifically identified the importance of consultation with non-G20 developing countries and the OECD (on the responsibility of the Secretary-General, that is, without yet the political support of the OECD/G20) has recently indicated an increased effort to engage developing countries in Part 2 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries, with political support perhaps to come from the G20 in November. This latest document seems to abandon simplification and adopt a technical assistance approach to skilling up developing countries. Given the inability of OECD countries to obtain satisfactory outcomes under the pre-BEPS transfer pricing norms, it is difficult to see how low income countries can ever hope to cope with the ever increasing complexity of transfer pricing. On the other hand the corporate tax is generally an even more important source of revenue in developing countries than most OECD countries and so low income countries are likely to share the policy preference of the BRICS to maintain and strengthen the corporate tax as a source based income tax and to maintain their source taxing rights under tax treaties.

So while there is an aspiration to bring non-G20 developing countries into the BEPS tent, it is an open question whether the right method is being adopted (in the sense of a method which will be acceptable to many of those countries).

The US

As well as bringing non-OECD countries on board, the BEPS project has to ensure that the major OECD countries stay on board, or at least do not get off. The big question mark is the US, because of both the well-known tax policy gridlock there, and some suggestions at the domestic political level that it is the patriotic duty of US multinationals to engage in BEPS. While it is unlikely that the BEPS project could survive active political opposition from the US president and Congress (such opposition effectively sunk the harmful tax competition project in the early 2000s apart from its transparency part which), the question is whether BEPS can be successful in the face of US inaction, which seems the not-unlikely position at least in the short-term.

One way of viewing Actions 2-4 in part at least (and perhaps less plausibly Actions 5 and 14, which will not be further argued here) is that they provide a way of dealing with BEPS when the country primarily affected does not take the action contemplated by the BEPS outcomes, which were referred to above as reactive BEPS rules. This reading is most obvious in relation to Action 2 on hybrid mismatch arrangements. The 2014 deliverable proposes that countries change their domestic law to make mismatches less likely (such as countries with a participation exemption not applying it to payments which are likely to be deductible in the country of source). If mismatches nonetheless continue, then there is a two stage response which may be (inaccurately) summarised by saying that the source country denies the deduction and if that does not occur, then the residence country denies the double non-taxation however it comes about. In other words there is a built-in response to non-adoption of the basic BEPS recommendations. So if the US does not modify its check-the-box regime which is the cause of a significant number of hybrid mismatches, then the country where a deductible payment would otherwise arise can disallow the deduction and increase its revenue, even if it is not be the main country to suffer from the BEPS activity (though often it will be).

Action 4 on interest and related deductions is likely to have a similar effect as one of the major forms of BEPS is loading (often effectively unreal) interest deductions into high tax source countries. Action 4 will permit, perhaps even require, source countries directly to deny interest deductions regardless of their treatment elsewhere and so in that case deal with hybrid mismatches and other tax planning around financing of investment without being required to show that there is a mismatch or other form of tax planning involved in the interest deduction. In that sense it may be regarded as an expansion of Action 2 – it is unlikely that debt financing will be used when the interest income is more highly taxed on the receipt side. In the case of US multinationals Actions 2 and 4 have the potential to significantly reduce BEPS in other countries.

Action 3 on CFCs can be seen also as a further way of dealing with failure by another country to deal with BEPS. CFC regimes produce tax in the residence country of a company and so may be thought an odd element for a source based corporate income tax, except to the extent that the income concerned represents the other side of base erosion in that same country (round tripping, transfer pricing, passive income external to the group and similar type cases where an offshore subsidiary is used to erode the tax base of that country). In this case as only one country is affected, whether that country takes action does not implicate other countries, except in a harmful tax practices (competition) sense. To the extent that the offshore subsidiary is used to erode the tax base of other countries, however, CFC taxation in the residence country can be viewed in the same way as Action 2 as a fall-back of tax in the residence country where the source country does not tax due to base eroding payments from that country. An important test of whether this is the intent (in part at least) of Action 3 will be whether the CFC proposals prevent the use of rules which permit base erosion of other countries without triggering CFC attribution (such as the US rules that intra-group passive income which traces to extra-group active income is not attributed). In relation to the US, the potential reactive nature of the action on CFCs will show up in other countries CFC regimes, that is, will deal with cases where the US tax base is permitted by the US to be eroded by foreign multinationals.

In all of these cases, the outcome is that revenue that otherwise goes untaxed in the US is taxed in other countries, even if those countries do not in accordance with the basic policy premise of BEPS of aligning taxable income with activities have the primary taxing right. To the extent that the US viewed this as taxing revenue that appropriately belongs with the US tax base and was minded to take action, the main courses open would be to get positively on board with the BEPS outcomes, or once again try to block those outcomes. Whether the power and political will of the US in future will be sufficient to prevent BEPS actions being implemented worldwide is a question which the writer hopes will not be put to the test.

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Policy Forum: The Policy Underpinnings of the BEPS Project—Preserving the International Corporate Income Tax?

Richard Vann*

KEYWORDS: BEPS ■ CORPORATE TAXES ■ INTERNATIONAL TAXATION ■ TAX POLICY

CONTENTS

BEPS2014

INTRODUCTION

The OECD/G20 *Action Pl*[illegible]*ofit Shifting*[1] (BEPS) is receiving significant attention from taxpayers and national governments. The subsequent release in January 2014 of the OECD's discussion draft on transfer-pricing documentation along with the template for country-by-country reporting, which was just 20 pages long, attracted 1,200 pages of submissions.[2] Even before the action plan was

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1 Organisation for Economic Co-operation and Development, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013) (herein referred to as "the action plan"). See the general OECD BEPS website, which provides links to the various OECD documents and other resources, at www.oecd.org/tax/beps.htm. As noted in the Editors' Introduction, the action plan is the product of an OECD study commissioned by the Group of Twenty (G20) and was issued five months after the release of the OECD's initial report on base erosion and profit shifting (infra note 4). The BEPS project is also supported by the Group of Eight (G8).

2 Organisation for Economic Co-operation and Development, *Discussion Draft on Transfer Pricing Documentation and CbC Reporting* (Paris: OECD, January 30, 2014), available at the general BEPS website, supra note 1, along with the submissions on the draft.

released, a number of countries, including Australia, Canada, and the United Kingdom, had announced tax changes in their 2013 budgets that were subsumed under the BEPS umbrella. After the action plan was released, two of the countries that seemed to be targeted by it, Ireland and Switzerland, took defensive action: Ireland announced that it would no longer be possible for an Irish incorporated company to be tax-resident nowhere, and Switzerland signed the OECD's Multilateral Convention on Mutual Administrative Assistance in Tax Matters.[3]

Because the action plan is about action, it contains little discussion of the tax policy questions involved, though these issues were discussed to some extent in the OECD's earlier BEPS report, released in February 2013.[4] One of the less-noticed aspects of the plan is action 11. From its heading and most of its content, action 11 seems to be largely about collecting data on BEPS, but it also involves the underlying policy—specifically, "developing an economic analysis of the scale and impact of BEPS (including spillover effects across countries) and actions to address it."[5] It is understood that the tax policy body at the OECD, Working Party 2 of the Committee on Fiscal Affairs, will undertake work on the policy issues as well as the collection of data. That is perhaps not surprising, since there is an inherent contradiction between the action plan and much of the policy work on corporate taxation undertaken by the OECD over the last 25 years.

In this short article, I will discuss the policy conflict and make the case for a more balanced view of the international corporate income tax.

3 For Ireland, see Ireland, Department of Finance, Budget 2014, Financial Statement of the Minister for Finance, October 15, 2013 (http://budget.gov.ie/Budgets/2014/FinancialStatement.aspx). See also Ireland, Department of Finance, *Ireland's International Tax Strategy* (Dublin: Department of Finance, 2013) (http://budget.gov.ie/Budgets/2014/Documents/Department%20of%20Finance%20International%20Tax%20Strategy%20Statement.pdf). This announcement was clearly a reaction to the Apple tax structure involving Ireland: see Antony Ting, "iTax—Apple's International Tax Structure and the Double Non-Taxation Issue" [2014] no. 1 *British Tax Review* 40-71. For Switzerland, a range of action is being considered. Although making automatic exchange of information the international standard is not strictly part of the BEPS project, that proposal sits alongside the transparency parts of the action plan and is always mentioned in the same context as BEPS at G20 and G8 deliberations on tax issues. Coincidentally, Switzerland signed the multilateral convention on the same day that Ireland announced its corporate residence changes: see Organisation for Economic Co-operation and Development, "Switzerland Signs Multilateral Convention on Mutual Administrative Assistance in Tax Matters," October 15, 2013 (www.oecd.org/tax/exchange-of-tax-information/switzerland-signs-multilateral-convention-on-mutual-administrative-assistance-in-tax-matters.htm).

4 Organisation for Economic Co-operation and Development, *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013).

5 *Action Plan*, supra note 1, at 21-22.

THE CONFLICT BETWEEN BEPS AND THE OECD'S PRIOR POLICY FOCUS

The basic BEPS policy problem is defined in the action plan as follows:

> No or low taxation is not *per se* a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it.[6]

More concretely, at the centre of the concern over BEPS is the recognition that many multinationals, especially those operating in the digital economy, are paying very little corporate income tax. This has both a direct impact on corporate tax revenue and, potentially, indirect impacts on tax revenue generally if, as a result, the tax system falls into disrepute. Apart from revenue issues, BEPS also raises economic efficiency and fairness concerns, since the ability to avoid tax seems to be greater for multinationals than for purely domestic businesses. The main objective of the whole BEPS exercise is thus the protection and restoration of the international corporate income tax base, as is reflected in the subtitle of one part of the action plan, "Establishing International Coherence of Corporate Income Taxation."[7]

Yet the OECD has long sponsored economic research indicating that the corporate income tax is inefficient (particularly because of the mobility of capital and tax competition) and should be replaced by more efficient taxes, such as increases in indirect taxes.[8] Similarly, at the national level, there has been an official acceptance of this line of reasoning.[9] The OECD continually trots out the "reduce inefficient taxes" advice in its reviews of its members' economies.[10] So far, there are only glimmers of

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6 Ibid., at 10.

7 Ibid., at 15.

8 See, for example, Organisation for Economic Co-operation and Development, *Taxing Profits in a Global Economy* (Paris: OECD, 1991); and Organisation for Economic Co-operation and Development, *Fundamental Reform of Corporate Income Tax*, Tax Policy Study no. 16 (Paris: OECD, 2007).

9 See Australia, Tax Review Panel, *Australia's Future Tax System: Report to the Treasurer* (Canberra: Australian Treasury, December 2009); and President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals To Fix America's Tax System* (Washington, DC: US Government Printing Office, 2005). In the United Kingdom, with typical eccentricity, major tax review seems now to be left to the private sector, supported by government money, but the same trend is evident: James Mirrlees, Stuart Adam, Timothy Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles, and James Poterba, *Tax by Design: The Mirrlees Review* (Oxford: Oxford University Press, 2011). See also Advisory Panel on Canada's System of International Taxation, *Final Report: Enhancing Canada's International Tax Advantage* (Ottawa: Department of Finance, December 2008).

10 See Organisation for Economic Co-operation and Development, *OECD Economic Surveys: Canada* (Paris: OECD, 2012), at 44, and *OECD Economic Surveys: Australia* (Paris: OECD, 2012), at 48.

questioning of this underlying policy line, in both OECD and national tax policy circles.[11]

What follows is an attempt to briefly explain some of the various strands of economic literature that seem to underlie this policy stance and to suggest that the international corporate income tax has been unfairly receiving a bad press as a result. As a preliminary matter, I must say that, given the variety of theories and models deployed with always the same message, it is hard to avoid the impression that there is an agenda here. The purpose of this article, however, is not to dismiss the economic literature—a number of lessons for practical tax measures from the literature are noted along the way—but rather to invite a degree of skepticism toward very strong policy recommendations being drawn from very simple and restrictive models.

ARGUMENTS FOR AND AGAINST THE CORPORATE INCOME TAX

The corporate income tax is primarily a source-based income tax,[12] making it vulnerable in two directions: to tax planning aimed at moving the source of the income without moving the activity (the BEPS concern quoted above); and to movement (relocation) of the activity because of the international mobility of capital. The policy conflict revolves around the second of these vulnerabilities, from which the death of the corporate tax has long been predicted by economists (and when the prediction failed to materialize, explanations were offered that the corporate tax was really dead but we just did not realize it).

Although the corporate tax is intended to be a tax on capital income levied at the corporate level, it is helpful to start with individuals in order to understand the kinds of economic arguments involved. There is an influential economic literature developed in the context of individuals arguing that capital income should not be taxed. Although there are various strands, the idea is that, given certain assumptions, in the presence of a labour income tax a capital income tax is either superfluous or positively damaging. Since the assumptions fed into the economic models drive

11 The most recent discussion emanating from the OECD, while more nuanced, does not suggest that too much questioning of the economic literature is occurring there: Pierre LeBlanc, Stephen Matthews, and Kirsti Mellbye, *The Tax Policy Landscape Five Years After the Crisis*, OECD Taxation Working Papers no. 17 (Paris: OECD, 2013). The Australian Treasury released a BEPS scoping paper in July 2013, *Risks to the Sustainability of Australia's Corporate Tax Base: Scoping Paper* (Canberra: Australian Treasury, July 2013) (www.treasury.gov.au/PublicationsAndMedia/Publications/2013/Aus-Corporate-Tax-Base-Sustainability), which said, at 24: "Overall, the view that corporate income tax collections would inevitably decline over time in response to increased mobility of capital, as countries compete to lower the cost of capital within their jurisdictions, is not borne out by the data to date. . . . Among other things this may reflect the fact that capital is not, in reality, completely mobile and the fact that tax competition impacts countries differently."

12 Richard J. Vann, "Taxing International Business Income: Hard-Boiled Wonderland and the End of the World" (2010) 2:3 *World Tax Journal* 291-346.

their results, it is important to note that those assumptions are very strong, and when they are relaxed, they do not support the zero capital taxation result.[13] At the individual level, the immobility of labour and the mobility of capital have both been overplayed.

In a variety of ways, primarily because (as discussed below) the corporation is modelled as a welfare-maximizing individual, the economic models and theories on corporate taxation focus on capital income and ignore labour income. It is widely agreed that the taxation of labour income is distortive because of the untaxed choices available to individuals, namely, household production and leisure. Optimal tax theory suggests that if there is distortion in one part of the tax system, it is likely not the optimal policy to remove distortions in another part of the system. It is therefore odd that all the analysis of the corporate tax assumes that removal of distortions in relation to the taxation of corporate income is the goal without considering distortions elsewhere in the tax system.[14]

Many of the models in the tax competition literature are similarly built on strong assumptions—in particular, the existence of perfect capital markets and perfect capital mobility; that the marginal investor in a local listed firm is non-resident; that the marginal investor is tax-exempt in the home country; and that labour is completely immobile.[15] It is not surprising that a corporate-source tax is impossible under these assumptions since the standard result will be that tax is shifted from capital to labour. The policy recommendations that are then usually made are to reduce or do away with corporate income tax and taxation of income from capital generally, and to levy taxes on immobile factors, which are taken—depending on the context—to be land, average employees, and consumption. The apparent buoyancy of the corporate income tax over the many years since this kind of analysis was first undertaken and the sense that the whole of the tax was not being shifted to labour was a puzzle—but, apart from shifting to labour, it has been suggested that income shifting from the

13 Two of the assumptions are that all households consist of a single person and not a family unit, and that time is divided between market work and leisure—that is, there is no household production. Apps and Rees have been in the forefront of showing that when realistic households of families involving household production (especially child care) are modelled, the results are turned on their head. See Patricia Apps and Ray Rees, *Public Economics and the Household* (Cambridge, UK: Cambridge University Press, 2009); and Richard J. Vann, "Tax Reform and Tax Expenditures in Australia," in Yariv Brauner and Martin J. McMahon Jr., eds., *The Proper Tax Base: Structural Fairness from an International and Comparative Perspective—Essays in Honor of Paul McDaniel* (Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2012), chapter 4, at 87. See also Peter Diamond and Emmanuel Saez, "The Case for a Progressive Tax: From Basic Research to Policy Recommendations" (2011) 25:4 *Journal of Economic Perspectives* 165-90.

14 For example, this seems to be the reasoning in Mirrlees et al., supra note 9.

15 This kind of model was deployed in Australia in the work of the Business Tax Working Group, which was tasked to look for ways to provide revenue for a corporate tax rate cut. See the discussion in Richard Vann, "Corporate Tax Reform in Australia: Lucky Escape for Lucky Country?" [2013] no. 1 *British Tax Review* 59-75.

unincorporated sector to the corporate sector was occurring (partly because of the implementation in many countries of lower corporate tax rates at the suggestion of the OECD and others), thus disguising the decline of the corporate tax.

No doubt some shifting of the corporate tax to labour occurs, and there is an increasing incentive for the very wealthy to put income in companies (especially as the corporate tax rate goes down, if no measures are in place to deal with the practice), but do these factors really explain the survival and apparent buoyancy of the corporate tax?[16] In Australia in recent years, the inflation of wages in the mining sector owing to labour shortages suggests that shifting is a two-way street. The most surprising aspect of some of the recent work in this area is the persistence of the assumptions in the midst of the global financial crisis involving various capital market failures, and at some points capital market freezes.

Another strand of the economic literature on the corporate tax is to segment the return to firms into three elements: the basic risk-free rate of return, the return to risk, and the return to economic rents.[17] With regard to the first element, one argument is that the risk-free return cannot be taxed because of the availability of unlimited borrowing to remove any tax on that return. Alternatively, it is argued that taxation of the risk-free return distorts the intertemporal choice between consumption and saving, and therefore the return should not be taxed—in everyday language, a consumption tax is better than an income tax, which is often a product of the kinds of models for taxing individuals discussed above. Again, the lessons of the global financial crisis are there for all to see. First, there is no such unlimited borrowing capacity; rather, the appearance of unlimited capacity was in fact a reflection of a fundamental market failure. And second, taxation produces minor effects on saving behaviour as compared with a crisis in the financial markets.

Concerning the second element, the return to risk, it is argued that the tax system should tax risk symmetrically (providing a full refund of losses) to get the right amount of risk-taking behaviour and that, if this occurs, there will be no net tax revenue, since over time, losses and gains will cancel each other out.[18] In this area, another lesson of the modern thinking about taxes is relevant—that it is necessary to view the system as a whole and not just focus on taxation. (This is usually said in relation to the tax and transfer system, but the idea has wider application.) The tax literature on risk assumes that there is nothing but tax involved, whereas we know from daily observation of subsidies for struggling firms, lists of banks that are too

16 See Organisation for Economic Co-operation and Development, *Revenue Statistics 1965-2012* (Paris: OECD, 2013), at table 11, which shows some variability of the share of the corporate tax in total revenue across countries but overall a fair degree of constancy, with, most recently, a dip during the global financial crisis and now the start of a recovery in revenue.

17 A good account of this literature is provided by Wolfgang Schön, "International Taxation of Risk" (2014) *Bulletin for International Taxation* (forthcoming).

18 As Schön explains, ibid., there is a justification for taxing any risk premiums that are associated with risky assets to induce risk-averse investors to bear undiversifiable risk.

big to fail, etc., that a full account of the downside of risk has to take account of much more than taxation.

With regard to the third element, economic rents, the economic view is that they can be taxed more or less without limit. In an international context, with the addition of the assumption of perfect capital mobility, this means that immobile rents can be taxed in a particular country but mobile rents cannot. In the real world, however, it is impossible to observe the line between risk and rents: for example, is a higher than risk-free return from rent, or from a risky activity that has turned out well? Accordingly, we cannot build a tax system based on this distinction, and the attempts to do so in Australia in the form of mineral resource rent taxes (which the recently elected government has pledged to repeal) have shown how difficult it is to try to isolate the rent element—not to mention the problem of how to deal with transitional issues when rents are capitalized into asset prices. In the digital economy in particular, and in the corporate world more generally, it seems plausible that high returns are a mixture of risk and rent, and that the mix changes over time. One of the benefits of the corporate income tax is that it does not generally seek to distinguish between returns to risk and rents.

In another more practical direction, the discussion of the elements of return captured under the corporate income tax has important lessons for the BEPS project. One of the major causes of BEPS has been identified as the current operation of transfer-pricing rules, and no fewer than 3 of the 15 BEPS actions relate to the substantive content of those rules. The premise of much of the recent transfer-pricing work at the OECD has been that all of the return earned by a corporation is from risk taking. Add to that the acceptance of risk shifting by contract, the increasing focus on risk management as the driver of corporate profit (as a result of the OECD's current preoccupation with the finance sector), and the identification of that risk-management profit potential with a very narrow range of people within the firm, and separation of profit from most of the activities of a corporation is inevitable. Once it is recognized that managing risk is only one of the contributors to corporate profit, and often not the major one, it becomes possible to reconfigure the transfer-pricing rules away from the tax-avoidance engine that they have become.[19]

The final assumption that needs to be examined in the modelling of the corporate tax is that the company (firm) is treated as a black box with the attributes of a welfare-maximizing individual. This is no doubt a convenient and often harmless assumption, but in the tax context it produces critical issues. It avoids questions of the incidence of the corporate tax and therefore assumes that the efficiency effects of the tax will not be affected by whoever is ultimately paying the tax. It is hard to see how ignoring incidence does not make a nonsense of the efficiency analysis. The approach also avoids issues of the internal economic dynamics of firms and how they affect corporate behaviour (including, in relation to tax, rent-seeking executives,

19 See Vann, supra note 12.

moral hazard, etc.)—a question that is much discussed in the corporate-law literature but is curiously absent in the international tax literature.

When attention does turn from the company to those who invest in it, the efficient-market theory that was developed for deep public markets in securities is deployed to the effect that the investors cannot achieve better than general market or risk-free rates of return.[20] This leads to proposals to tax a flat low rate of imputed return. One wonders where the economic rents went. More importantly, this line of thinking reinforces the disconnect between the individuals who bear taxes and the firms that pay most of these taxes, and in that sense may be an implicit—and likely wrong—attempt to fix the problem produced by ignoring the investors when modelling tax policy for the firm.

ALTERNATIVES TO THE CORPORATE INCOME TAX

Various alternatives to the corporate tax are proposed in the economic literature, one of which, the allowance for corporate equity, received very short shrift when it was investigated recently by a government committee in Australia.[21] One rising favourite seems to be the corporate cash flow destination tax ("cash flow" meaning that capital outgoings are expensed, and "destination" meaning that exports are exempt from the tax and imports are taxed). The model assumes that the firm is a producer in a perfect competitive open market with no rents, and produces the unsurprising result—given the assumptions—that such a tax is neutral as to the location of production activities (and so deals with location competition). There is no discussion of incidence, but it will come as no surprise that the incidence of the tax is likely to fall on the consumers in the destination country.

There are several-real world problems with such a tax. It requires a global shift of all countries to the system, since one cannot have a corporate income tax in some countries and a corporate cash flow destination tax in others without producing significant double-taxation and double-non-taxation distortions. The tax also moves the tax base from producing countries (primary products, resources, etc.) to consumption countries and hence is very prejudicial to both developing countries and producing countries (such as Australia and Canada). What it amounts to is just an

20 For example, Peter Birch Sørensen and Shane Matthew Johnson, "Taxing Capital Income: Options for Reform in Australia," in *Melbourne Institute—Australia's Future Tax and Transfer Policy Conference: Proceedings of a Conference* (Melbourne: University of Melbourne, Melbourne Institute of Applied Economic and Social Research, 2010) (http://taxreview.treasury.gov.au/content/html/conference/downloads/AFTS_Tax_and_Transfer_Policy_Conference.pdf), 179-235. This paper deploys several of the economic models and theories discussed here and was produced at the request of the Australia's Future Tax System review.

21 See Vann, supra note 15.

increase in the rate of value-added tax (VAT)/goods and services tax (GST) in the destination country (if the incidence falls on consumers), produced in a way that probably only economists understand, and so may be appealing to those who are minded to rely more on GST/VAT but are unwilling to come out and say so.

CONCLUSION

The advent of the BEPS project and its underlying shift in thinking back to the corporate income tax seems to have caught some economists on the hop; but while to some degree the economists are beating a retreat and are now discussing how to fix the income tax, underneath the corporate cash-flow destination tax still seems to be the favourite.[22] Not surprisingly, I remain unconvinced that the corporate tax is doomed in theory or practice, especially for a country like Australia, where it works very well to produce very significant levels of revenue. I leave readers to form their own views about Canada. While this brief article is largely designed to invite skepticism of much of the economic literature, to the extent that it goes straight from simple models to strong policy prescriptions to do away with the corporate income tax, the elements of a case for the corporate income tax also begin to emerge—namely, its ability, if properly designed, to provide a good measure of all forms of corporate return and to locate the tax base in the country where the value is added.

The BEPS project at the moment is mainly focused on the proper design of the corporate income tax internationally to achieve this objective. It is to be hoped that the policy work to be undertaken by the OECD on the project will re-establish the reputation of the corporate income tax as an effective policy instrument for the operation of the income tax internationally.

22 Clemens Fuest, Christoph Spengel, Katharina Finke, Jost H. Heckemeyer, and Hannah Nusser, "Profit Shifting and 'Aggressive' Tax Planning by Multinational Firms: Issues and Options for Reform" (2013) 5:3 *World Tax Journal* 307-24.

The BEPS Agenda:
Themes of Abuse and a Digital World

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I. Introduction

This paper will address the themes of "abuse" and "digital world" that run through the whole BEPS project as well as appearing or having consequences in many of the specific BEPS Action Items. I address only those reports that have been delivered to date. The two themes of "abuse" and "digital world" are separate and distinct but they have similarities in their breadth and vagueness. They both seem to identify a challenge of behaviour or context for the international tax system. However, "abuse" has a pejorative meaning while "digital economy" seems to have an approbative or positive meaning, although it may actually pose greater challenges; or rather, we are currently disguising many of those challenges under the heading "abuse".

The BEPS project is an exercise at a large scale and the detail and level of analysis, and goals are unmatched, I suggest, in previous exercises in international tax reform. I do not agree with suggestions that the project is just tinkering at the margins; of course, if only one or two items are actually delivered or implemented, that could be tinkering, however taken as a whole BEPS is very significant. The 2014 BEPS deliverables relate to Action 2 (hybrid mismatches), Action 6 (treaty abuse), Action 8 (transfer pricing and intangibles) and Action 13 (transparency), all of which have been delivered. Reports have also been released on Action 1 (digital economy), Action 15 (multilateral instrument) and Action 5 (harmful tax practices). We have also just now seen the release of draft discussion papers on Action 7 (permanent establishment) and a further draft on transfer pricing, and I look forward to more papers on Christmas eve (as it is, I have for my summer reading 343 Luxembourg advance rulings).

There have been a few different attempts to categorise the various Action items. The OECD has framed the BEPS Action Plan and 15 Actions into three "Pillars":[1]

1. *Coherence.* Actions that aim to establish "coherence" in the international tax system through establishing a "new set of standards designed to avoid double non-taxation". There is an assumption here that domestic tax systems are coherent because "tax deductible payments by one person results in income inclusions by the recipient" (which is of course not always the case). On this basis, "coherence" seems to require that there is a level of taxation by one jurisdiction, however there is no overall statement as to what that level should be, or why taxation in one or other jurisdiction is appropriate. Actions 2, 3, 4 and 5 are said to relate to "coherence".
2. *Substance.* Actions that aim to "fix the flaws" in the existing treaty rules which seem especially to be generating abuse, essentially aimed at "aligning taxing rights with substance" - including triangular arrangements, shell companies with "little or no economic substance", transfer pricing returns "related to over-capitalisation, risk and intangible assets". Actions 6, 7, 8, 9 and 10 are said to relate to this goal.
3. *Transparency.* Improved data collection, analysis and transparency: Actions 11, 12, 13 and 14.

Actions 1 and 15 are described as "horizontal" or cross-cutting, Action 1 being about the "digital economy" which the OECD recognises is a "cross cutting issue" and Action 15 about "hard law" or a multilateral treaty instrument for implementation.

A slightly different grouping of BEPS Actions is provided for the editors of papers coming out of the January 2014 Max Planck Institute conference on BEPS (Hugh Ault, Steve Shay and Wolfgang Schon):

- *Digital economy* - Action 1
- *Prevention of double non-taxation* - Actions 2, 3, 4, 5, 6
- *Alignment of economic activity and taxation* (substance) -Actions 7, 8, 9, 10
- *Transparency and dispute resolution* - Actions 11, 12, 13, 14

[1] http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm Question 55

- *Effective and efficient implementation* - Action 15

Ostensibly, BEPS is not about a global tax system. The concept of "coherence" is about the structure of the international tax system, while the concept of "substance" seems to be about abuse of the rules. The various reforms proposed in the BEPS Actions at the international and domestic level purport to establish a divide between technical or underlying legal solutions that provide new bright lines about taxing jurisdiction and those measures that require or fall back on a definition requiring abuse. However, these two categories of "coherence" and "substance" overlap. It is interesting that Action 6 (the anti-abuse rule) is categorised by the OECD in its "Pillars" as being one of the measures aimed at "fixing the flaws" and "aligning taxing rights with substance" (that is, it is an "abuse" issue) but it is categorised by Ault et al as one of the rules aimed at preventing "double non-taxation" which seems to be perceived as a "structural" issue in the international tax system.

II. Abuse

The concept of "abuse" is a foundational reference that drives the project, as it is referred to in the general introduction and asserted reasons for BEPS as well as specifically in Action 6. The overarching language of the BEPS project concerns abusive or aggressive tax planning and the Action Plan stated that "treaty abuse is one of the most important sources of BEPS concerns". [2] While Action 6 is the only action that specifically focuses on a general anti-abuse rule, many of the remaining Actions including the substantive and procedural actions (such as transparency) are specific strategies that are aimed at what is called abuse and require an analysis of whether action is abusive or not. This is because in the international context, the ground covered by a general anti-abuse rule is essentially the question of economic substance.

The Action 6 Report observes that countries should modify existing domestic and international tax rules "in order to more closely align the allocation of income with the economic activity that generates that income" (p. 17). While most of the other Actions are not stated to be about "abuse", many of them do include an abuse or economic substance rule which is going to require discretion and judgment in the relevant Competent Authority. Moreover, as Richard Vann observed in the recent IFA

[2] Quoted in Para 2 of the Article 6 Report, p. 17.

Panel at Mumbai (and a consequence of many technical rules), many of the more specific rules in BEPS Actions may be able to be structured around by taxpayers (eg, the revised immovable property company rule). The question then is whether Competent Authority is thrown back to the treaty anti-abuse rule, or to domestic country GAARs or SAARs. This raises questions about (1) who defines abuse in relation to each kind of transaction or Action; (2) what is demanded of the taxpayer, advisors and administrator by the concept of abuse; (3) What is the consequence of finding abuse; (4) when and how is the rule to be administered; and (5) how are conflicts in interpretation as to what is "abusive" between countries to be dealt with?

A. Action 6: LOB and anti-abuse

The Action 6 Report[3] explains that anti-abuse rules or principles are not completely new to the OECD Model Convention or to tax treaties. In particular, the issues of treaty shopping and beneficial ownership has a history of some decades and some countries, such as the US have had Limitation of Benefits (LOB) and conduit company rules dating to the 1980s.

First, the OECD recommends that treaties include in the title and preamble "a clear statement that the Contracting States, when entering into a treaty, intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance". Again, this issue was identified in the 1970s, and an optional extension of the title to cover avoidance and evasion was initially suggested in the Commentary (which has been taken up by a number of countries including Australia). The optional character of this extension has been removed and the Title of the Convention will read as follows:

> Convention between (State A) and (State B) for the elimination of double taxation with respect to taxes on income and on capital and the prevention of tax evasion and avoidance.

Specific wording of a new Preamble is proposed for the first time (this being previously left to the parties entirely):

> *PREAMBLE TO THE CONVENTION* (State A) and (State B),
>
> Desiring to further develop their economic relationship and to enhance their cooperation in tax matters,

[3] OECD (2014), Preventing the Granting of Treaty Benefits in Inappropriate Circumstances available at http://dx.doi.org/10.1787/9789264219120-en

> Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States)
>
> Have agreed as follows: …

The general anti-abuse rule

Proposed new Art. X(7) is embedded at the end of a rather long and complex Limitation on Benefits (LOB) rule, which I will return to discuss shortly. The new anti-abuse rule or Principal Purposes Test (PPT) is as follows:

> "Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention."

The draft Commentary to the anti-abuse rule explains that it is intended to mirror the Commentary on Article 1 about when the benefits of a tax convention should be available, or not. The provision "is intended to ensure that tax conventions apply in accordance with the purpose for which they were entered into, ie to provide benefits in respect of bona fide exchanges of goods and services, and movements of capital and persons as opposed to arrangements whose principal objective is to secure a more favourable tax treatment."[4]

The terms of the anti-abuse rule are broader than Australia's GAAR which would require a "sole or dominant purpose" of obtaining a tax benefit. The language of "one of the main purposes" is similar to that of the recently enacted UK statutory GAAR, which however also requires that the arrangement be found to be "abusive". The "abusiveness" concept requires an examination of the "substantive results" of the arrangements in light of the principles and policy objectives of the specific provisions; artificiality in the sense of "contrived" or "abnormal" steps in the arrangement; and whether the arrangements "are intended to exploit any short-comings" in the specific provisions.[5]

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[4] Action 6 Report, draft Commentary para 6, p. 68.

[5] Section 206-15 of Finance Act 2013; see Judith Freedman, "Designing a General Anti-Abuse Rule: Striking a Balance" (May/June 2014) 167.

In other respects, the Commentary indicates an approach to the anti-abuse rule which is similar to that taken in some existing domestic GAARS, including Australia's GAAR.[6] The treaty benefit is broadly defined, as is "arrangement or transaction", and an "objective analysis of the aims and objects of all persons involved in putting that arrangement or transaction in place or being a party to it" must be considered taking account all of the circumstances (this would include advisors as well as in-house staff of taxpayers).[7] However, the Commentary warns "it should not be lightly assumed" that obtaining a treaty benefit was "one of the principal purposes" of an arrangement or transaction, so that "merely reviewing the <u>effects</u> of an arrangement will not usually enable a conclusion to be drawn about its purposes."[8]

Further guidance is indicated in the Commentary as to when a treaty benefit can be shown <u>not</u> to be a "principal consideration": "In particular, where an arrangement is inextricably linked to a <u>core commercial activity</u>, and its <u>form</u> has not been driven by considerations of obtaining a benefit, it is <u>unlikely</u> that its principal purpose will be considered to be to obtain that benefit."[9] This exclusion shows, I suggest, that application of the anti-abuse rule will be, in most cases, tied to an assessment of substantial and genuine economic (or "commercial") activity, investment or presence. The examples in para 14 of the Commentary all relate to "genuine investment" and are considered not to breach the anti-abuse rule, although a treaty benefit is considered and is a factor relevant to the investment decision of the taxpayer in all of the examples.

Limitation on Benefits rule

The proposed new anti-abuse rule appears at the end of a long and technical limitation of benefits rule in the US style. Some have expressed a hope that Australia and some other countries will not proceed to adopt the LOB approach but will be able to rely on our domestic GAAR and the other BEPS Actions to address any treaty shopping concerns. Our relatively small number of treaties also protects Australia from treaty shopping to some extent – however, we have limited control over how taxpayers plan

[6] Part IVA of the Income Tax Assessment Act 1936.
[7] Action 6 Report, Commentary para 9, p. 69.
[8] My emphasis; Action 6 Report, Commentary para 10, p. 70.
[9] Action 6 Report, Commentary para 13, p. 70.

and structure transactions involving multiple overseas jurisdictions with various treaties.

A key aspect of the anti-abuse rule is that it may deny a particular benefit, rather than denying the benefit of the Treaty as a whole to a taxpayer who fails a test such as the LOB (discussed below). Proposed Art X.7 is intended to be able to apply independently of the other provisions in the LOB, and not to constrain the application of those other provisions. For example, a publicly traded bank which satisfies the qualified person test may still be denied benefits under Art X.7, if it "enters into a conduit financing arrangement intended to provide indirectly to a resident of a third State the benefit of lower source taxation under a tax treaty." [10]

The LOB is, as is well known, highly technical, entity and numbers based. I do not propose to discuss it in detail. However, some observations are relevant as regards the interaction between the LOB and the anti-abuse rule, and also the potential for anti-abuse approaches to creep into the LOB itself. The positioning of the general anti-abuse rule in the LOB Article also begs the question, is it really true that the "technical" or bright line provisions are certain and a general anti-abuse provisions is not? Many of the technical rules of the LOB will come down to questions of interpretation and judgment about concepts of control, active business and ownership.

First, much of the LOB consists of exceptions: for individuals, publicly traded companies, non-profit entities and those satisfying the various ownership and voting thresholds. The anti-abuse rule, if included in a treaty, can nonetheless apply to any of these entities.

Second, the exception in Cl X.3(a) for the "active conduct of a business" that would enable treaty benefits even if the qualifying person tests are not satisfied, calls for examination of: (i) "if the business activity … is substantial in relation to the business activity carried on by the resident or associated enterprise in the other Contracting State" (Cl. 3(b)); (ii) whether one person has "control" of another "based on all the relevant facts and circumstances" (Cl. 3(c)); and whether executive officers and senior management "exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company (including its direct

[10] Action 6 Report, draft Commentary para 5, p. 67.

and indirect subsidiaries) in that Contracting State than in any other state …" (Cl. 3(d)). The proposed Commentary to the LOB states that the business "substantiality" requirement:

> "is intended to prevent a narrow case of treaty-shopping abuses in which a company attempts to qualify for benefits by engaging in de minimis connected business activities in the treaty State of which it is resident (ie activities that have little economic cost or effect with respect to the company's business as a whole)."[11]

The proposed Commentary goes on to comment that "the application of the substantiality requirement only to income from associated enterprises focuses only on potential abuse cases, and does not hamper certain other kinds of non-abusive activities."[12] This "substantiality" requirement looks rather similar to the genuine investment or activity type cases discussed in the general anti-abuse Commentary. However, it applies more generally to the entity as a whole and its relationship with a country, rather than to a specific activity, investment or transaction and determining if that is truly substantial or commercial.

Also worthy of consideration is Cl X.5 that would empower a Competent Authority to provide "discretionary relief". This is a kind of negative anti-abuse rule. The paragraph empowers the Competent Authority with a "broad discretion" to do this upon request of a taxpayer and after considering all facts and circumstances.[13] Having considered the matter, the Competent authority is empowered to conclude that treaty benefits *can* be allowed because of a determination "that the establishment, acquisition or maintenance of the resident and the conduct of its operations <u>did not have as one of its principal purposes the obtaining of benefits under this Convention</u>." The Competent Authority is expected to consult with the authority of the other state of which the taxpayer is resident "before rejecting a request made under this paragraph". The proposed Commentary states that this process requires the taxpayer to establish:

> "to the satisfaction of the competent authority … that there were clear reasons, unrelated to the obtaining of treaty benefits, for its formation, acquisition, or maintenance and that any reasons related to the obtaining of treaty benefits were clearly secondary to those unrelated reasons. … Where a foreign company is engaged in a mobile business such as financing, or where the

[11] Action 6 Report, Commentary para 56, p. 52.
[12] Ibid.
[13] Action 6 Report, p. 56.

> domestic law of a Contracting State provides a special tax treatment for certain activities conducted in special zones or offshore (eg licensing intangibles) those factors will not be evidence of a non-tax business reason for locating in that state. In such cases, additional favourable business factors must be present to establish a sufficient relationship to that State. …
>
> 67. … examples of such facts and circumstances include the history, structure, ownership and operations of the resident that makes the request, whether that resident is a long standing entity that was recently acquired by non-residents for non-tax reasons, whether the resident carries on substantial business activities, whether the resident's income for which benefits are requested is subject to double taxation and whether the establishment or use of the resident gives rise to non-taxation or reduced taxation of the income."

This is a really broad range of factors, which one might consider are all relevant for application of the anti-abuse rule in Cl. X.7. The Commentary to the discretionary exception for the LOB provides more detailed explanation of the factors relevant for identifying "abuse" than does the Commentary relating to the anti-abuse rule itself.

Other anti-abuse type rules

Action 6 goes on to discuss various specific anti-abuse rules that could be adopted, either instead of the general anti-abuse rule, or in addition. These include a "conduit arrangements" rule;[14] the possibility of a rule to address "splitting-up of contracts", however it was decided this should be dealt with in Action 7 (prevent the artificial avoidance of PE status); labour hire-out and dividend schemes (that seek to characterise or transfer "dividend" treatment so as to access treaty benefits); and whether an additional rule is needed to prevent transactions that could apply to ensure capital gains tax on indirect transfers in shares (with underlying real property), under Article 13;[15] and concerns about dual resident companies.

A final case for a specific anti-abuse rule was already noted in the existing OECD Model Commentary and relates to the situation where intangible assets such as shares or intellectual property may be transferred to a third state which has "very favourable tax treatment" and "in certain circumstances the resulting income may not be taxed in any of the three States."[16] The Action 6 Report proposes a specific anti-abuse rule to enable a state to deny treaty benefits in this case where the profits from the PE would be exempt in that state. The proposed rule establishes a bright line test

[14] Action 6 Report, p. 74.
[15] Action 6 Report, p. 78.
[16] Commentary on OECD Model Article 24, para 71; see Action 6 Report, p. 83.

which operates as a minimum tax requirement on the profits attributable to the PE intangibles (p. 83-84):

> "Where
>
> a) an enterprise of a Contracting State derives income from the other Contracting State and such income is attributable to a permanent establishment of the enterprise situated in a third jurisdiction, and
>
> b) the profits attributable to that permanent establishment are exempt from tax in the first-mentioned state
>
> the tax benefits that would otherwise apply under the other provisions of the Convention will not apply to any item of income on which the tax in the third jurisdiction is less than 60 per cent of the tax that would be imposed …"

It is proposed that if this provision applies, the taxpayer may have recourse to the discretionary allowance of benefits as discussed above, under Art X.5. This minimum tax rule may in some respects have the effect of establishing a new rule or norm of international taxation, that there must be a minimum tax somewhere.

Treaties not to prevent application of domestic GAARs

Finally, the Action 6 Report discusses the interaction of tax treaties and domestic legislative GAARs, judicial approaches or specific anti-abuse rules. This is addressed through an expanded discussion in the Article 1 Commentary which will now acknowledge that "domestic anti-abuse rules and judicial doctrines play an important role in preventing treaty benefits from being granted in appropriate circumstances"; that specific savings rules could be developed for specific Articles; and that domestic GAARs or judicial approaches such as economic substance, sham, business purpose, step-transaction, abuse of law or fraus legis, will not generate a conflict with a treaty "in the vast majority of cases".[17]

B. What does a general anti-abuse rule do?

What is the role of a general anti-abuse rule in the international tax system? More specifically, what does it empower a revenue authority to do? Jacques Sasseville explained recently at the IFA Congress in Mumbai that the anti-abuse rule is intended to "prevent the granting of treaty benefits in inappropriate circumstances". But the question is, of course, what would be inappropriate in the international tax context?

In a national tax system, a GAAR usually aims at arrangements or transactions that have a dominant or principal purpose of avoiding tax. Usually, a GAAR directs

[17] Action 6 Report, *Commentary to Art 1* para 2, 12, 13, p. 89.

our attention to whether there is a business or commercial purpose of a transaction as opposed to "merely" a tax minimisation purpose, and to the economic substance of an arrangement rather than its legal form, taking into account various aspects including associated parties, risk, price and so on. Where the transaction or arrangement as legally designed does not match the "reality" or economic substance of the transaction, the tax authority is empowered to take steps to apply the tax law differently to the arrangement or transaction.[18] The GAAR then authorises the revenue authority if various conditions are met, to void or deny that transaction, and in some cases then to "reconstruct" a new transaction that will be subject to tax for various taxpayers in the jurisdiction. The extent of revenue authority empowerment to apply more tax varies significantly from country to country, as a result of different drafting of statutory rules and different judicial approaches to their application. Many countries, for example in the Asia Pacific region, do not have a GAAR at all; but in recent years, many are intending to adopt one. The whole point is to subject the transaction to *more tax* than was achieved under the core rules, because of an "abuse" of those rules however defined. However, it is of critical importance in our conceptual understanding of a GAAR that it is *not* a core taxing provision.

In many domestic law contexts including Australia, in operation, the GAAR performs primarily the role of an economic substance rule. In fact the recent amendments to Australia's GAAR in 2013, while quite difficult to understand, seem to bring our rules even closer to an economic substance rule, emphasising this aspect in the same way that the US codification of the "substance-over-form" doctrine emphasises this aspect as important.

This is, I suggest, the main goal of the anti-abuse rule proposed by Action 6. In terms of applying both the specific LOB rules in proposed Article X and the anti-abuse rule in X.7, competent authorities will need to weigh up all the particular facts and circumstances of the taxpayer. And it is this question of economic substance and in particular the location and proof of "real" commercial business underlies many of the BEPS Actions. Most countries now have corporate exemption methods for active foreign source income. Presumably, tax treaties should not be interpreted (preamble)

[18] This is not the same thing as the "sham" doctrine that would, at least in common law countries, deny the legal effectiveness of a transaction. Of course, a GAAR may apply even to legally effective transactions. However, depending on how it is applied, the sham doctrine in some countries comes fairly close to the concept of the GAAR.

to prevent legitimate use of the exemption method relating to “real investment” into other countries – again, if it is done “not abusively”.

Anecdotally, Australian tax advisors and companies seem relatively unconcerned about it at least as it applies to Australian operations. This may be because they are well aware of the strength of the domestic Australian GAAR and are used to navigating its risks and constraints. I have also heard observations that Australia’s domestic rules may give as generous tax treatment to a transaction as a treaty and so they are not reliant on treaty benefits to achieve a good outcome. (One example is the 10% withholding tax rate on interest which applies with or without a treaty). Consequently, an anti-abuse rule that would deny the benefits of the treaty is not relevant. This raises a question, to which I do not know the answer, of what coverage an anti-abuse treaty rule will actually have overall.

However, the same relaxed attitude (relative to the concern of advisors about interest deductibility, PE or transfer pricing) may not apply for taxpayers in other jurisdictions which may seek to apply the anti-abuse rule, perhaps to deny treaty benefits at that end of a transaction or to the subsidiary/taxpayer in that country, and apply tax to it. This does raise an important question about who gets to decide what is abuse? The revenue authority seeking to deny the treaty benefit will do so. We know that different authorities take very different approaches to abuse. Of course, the approach of *other* jurisdictions in applying the anti-abuse rule could potentially generate double tax. Would it be expected that a competent authority MAP would apply in this case?

An assumption is that it is only in the “abuse” rule that we see fuzziness or uncertainty or discretionary judgment, and that in other rules, we have certainty or a rule-based approach. You are either “in” or “out”. However, discretionary judgment is going to be required in many of the other rules that are recommended in the BEPS project. We will see an increase in discretionary decision-making across provisions. We know that different authorities and different courts in various countries take quite different approaches to GAARs and concept of abuse.

C. Other Actions – is there "abuse"?

The OECD "Pillars" propose that Actions 6 to 10 concern substance. However, the other Actions – about "coherence" – also contain references to substance and either explicit or implicit discussion of abuse. This section discusses the way in which "abuse" and "substance" appear across a range of BEPS Actions.

Action 5: harmful tax practices

Action 5 focuses on "revamping" the work on harmful tax practices of the OECD conducted during the 1990s. On first glance, this is about core structural rules of nation states, and it is the most explicit element in the BEPS Agenda concerning a potential "race to the bottom" on the mobile tax base. This Action may be seen as aimed at filling gaps or loopholes in the international tax system. This is reflected in the aim of addressing the rules of some country regimes "that unfairly erode the tax bases of other countries".[19] The OECD is careful to be explicit that this work "is not intended to promote the harmonisation of income taxes or tax structures generally within or outside the OECD, nor is it about dictating to any country what should be the appropriate level of tax rates."[20]

There are two ways that the Action 5 report addresses the potential conflict here. The first way concerns process and institutions – specifically, requirements for disclosure, transparency and information exchange between countries about their preferential tax regimes and especially about rulings (see Luxembourg). The peer review of existing preferential regimes of OECD members and other countries in the BEPS project will provide useful information about these measures, although a feature of this space is that new regimes are emerging all the time. The second way is by shifting the focus to economic substance, by "requiring substantial activity for any preferential regime".[21] A key aim will be to identify "substance" with respect to intangibles especially financial, service and intellectual property:

> "Action Item 5 specifically requires substantial activity for any preferential regime. … this requirement contributes to the second pillar of the BEPS project, which is to align taxation with substance by ensuring that taxable profits can no longer be artificially shifted away from the countries where value is created."[22]

[19] Action 5 Report, p. 15.
[20] Ibid.
[21] OECD Action Plan (2013), Action Item 5; Action 5 Report (2014), p. 9.
[22] Action 5 Report, p. 27.

This language makes the harmful tax practices work look like an anti-abuse rule; and yet, this anti-abuse rule is doing "core" tax work of shoring up some kind of minimum tax unless there is with substantial business activity. This substantiality approach enables the broadening of the harmful tax practices work beyond just ring-fenced or discriminatory preferential regimes so that it can encompass the problem of more general company tax rate exemptions or very low rates, where there is no "substance" in the jurisdiction. However, we have yet to see what proxy rules will support "substance" while still stitching together the coalition of OECD/G20 countries who want their patent boxes and BEPS too; for example, the expenditures approach (for R&D and related IP concessions). Action 5 treads the most difficult political boundary in the whole BEPS project.

Action 7

On 31 October we saw the release of the Discussion Draft on BEPS Action 7, *Preventing the Artificial Avoidance of PE Status*. As indicated by the title, the focus on "artificiality" places this Action in the "anti-abuse" camp. However, a significant amount of the challenges for Action 7 relate to the digital economy. Many of the possible changes concern expanding the concept of permanent establishment to cover "activities that were previously considered to be preparatory or auxiliary" in relation to sales arrangements, in respect of insurance companies that collect premiums in a state through an agent, or in respect of the "fragmenting" of operations of MNEs among multiple group entities.

Action 7 is particularly important because it is about preserving the source basis for taxation; however, arrangements now defined as "artificial" or abusive were once a key way for international trade and investment to happen. The concept of abuse appears specifically only in relation to splitting up of contracts, for example in relation to the exception in paragraph 3 of Article 5 (12 month or 183-day time thresholds for PE status). A proposal is for a specific anti-abuse rule that requires the inclusion of other periods of time ("split up" portions) be implemented.[23] In some ways, it could be simpler to rely on a general anti-abuse rule to address this, and that is an alternative proposal in the Discussion Paper. This is already discussed in the OECD Model Commentary, and it is suggested that domestic legislative or judicial

[23] Action 7 Discussion Paper, p. 22.

GAARs may already address this kind of abuse. However, the notion of “artificial avoidance” of PE status appears throughout.

Action 2: Are hybrids different?

Can this anti-abuse analysis apply to international tax arbitrage, for example using hybrids? As identified by Brauner, in relation to hybrids, in the previous technical OECD reports, “GAARs are rejected since they primarily target artificial arrangements when the target of this challenge is non-artificial arrangements”.[24]

In the case of hybrids where there is different characterisation of an arrangement in two different countries, leading to double non-taxation, the question to be asked is not “what, and where, is the economic substance of the transaction?” The concept of arbitrage and hybrids brings to mind abusive or avoidance behaviour: as recently noted, “Tax arbitrage” is, of course, a pejorative term and suggests manipulation or deliberative avoidance”.[25] However, does this mean that it should be only “abusive” hybrids that are caught?

The challenge for hybrids is that there are two different legal frameworks for determining what the transaction actually is, in each country, and they generate different results, producing an arbitrage opportunity. The first step, that of identifying non-taxation (a “tax benefit”) is the same first step as in applying a GAAR. However, the next step or solution to the problem is different, as there is no one answer to the question of what and where is the economic substance. If the two countries take different approaches and contest that question, then the only solution to prevent double non-taxation is either for one country to “give way” – that is, to accede to the other country’s rule defining the transaction – or for the countries to agree on a new rule, which says that, if double non-taxation arises, we will adjust our rules accordingly so that one level of tax applies. Austria’s recent implementation of a denial of deduction rule for outbound royalties or interest, unless the royalty or interest is taxed at a minimum of 10% offshore, is an interesting example of unilateral action that is likely to lead to double taxation.[26]

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[24] Yariv Brauner, ‘BEPS: An Interim Evaluation” (2014) World Tax Journal (Feb 2014), 11.
[25] Stephen Edge, “Base erosion and profits shifting: A roadmap for reform – Tax arbitrage with hybrid instruments” *Bulletin for International Taxation* (June/July 2014), p. 319.
[26] Hermann Peyerl, “Deductibility of Interest and Royalties Restricted: Is Austria a BEPS role Model?” (2014) 54 *European Taxation* 12.

III. Digital economy

As identified by the OECD in its initial Action 1 Report, the "digital economy" raises much broader questions about how we can think about or apply our domestic and international tax rules, which it identifies as being in relation to "nexus, data and characterisation".[27] Some of these issues were identified in earlier work by the OECD and others on e-commerce, and in the work of tax experts and researchers some years ago.[28] I suggest above that the notion of "economic substance" is the main goal of the anti-abuse rule and is also a driving concept in the majority of the other BEPS Actions concerning restoration or protection of the source tax base. This then links us to the issue of what has changed in the actual operation of global investment and trade that generates taxable profit: where is "substance" in the digital economy, or alternatively, in trying to engage with the digital economy, is the OECD really . I don't claim to be a futurist or, certainly, an expert on the digital economy. However, I want to highlight a few aspects that, while they are alluded to in the Action 1 report, are not given the full attention that they deserve.

A. MNES: Or, what can the company tax actually do?

A first question that arises in the face of the "digital economy" is: what can be achieved in relation to global businesses using the mechanism of the company tax? A common feature of the OECD BEPS papers, together with much other literature, is that it discusses the corporate tax as if it is a *direct tax* on a real entity. Of course, the OECD and all of us know this. Yet we persist in this language which perpetuates the illusion. The corporate tax is an *indirect tax* levied on a fictional intermediary because it developed as a very useful tax handle in the context of the regulatory capitalism of the 20th century.

We all know the economic analysis that company tax incidence may fall on shareholders, customers, employers or the "cost of capital" (other investors) more generally. I am not advocating that we should not levy company tax – quite the contrary. The company tax is a tax collection mechanism that performs a wide range of functions, and these functions differ depending on the particular economy and on

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27 Action 1 Report, p. 17.

28 See, eg, Niv Tadmore, "Source Taxation of Cross-border Intellectual Supplies – Concepts, History and Evolution into the Digital Age", *Bulletin for International Taxation* (January 2007), 1, 8; OECD, *A Borderless World: Realising the Potential of Electronic Commerce* ("Ottowa Report") (1998).

the particular design of the company and shareholder tax laws (including the design of debt/equity and other aspects of company tax law). It may collect economic rents of all descriptions, including resource rents, monopoly or oligopoly rents through control of particular markets, professional rents in terms of expertise, or more generally returns to capital of owners. Those net returns are best calculated at the entity level – this is what makes it look like a direct tax.

The question in the BEPS and digital age is, what can company tax *do* as a mechanism for revenue collection for country governments How does the technology of company tax stand up in this new era? The question of what company tax can really *do* is related to the observations of Walter Hellerstein about the need to align what he calls "substantive jurisdiction" (by which I take him to mean, jurisdiction allocated under the international tax regime), and "enforcement jurisdiction" (can taxes actually be collected).[29] Hellerstein observes, correctly in my view, that the BEPS analysis through its correct focus on both corporate tax and VAT has revealed that "the underlying problem that the digital economy raises for income tax regimes is the same problem that it raises for consumption tax regimes once one determines that there is substantive jurisdiction to tax in a country, namely, the practical difficulties of enforcing a tax when the economic actors that one normally looks to for tax enforcement are physically absent." – further, "one should not assume that consumption tax regimes are any better equipped than income tax regimes to address these issues."[30]

It is precisely because companies are not "real" that we need a large set of rules that address the underlying "economic substance" so as to draw boundaries around the "real" stuff that companies do. This is magnified in the global context as we are talking about MNEs which are corporate groups with multiple companies or fixed bases or marketing units or branches or warehouses or servers or captive finance or insurance companies or *commissionaire* arrangements. But how much "substance" should there be in a company? Where and how do we locate what a company "does"? We need to consider the MNE and its global operations as a whole, thereby reintroducing this useful tax handle that we call the "company" into the national tax armoury, only this time at the level of the "MNE". But that, of course, does not have a

[29] Walter Hellerstein, "Jurisdiction to tax in the digital economy: Permanent and other establishments" (June/July 2014) *Bulletin for International Taxation* 346.
[30] Ibid., 351.

specific country residence or place of operation. Until we can sort out that problem, rules about economic substance, although we tend to call them anti-abuse rules, are becoming the rules in the international tax system where the real work of taxing the economic return to capital is done.

B. Intermediaries and place

Multinational enterprises have succeeded in subdividing the single legal intermediary of the company into multiple, diverse and specialised sub-entities across multiple jurisdictions. They are permitted and even encouraged to do this, by the lack of cooperation among the "rogue fiscal sovereigns" of the globe and by specific targeting of a whole range of country rules and by the international treaty framework.[31] This issue of "fragmentation" is highlighted across many of the BEPS projects.

From a conceptual perspective, what difference is there between a single fictional intermediary and many hundreds of different fictional entities? The difference primarily relates to regulation and taxation. Our international company tax and VAT systems depend on legal intermediaries for definition, nexus, information, withholding and collection of taxes. The company tax is able to be collected in the place we can easily identify and locate an agent or intermediary on which the tax can be levied and – importantly – which controls assets of value from which tax can be remitted. Yet as identified in the BEPS Actions which refer to locating taxation at the place of "value creation", it is difficult under current rules about legal entities and transactions to locate the tax burden at the intermediary which has value.

A rather different and perhaps extreme example (that does not involve MNEs) is cryptocurrencies, which are fairly briefly referred to in the Action 1 report. Cryptocurrencies such as bitcoin are peer-to-peer networks and therefore may *eliminate the intermediary* altogether from financial transactions, by building the transfer of value and authorising trust in it, directly between businesses and consumers for a transaction. This means taxation can only be achieved by finding the ultimate buyer or seller; if anonymity is embedded, this becomes very difficult. Yet, in reality it seems that many people do use bitcoin agents or intermediaries (three have been identified as controlling most of the Australian bitcoin trade). The

[31] John Braithwaite and Peter Drahos, Global Business Regulation (2000).

identification and location of intermediaries within reach of regulatory networks would be a positive step for both taxation and regulation, if it is desired not to ban, but rather to support, such new technologies as bitcoin.[32] The challenge from this aspect of the digital economy is how our tax and regulatory rules should engage and support such intermediaries in the system – for example, by mandating engagement with a bank in some way, or a centralised registration process – without shutting down the digital technology or market altogether.

A final issue, which is dealt with in some detail in Action 1 (and other BEPS Actions) but not in quite the language I suggest here, is that of place. Virtual or digital economies may remove "place" or territoriality altogether from the transactions. I suggest it is rather a stretch to use the language of a business "presence" because of ultimate customers – we are again in the realm of deeming and fictions so as to create a jurisdiction to tax. For example, if 3D printing of products can be done by consumers in their own homes, then the "digital economy" has located the place of production, of the good at least, at the same territorial location as the place of consumption. Our fundamental concepts of jurisdiction and tax bases are collapsed.

Finally, the discussion in the Action 1 report does not really get into the serious contest between source and residence countries that may result from what is, ultimately, a major threat to the source tax base. Niv Tadmore identified this some years ago the concern that as a result of the advent and growth of e-commerce, or the digital age, "the dispute between source and resident states has assumed a new dimension, and has intensified."[33] He notes further that "the overall effect of the OECD's conclusions [for e-commerce] on the PE and income characterisation issues operate in favour of the residence state" – and that "the OECD's next significant failure to set or reflect international norms and market forces may well be the OECD's approach to income characterisation in the digital age."[34]

[32] Terence Wong, 'Bitcoin Deconstructed: Part 2 – Real and Virtual Worlds' (August 2014) *Australian Banking and Finance Law Bulletin* 122; Omri Marian, "A Conceptual Framework for the Regulation of Cryptocurrencies' (2015 81 *University of Chicago Law Review* (forthcoming). I am indebted to my research assistant Joel Emery and his unpublished paper on regulating bitcoin for most of my learning on cryptocurrencies.

[33] Tadmore, ibid., 10.

[34] Ibid., p. 12.

C. Uniqueness

A final feature of the digital economy that could drastically change the way we approach international tax concepts is the growing tendency towards uniqueness and individualisation. Digitalisation is producing changes in how businesses and consumers engage with mass marketed products. Both production and consumption are increasingly shifting towards individualised services, goods and experiences. As we move increasingly to virtual IP, storage, digital printing as production and the ability to add, subtract or modify what we acquire at one click, we move away from a world of mass production to a world of tailored solutions. This is occurring at the same time that modular production, value chains and centralised IP make the production of such bespoke goods and services ever more efficient. Each taxpayer (MNE) operates quite differently, as is already understood in the world of transfer pricing and each consumer receives and pays a unique price for a unique solution. In fact, the same is happening in governments in relation to their engagement with citizens in service delivery, and taxpayers as "clients" – a unique, tailored experience of regulation and taxation.

The challenge here is not just to "nexus" with a jurisdiction. The challenge is to the fundamental principles on which we designed the international tax system from its allocation rules all the way down to its remittal and collection systems. A company and international tax system premised on industrial-age notions of 'mass' production, equivalent products and commoditisation and comparable pricing is becoming less viable. All aspects of the tax analysis become "case by case". Most prices will be either not arm's length at all (ie, fully integrated within the MNE), or they may be unique market prices for services and products determined uniquely, in which case, comparability also loses its usefulness.

IV. The existential challenge

The BEPS project faces an existential challenge to the overarching aim of the project on a global scale and the real and continuing acceptance of national tax sovereignty. Fundamentally, current international tax rules leave the power to tax, and the definition of the tax base, to each nation state. Unlike some other arenas of global governance or regulation, international tax rules do not establish a regime that actually addresses the problem of how to tax international flows. Where two states assert jurisdiction to tax, widely accepted international tax rules do three things: (i) identify the residence or other jurisdictional link of entities to be subject to tax in the country; (ii) establish the territorial source or location of income, consumption or other activity that attracts jurisdiction and to which a taxable profit is attributed; and (iii) provide a rule for resolving inter-jurisdictional conflicts and so preventing 'double taxation' by more than one country. These international tax rules are embedded in tax treaties and in domestic laws. They might even rise to the level of an international customary law of taxation.[35]

If 'full taxation' (whatever that is) in contrast to 'non-taxation' of an international dealing or investment comes about, it is the result of a happy coincidence of national tax rules for the tax base, rate, source, exemption or credit. The international tax rules do not create an international regulatory framework through which nation states agree to tax international activity and they do not have the purpose or effect of assessing or levying taxation on entities or transactions in the international economy.

A. BEPS dichotomies

Tracing the two concepts or themes of "abuse" and "digital economy" throws up a number of dichotomies in our thinking about the international tax regime, which need to be interrogated. In some cases the dichotomy breaks down altogether, while in others, we can be clearer about what we are seeking to achieve if we test whether we are truly on one side or the other of a line.

Digital v real

As already noted, the OECD project has moved further along in this analysis and the Action 1 report accepts that the digital economy is not at the margins of some "real" or physical economy but that all of the economy is becoming "digitised" in some degree. Consequently, it is accepted that the digital economy raises policy and design issues across the range of BEPS Actions, and across the international and domestic tax system as a whole. It is also acknowledged fairly clearly that new substantive rules, which are ideally harmonised across jurisdictions, may be required in both direct and indirect tax contexts. However, as indicated in the short discussion above,

[35] Reuven Avi-Yonah 2007 *

the full implications of breaking down this dichotomy have not been fully acknowledged or addressed.

Anti-abuse v structural

In the domestic tax law context, anti-abuse rules are applied to prevent "abuse" or misuse of existing core structural rules that aim to tax particular economic gains in particular ways. Anti-abuse rules are therefore by definition *marginal* but necessary to protect the "spirit" or "purpose" of the *core* structure. It is frequently argued that where an anti-abuse rule is applied, this is an indication of a flaw in the existing core structure that should be remedied with more general reform. The marginal GAAR operates to set the boundaries of appropriate behaviour under the structural rules. Another way to think of a GAAR is that it is an organic or foundational rule that supports the framework of the core rules. It is there to prevent "abuse" of core structural rules. In this regard, it would be appropriate for the anti-abuse rule to be in the multilateral treaty and effectively incorporated into all treaties, and it is also embedded in the convention title and preamble.

But if a large part of the core rules in the international tax regime are about establishing the conditions for *non*-taxation or limited taxation of global flows, what is the function of an international anti-abuse rule? Clearly, it is not to ensure *non*-taxation. But then does it have a function of ensuring *taxation*? Does this make the anti-abuse rule a structural rule instead of a marginal rule in the international tax system? And if that is the case, are we asking too much of this concept of abuse?

Further, if "abuse" is at the core of the project, this may demand that we reconceive the project. The current basic international tax rules and international treaty system which aims to resolve conflict between domestic law actions cannot themselves *tax* global transactions of MNEs; they are, rather designed to identify where countries *have power to tax* (although they may not do so), or where they *cannot tax* (to prevent double taxation). However, as Yariv Brauner observes, we now know that uncoordinated domestic tax law actions, "primarily of the anti-abuse variety", "can never succeed".[36]

[36] Yariv Brauner, 'BEPS: An Interim Evaluation" (2014) World Tax Journal (Feb 2014), 10.

Substance v form

The third dichotomy concerns what is "substance" in business activities, entities, investments, transactions, or jurisdictional presence, compared to what is "form". The concept of "economic substance", "substantive presence" or similar phrases appears in many BEPS Actions. While it is not always explicitly contrasted with legal form, it generally demands some sort of examination of underlying or "real" facts compared to "legal" facts, such as the existence of legal entities, which may be mere "form" or "artificial".

A substance approach in the international tax system is not new: the long-standing concept of "permanent establishment" or "place of business" has as its goal examining the real business underlying the legal form of the MNE and there are many other examples. However, like any rule, over time the OECD Model and other sources of international and domestic tax law have built in a range of proxies for "substance" that may no longer be a good reflection of the "substance" of the business or transaction. Moreover, the substance approach seems to be of much broader significance in the BEPS project; the concept of economic substance underlies both the digital and the anti-abuse aspects of the project. Sometimes, international legal transactions or entities are attacked on the basis that they are a "sham", that is, not even legal realities or of legal substance. However, we are in general speaking here of a "substance" approach even where legal entities or transactions are respected as such, and even if they are only "conduits" for financial flows enabling low taxation.

An important question is whether embedding a "substance" approach can actually be effective. In rule design, we must always fall back on proxies or fictions to reflect economic or commercial "substance". Further, embedding a "substance" approach across the board in the international tax system may pose, rather ironically, a significant challenge to the legal design and implementation of our *domestic* income tax base rules and company tax systems. The BEPS "substance" approach to defining a tax base in the international tax system challenges domestic legal forms and interpretation that is dominant in very many jurisdictions, both of common law and civil law origins.

B. Rules and institutions in the international tax system

A final dichotomy that arises in tax reform is that between law and administration, or between the establishment of rules that set the substantive rules and jurisdictional framework that seek to *tax* transactions, or establish the right to tax and the institutions that are needed for implementation and administration of the tax system. However, the institutions that the OECD/G20 BEPS project builds are going to be central to both the shape and success of any reform. Particular legal rules will have significant implications for design of institutions for administration and enforcement of particular changes to the international tax system and will also generate new pressures – if they have any effect at all – for institutional changes in the tax system.

In particular, I argue that we should work actively towards establishing a framework of rule of law around BEPS, building the international tax system from the ground up. This can address many of the concerns about the impact of BEPS rules. Acknowledging that the concepts of "abuse" and "economic substance" are overlapping or interconnected with the basic structure of the international tax system, we should consider how legal institutions can contribute to certainty, predictability and the minimisation of disputes.

In 1997, Professor Graeme Cooper edited a book which explored from different disciplinary and comparative perspectives the whole concept of anti-abuse provisions and the rule of law. In a domestic setting, the application of a GAAR has a range of legal and institutional consequences. Its application may gradually lead to a different approach in the revenue authority (and by the taxpayer) to audit, in terms of risk-rating or procedural approaches of the authority; extended time limits for amending assessments; modifications for the burden of proof in contested matters; the application of penalties (though not always); and an escalation of decision-making up the bureaucratic ladder inside the revenue authority. Probably, application of an anti-abuse rule also leads to an escalation of decision-making inside the taxpayer, especially a large MNC, because of potential risk of director liability, public shaming or longer term uncertain tax liabilities. In some countries, a GAAR will trigger specific administrative processes aimed at protecting the taxpayer. In Australia, the UK and some other countries, either the long-standing existence of a GAAR or its recent implementation in a controversial process, has led to establishment of a Panel to review GAAR cases.

These elements are going to be necessary. We need to develop an approach to "rule of law" in the international tax system in a depth that is unprecedented. We will need a new emphasis on judgment and decision-making of a competent authority and in view of the heightened likelihood of disputes between competent authorities (whether BEPS is a success or a failure), we will move inevitably towards the need for more dispute-resolution processes. Secret and slow competent authority negotiations are not going to be adequate. Large taxpayers – MNEs – to whom all of this is presumably directed – will call increasingly for more certainty and transparency of governmental decision-making, just as governments are currently calling for more transparency by MNEs. This is beginning to occur through networked tax agencies and, I suggest an increasingly centralised interpretive approach and increasingly cooperative audit and enforcement functions.

It is worth noting the statement in the Action 6 Report that "the administrative capacity of some countries may prevent them from applying certain detailed anti-abuse rules and require them to adopt more general anti-abuse provisions" (p. 9). This statement implies that it is easier to apply a GAAR than it is to apply specific technical rules; however, this is disputable. The difficult question of "abuse" or "substance" is thereby moved out of technical law and into the domain of discretionary judgment. It is likely to push contested issues into a non-transparent process of judgment and discretion which carries risks for administrative abuses of power and also for corruption, or a negotiated settlement that is not in accordance with law and in which the wrong amount of tax is paid.

Of course, the OECD BEPS project understands that there is potential for more disputes and that the BEPS process will lead to a need for better processes. In particular, Action 14 relates to dispute resolution, with a possible focus on arbitration. From a point of view of coherence of law, administration and transparency, however, I suggest that arbitration performs poorly. We have also recently heard that arbitration is not much liked by many tax authorities. I would like to put forward the radical suggestion (though others have actually already made it) that it may be time that we started considering a Panel approach to decision-making, or at the least, to common interpretation of key issues. Many questions arise as to how this could be designed and achieved, which are beyond the scope of this paper.

The more that a legitimate, coherent and consistent decision-making framework can be embedded, the more successful will be the BEPS substantive moves towards identifying and taxing an international tax base.

V. Conclusion

This paper has attempted to trace two foundational themes of the BEPS project – "abuse" and the "digital economy". It has long been stated that tax treaties are intended to facilitate and remove barriers to international investment and trade. Historically, perhaps, tax treaties were intended to permit treaty shopping. Basically, the international tax framework establishes rules about *non-taxation*. To be consistent with the mantra of national sovereignty in terms of tax rates and the supposed goal of the tax treaty system to remove barriers to international trade and investment, none of the proposed BEPS measures actually prohibit a situation of non-taxation. As recently observed, "if double non-taxation was intended to be banned, there would be no distinction between abusive and non-abusive treaty shopping, and the GAAR would be supplemented with a subject-to-tax provision."[37]

If we are seeking to change the rules to move towards "anti-abuse" and "economic substance", are we actually changing the foundation principles of tax treaties and of the international tax system more generally? We might yet need to turn to the proposals of some economists, for example Grubert and Altshuler who recently observed (after many studies of the US corporate and international tax system) that "a per country minimum tax with expensing has many advantages" with regard to planning including income shifting and choice of location, and "the simpler overall minimum tax is a serious alternative."[38] Non-taxation in the global context, *whether "abusive" or not*, seems to me to be untenable in the longer term. The BEPS Actions treat "abuse" as being about "economic substance" and "substance" as being a core concept in the international tax framework. As a result, it seems that BEPS is moving inevitably towards a new paradigm of international taxation.

[37] Adiran Wardzynski, "The Limitation on Benefits Article in the OECD Model: Closing Abusive (Undesired) Conduit Gateways" (September 2014) *Bulletin for International Taxation* 471, 472.
[38] Rosanne Altshuler, *Bulletin for International Taxation* (June/July 2014) 361, 363; H Grubert & R Altshuler, *Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax* (2013) 66 *National Tax Journal*, 671-712.

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The BEPS Agenda

Themes of abuse and a digital world

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Overview

- Pillars of BEPS
- Abuse and substance
- The anti-abuse rule (Action 6)
- Abuse in other BEPS Actions
- Digital economy (Action 1)
- BEPS dichotomies
- The rule of law and institutions
- The existential challenge and the ghosts of BEPS

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Pillars of BEPS

- Coherence
- Substance
- Transparency

- Rule of law, institutions and implementation

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The pervasive theme of abuse

- A foundational justification and reference for the BEPS project
- Rules to counter, void or reconstruct abusive transactions
- Rules to prevent opportunities for abuse

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The anti-abuse rule and approach

PREAMBLE TO THE CONVENTION

Desiring to further develop their economic relationship and to enhance their cooperation in tax matters,

Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital

without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States)

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The anti-abuse rule and approach

Art X.6

"Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted … in respect of an item of income or capital

if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit,

unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention."

The anti-abuse rule and approach

- *Commentary*

"Where an arrangement is inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its principal purpose will be considered to be to obtain that benefit."

What does an anti-abuse rule do?

- The treaty anti-abuse rule specifically only permits denial of a particular treaty benefit by a revenue authority
- "Abusive" transactions under other Actions may be subject to much greater reconstruction or reallocation by a revenue authority

Abuse in other BEPS Actions

- Action 5 – harmful tax practices
- Action 7 – artificial avoidance of PE status
- Action 2 – are the hybrid rules of a different character?

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Digital economy

- Nexus
- Data
- Characterisation

- The BEPS Ghosts (apologies to Hamlet)
  - “a fully dematerialised digital activity”
  - the Apple intermediary companies

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Digital economy

1. Multinational enterprises are already ghosts
   - Is the problem really digital?
   - What can company tax *do* in the digital age?
   - “Enforcement” jurisdiction (Hellerstein)

“the underlying problem that the digital economy raises for income tax regimes is the same problem that it raises for consumption tax regimes once one determines that there is substantive jurisdiction to tax in a country, namely, the practical difficulties of enforcing a tax when the economic actors that one normally looks to for tax enforcement are physically absent.”

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Digital economy

2. Intermediaries
   - Fragmentation across jurisdictions
   - It is a governmental decision whether to create, recognise and utilise intermediaries (eg bitcoin)

Forbes: “Apple has an Irish holding company with no operations or employees at the top of its foreign operations. This company also serves as a group finance company. Apple Inc., the U.S. parent of the whole group, pays U.S. tax on the investment earnings of this company. Otherwise, the holding company pays no tax to any government, and has not paid tax for five years. It claims tax residence nowhere”.

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Digital economy

3. Uniqueness
   – Everything is case by case
   – *Within* multinationals because of fully integrated value chains, unique intellectual property, etc
   – *To* consumers because of the individualisation of the market
   – An end to comparability?

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BEPS dichotomies

1. Digital – real
2. Anti-abuse - structural
3. Substance – form
4. Rules - institutions

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Rule of law and institutions in BEPS

- *Principles: legitimacy, certainty, fairness*
  – Power of competent authorities
  – Processes of decision making
  – Institutions to bind parties
  – Dispute resolution
  – Administration, information, transparency
  – Networked systems
  – Collection and revenue sharing

The existential crisis

- What is the point of the international tax system?
  - "if double non-taxation was intended to be banned, there would be no distinction between abusive and non-abusive treaty shopping, and the GAAR would be supplemented with a subject-to-tax provision." (Wardzynski)
- Is non-taxation of MNEs in the global context, *"abusive" or not*, really tenable?

TAX TREATY ISSUES RELATED TO THE BEPS ACTION PLAN

BEPS Actions dealing with tax treaties

1. The BEPS Action Plan[1] includes four Actions that are specifically focussed on tax treaties:

- Action 6 – Prevent Treaty Abuse
- Action 7 – Prevent the Artificial Avoidance of PE Status
- Action 14 – Make Dispute Resolution Mechanisms More Effective
- Action 15 – Develop a Multilateral Instrument

2. Since the work on Actions 7 and 14 will be addressed by other speakers, this note focusses on Actions 6 and 15. It is important to remember, however, that other parts of the work on the BEPS Action Plan could have a significant impact on tax treaties. Action 1 (Address the Tax Challenges of the Digital Economy) expressly calls for an examination of issues such as "the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules" and "the characterisation of income derived from new business models [and] the application of related source rules". The reference to treaties is even more specific in Action 2 (Neutralise the Effects of Hybrid Mismatch Arrangements):

> [d] evelop ***model treaty provisions*** and recommendations regarding the design of domestic rules to neutralise the effect (e.g., double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. This may include: (i) ***changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly***; .... ***Special attention should be given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention***. This work will be co-ordinated with the work on interest expense deduction limitations, the work on CFC rules, ***and the work on treaty shopping***. [emphasis added]

3. As was made clear in the Report on Action 2 delivered on 16 September 2014,[2] however:

- the main objective of that work, which is to neutralise the effect of hybrid instruments and entities (e.g. double non-taxation, double deduction, long-term deferral), is not really a treaty matter: as noted in the report, "[a]part from the rules of Articles 7 and 24, the provisions of

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1 See http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/action-plan-on-base-erosion-and-profit-shifting_9789264202719-en#page1.

2 See http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/neutralising-the-effects-of-hybrid-mismatch-arrangements_9789264218819-en#page1

tax treaties do not govern whether payments are deductible or not and whether they are effectively taxed or not, these being matters of domestic law".[3]

– Although the change to the tie-breaker rule for treaty residence of legal persons[4] that is recommended in the report on Action 6 will address some of the BEPS concerns related to the issue of dual-resident entities, it cannot address all BEPS concerns related to dual-residence. That change will not, for instance, address avoidance strategies resulting from an entity being a resident of a given State under that State's domestic law whilst, at the same time, being a resident of another State under a tax treaty concluded by the first State. The solution to such avoidance strategies must be found in domestic law.[5]

4. Finally Actions 8, 9 and 10 (Assure that Transfer Pricing Outcomes are in Line with Value Creation), which all deal with transfer pricing, will have an impact on the interpretation of Article 9 (Associated Enterprises). As can be deduced from the case law on transfer pricing, however, the application of transfer pricing rules is primarily a matter of domestic law (except to the extent that Articles 7 and Article 9(2) are concerned).

Work on Action 6

5. Paragraph 5 of the report on Action 6 "Prevent the granting of treaty benefits in inappropriate circumstances"[6] refers to follow-up work that needs to be carried on in three different areas:

1. The implementation of the minimum standard.
2. The precise contents of the model provisions and related Commentary included in Section A of the report, in particular the LOB rule.
3. The policy considerations relevant to the treaty entitlement of collective investment vehicles (CIVs) and non-CIV funds.

Implementation of the minimum standard

6. Paragraph 14 of the report on Action 6 describes the minimum standard as follows:

> As long as the approach that countries adopt effectively addresses treaty abuses along the lines of this report, some flexibility is therefore possible. At a minimum, however, countries should agree to include in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements (see Section B); they should also implement that common intention through either the combined approach described in paragraph 11 (subject to the necessary adaptations referred to in paragraph 6 above), the inclusion of the PPT rule or the inclusion of the LOB rule supplemented by a mechanism (such as the alternative provision included in paragraph 15 of the Commentary on the PPT rule that appears in subsection A.1(a)(ii) below or domestic anti-abuse rules or judicial doctrines that would achieve a similar result) that would deal with conduit arrangements not already dealt with in tax treaties.

3 Paragraph 134 of the report on Action 2.

4 Art. 4(3) of the OECD Model Tax Convention.

5 Paragraphs 127-128 of report on Action 2.

6 See http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances_9789264219120-en#page1

7. Although the report describes the minimum standard and indicates that there is agreement that it should be adopted, it acknowledges that further work is needed with respect to the implementation of that minimum standard.[7] The following are examples of implementation issues that may need to be addressed as part of that work:

a) How would the minimum standard be reflected in the OECD Model Tax Convention? What types of reservations/observations/positions would be possible?

b) Whether and how should the minimum standard be reflected in the multilateral instrument envisaged under Action 15?

c) Should the minimum standard be purely prospective or should it also apply to existing treaties (*i.e*. should countries be required to modify existing treaties in order to implement the standard)?

d) Should there be some form of monitoring of compliance with the minimum standard?

e) What happens if, in the course of future bilateral negotiations, a country refuses to allow a treaty partner to incorporate provisions that are recognised as complying with the minimum standard?

Contents of the model provisions and related Commentary included in Section A of the report

8. As noted in paragraph 5 of the report, the model provisions and Commentary included in the first part of the report should be

> ...considered as drafts that are subject to improvement before their final version is released in September 2015. Some of the changes to be made will be necessary to take account of the results of other parts of the BEPS Action Plan. This is consistent with the holistic approach of the BEPS Action Plan. For example, one assumption in the drafting of the limitation-on-benefits rule found in Section A.1 below is that Action 5 (Counter harmful tax practices more effectively, taking into account transparency and substance) and Action 8 (Intangibles) will address BEPS concerns that may arise from a derivative benefits provision; that provision, or alternative means of addressing those BEPS concerns, may therefore need to be reviewed based on the outcome of the work on these Action items. Also, Section A.2, which addresses the relationship between domestic anti-abuse rules and tax treaty provisions, will need to take account of recommendations for the design of new domestic rules that may result from the work on various Action items, in particular Action 2 (Neutralise the effects of hybrid mismatch arrangements), Action 3 (Strengthen CFC rules), Action 4 (Limit base erosion via interest deductions and other financial payments) and Actions 8, 9 and 10 dealing with Transfer Pricing.

9. The specific issues on which that follow-up work will focus will be described in a discussion draft that will be released during the third week of November 2014. Given the length and complexity of the limitation-on-benefits (LOB) rule, it will not come as a surprise to anyone that the majority of these issues will deal with that rule. Apart from the specific issue of investment funds, which is discussed in the next section, the issues that will raise the most difficult questions are probably:

- The inclusion of alternative LOB provisions that EU countries would need to adopt in order to comply with EU law

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7 Paragraph 5 of the Report.

- The drafting of the "broad" derivative benefits provision and of the equivalent beneficiary definition.
- Whether changes should be made to the alternative test of having its shares principally traded on a local stock exchange or having a local primary place of management and control, which is a test that has to be met for the LOB publicly-listed company provision to apply
- The design /drafting of a rule for PEs situated in third States

Policy considerations relevant to the treaty entitlement of CIV and non-CIV funds

Collective investment vehicles

10. One of the strongest criticisms that was received on the first version of the LOB rule that was included in the Discussion Draft released in March 2014 was that the rule, as drafted, would have resulted in a large number of investment funds losing (or not getting) treaty benefits. In many cases, these funds would have been denied treaty benefits under the draft LOB because they

a) would not qualify as publicly traded companies;

b) would not meet the 50% ownership requirement of subparagraph 2 *e*) if they are owned by persons that are not residents of the State in which these vehicles are established; and

c) would not qualify under the active business test of paragraph 3 to the extent that deriving investment income might not qualify as an "active business".

11. As part of the consultation process, the Working Party recognised that denying treaty benefits to collective investment vehicles (CIVs) under the draft LOB would seem to contradict the conclusions of the 2010 Report on the *Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles* (the "2010 Report"). Subparagraph 2 *e*) was subsequently added to the revised version of the LOB rule that appears in the report on Action 6. It provides for the inclusion, in the list of "qualified persons", of a provision dealing with CIVs. A footnote indicates that the subparagraph should be drafted, or omitted, based on how CIVs are treated in the Convention and are used and treated in each Contracting State; that footnote also refers to paragraphs 6.4 to 6.38 of the Commentary on Article 1. The Commentary on the LOB rule includes a discussion of how CIVs could be dealt with as well as a number of alternative provisions that correspond to the various approaches included in the 2010 Report.

12. As part of the follow-up work on the Report on Action 6, it is intended to review these alternative approaches and to examine whether it would be possible to suggest a single preferred approach not only with respect to the application of the LOB to CIVs but also with respect to the more general question of the treaty entitlement of CIVs, taking into account developments since 2010 and, in particular, the results of the work on the Treaty Relief and Compliance Enhancement (TRACE) project.

Non-CIV funds

13. Many comments that were received on the discussion draft (and in subsequent representations received by the Secretariat and by delegates) also raised LOB issues in relation to Sovereign Wealth Funds (SWFs), pension funds and alternative funds (including private equity funds).[8] Paragraph 6 of the report

[8] Issues were also raised with respect to Real Estate Investment Trusts (REITs) but these issues are similar to those of CIVs in the case of REITs they are widely-held and regulated. Issues faced by REITs that are not CIVs are similar to those of private equity funds.

therefore indicated that further work was needed with respect to the policy considerations relevant to treaty entitlement of these "non-CIV funds."

i) Sovereign wealth funds

14. These funds are owned and operated by States themselves. The legal status and tax situation of sovereign wealth funds vary but in many countries, foreign sovereign wealth funds are entitled to an exemption from taxes on their portfolio investment income under the sovereign immunity doctrine. Paragraphs 6.35 to 6.39 of the Commentary on Article 1, which were added to the OECD Model Tax Convention in 2010, explain how treaties apply to sovereign wealth funds. These paragraphs discuss the application of the sovereign immunity doctrine to taxation, which is a matter of domestic law, and the application of the definition of "resident" in the light of the different views reflected in paragraphs 8.6 and 8.7 of the Commentary on Article 4.

15. It has been suggested that the LOB rule that is included in the Report on Action 6 may create difficulties for sovereign wealth funds. Where a sovereign wealth fund invests directly in a country, however, the definition of "qualified person" included in the LOB rule would apply to a resident who is "*a Contracting State, or a political subdivision or local authority thereof, or a person that is wholly-owned by such State, political subdivision or local authority*" (subparagraph 2 *b*) of the LOB rule), which would cover a sovereign wealth fund that qualifies as a resident of a Contracting State and that is wholly-owned by that State or its subdivisions. Similarly, investments that a sovereign wealth fund resident of one Contracting State makes through a subsidiary established in the same State would typically be covered by the "ownership / base erosion" provision (subparagraph 2 *e*) of the LOB rule). Problems could arise, however, in the case of investments made through an entity that is a resident of a third State (*e.g.* a sovereign wealth fund of State R uses a company in State T in order to invest in State S). Also, sovereign wealth funds are often among the institutional investors that invest in alternative funds and private equity funds and these may be established in other countries (see under subsection *iii)*).

ii) Pension funds

16. The LOB rule included in the Report on Action 6 does not restrict benefits in the case of a resident who "was constituted and is operated exclusively to administer or provide pension or other similar benefits, provided that more than 50 per cent of the beneficial interests in that person are owned by individuals resident in either Contracting State". The LOB rule also does not restrict benefits in the case of an entity that was constituted and is operated to invest for the benefit of such pension funds, "provided that substantially all the income of that entity is derived from investments made for the benefit of these pension funds." Similarly, investments that a pension fund that is a resident of one Contracting State makes through a subsidiary established in the same State would typically be covered by the "ownership / base erosion" provision (subparagraph 2 *e*) of the LOB rule).

17. As in the case of sovereign wealth funds, however, problems may arise where a third State entity is used, *e.g.* a pension fund of State R sets up an entity in State T in order to invest in State S: in that case, the LOB rule of the T-S treaty could deny benefits to the entity even if all participants in the fund are residents of State R (in such a case, however, the treaty entitlement and benefits of the pension fund under the R-S treaty may be different from those available under the T-S treaty, which could raise treaty-shopping concerns). In addition, pension funds, like sovereign wealth funds, are often among the institutional investors that invest in alternative funds and private equity funds and these may be established in third countries (see under subsection *iii)*).

18. Another specific issue for pension funds that arises in relation to the LOB rule relates to the requirement that more than 50% of the beneficial interests in a pension fund be owned by individual

residents in either Contracting State. This requirement may create difficulties for some EU pension funds (this issue is one of the issues that will be examined as part of the follow-up work on alternative LOB provisions for EU countries).

19. It has been suggested that, as part of the work on the treaty entitlement of non-CIV funds, the OECD should look at how the treaty definition of "resident" applies to pension funds in the light of the different views reflected in paragraphs 8.6 and 8.7 of the Commentary on Article 4. It has also been suggested that many of the above issues related to pension funds could be addressed by countries including in their treaties the alternative provision that is found in paragraph 69 of the Commentary on Article 18 of the OECD Model Tax Convention, which deals with the source taxation of income of foreign pension funds. As the preamble of that paragraph recognises, however, such a provision should be used where it will be mutually beneficial and there may therefore be valid policy reasons for not including that provision in a bilateral treaty.

iii) Alternative funds / private equity funds

20. For the purposes of the 2010 Report, "collective investment vehicles" are defined as "funds that are widely-held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established". Alternative funds / private equity funds generally do not meet these conditions because they typically have a limited number of institutional investors, may not hold a diverse portfolio and are not subject to the same investor-protection regulation.

21. The problems that the LOB rule creates for CIVs may also be encountered by private equity funds / alternative funds (*i.e.* since their investor base is not restricted to a single country, they would be denied benefits under the LOB rule and would probably not get the active business exception; any provisions dealing expressly with CIVs would not apply to them). Also, these funds face many of the treaty issues that were addressed in the 2010 OECD Report on CIVs (*e.g.* whether they qualify as residents).

22. As part of the follow-up work on Action 6, it is intended to examine how these issues related to the treaty entitlement of sovereign wealth funds, pension funds and alternative funds / private equity funds could be addressed in a way that would not create treaty-shopping opportunities.

Work on Action 15

23. Action 15 (Develop a Multilateral Instrument) envisaged a two-step process. The first step, which resulted in the report "Developing a Multilateral Instrument to Modify Bilateral Tax Treaties"[9] delivered on 16 September 2014, was to "[a]nalyse the tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties." That report concluded that a multilateral instrument is desirable and feasible, and that negotiations for such an instrument should be convened quickly.

24. The second step, which has a December 2015 deadline, will require moving from a feasibility analysis to the actual development of the multilateral instrument: "[o]n the basis of this analysis, interested Parties will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to

9 See http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/developing-a-multilateral-instrument-to-modify-bilateral-tax-treaties_9789264219250-en#page1.

this evolution." A mandate for the development of that multilateral instrument is currently being drafted for consideration by the CFA in January 2015.

25. The objective of the multilateral instrument will be to expedite and streamline the implementation of the measures developed to address BEPS and amend tax treaties. It is envisaged that this multilateral instrument will coexist with the existing network of bilateral tax treaties. Flexibility, respect for bilateral relations, and a targeted scope are keys to the success of the negotiation of such an instrument. Flexibility could be provided through various mechanisms, such as excluding the application, in full or in part, of certain provisions; providing a choice between alternative measures set out in the instrument and providing the possibility for parties to take on additional commitments. The parties to the instrument could therefore commit to a core set of provisions in the multilateral instrument but could have the possibility to opt-out of certain measures (e.g. though reservations on non-core provisions), choose between alternative – clearly delineated – measures and/or opt-in to additional measures.

26. Based on the work done so far, the main candidates for inclusion in such a multilateral instrument would appear to be the treaty changes that will result from the work on Action 6 (Prevent Treaty Abuse), on Action 7 (Prevent the Artificial Avoidance of PE Status) and on the part of Action 2 that produced a treaty provision or transparent entities. Other possibilities that have been put forward relate to provisions for a multilateral MAP, for triangular PE cases and for a legal basis for safe exchanges of country-by-country reporting information. It is important to remember, however, that decisions as to what will be included in the multilateral instrument will ultimately be made during the negotiation by the interested parties.

Actions 6 and 15
Unfinished Business

Jacques Sasseville
Head, OECD Tax Treaty Unit

1

Action 6

- Discussion draft released in March 2014
- The report on Action 6 (16 September 2014)
  - Adoption of a minimum standard against treaty shopping
  - LOB: number of changes (CIV provision, derivative benefits provision, detailed Commentary)
  - PPT: minor changes; alternative for conduit arrangements

2

Other changes

- Lower treaty rate on direct dividends:
  - Minimum shareholding period: decision to go for 365 days (moving period; excludes changes resulting from corporate reorgs of either company)
  - US RIC exclusion
- Land-rich company provision:
  - Extended to comparable entities
  - Provision applies if 50% test is met at any time during the preceding 365 days

3

Other changes

- Tie-breaker rule for corporate residence: alternative provision in the Commentary for the POEM addicts
- PE in third State rule
- Commentary changes that clarify that the new PPT rule does not affect the conclusions in the Commentary on Article 1 concerning the interaction between treaties and domestic anti-abuse rules
- Departure tax clarification

4

Action 6 – Follow-up work (para. 6)

1. The implementation of the minimum standard
2. The policy considerations relevant to the treaty entitlement of collective investment vehicles (CIVs) and non-CIV funds
3. The precise contents of the model provisions and related Commentary included in Section A of the report, in particular the LOB rule

5

The minimum standard

- Agreement on a minimum level of protection against treaty shopping
- Countries agree that, as minimum, their treaties should include
  - An express statement that their common intention is to eliminate double taxation without creating opportunities for treaty shopping, and ...

6

The minimum standard

... and either

- The general treaty anti-abuse rule
- The LOB rule supplemented by a mechanism that would deal with conduit arrangements, or
- Both the general treaty anti-abuse rule and the LOB rule

7

Examples of implementation issues

- How would the minimum standard be reflected in the OECD Model Tax Convention? What types of reservations/observations/positions would be possible?
- Whether and how should the minimum standard be reflected in the multilateral instrument envisaged under Action 15?
- Should the minimum standard be purely prospective or should it also apply to existing treaties (*i.e*. should countries be required to modify existing treaties in order to implement the standard)?

8

Examples of implementation issues

- Should there be some form of monitoring of compliance with the minimum standard?
- What happens if, in the course of future bilateral negotiations, a country refuses to allow a treaty partner to incorporate provisions that are recognised as complying with the minimum standard?

9

Treaty entitlement of CIVs and non-CIVs

- Primarily an LOB issue although funds have also complained about PPT
- Many CIVs would be denied benefits under LOB
  - would not qualify as publicly traded companies;
  - would not meet the ownership-base erosion test if not owned by persons that are not residents of the State in which these vehicles are established; and
  - would not qualify under the active business test to the extent that deriving investment income might not qualify as an "active business"

10

Provision added to the September Report

[Qualified person includes...]

f) [possible provision on collective investment vehicles][1]

[Footnote 1] This subparagraph should be drafted (or omitted) based on how collective investment vehicles are treated in the Convention and are used and treated in each Contracting State: see the Commentary on the subparagraph and paragraphs 6.4 to 6.38 of the Commentary on Article 1.]

11

Options based on 2010 CIV report

- Conditions for treaty entitlement of CIV income
- Alternative provisions
  - All CIVs get benefits at fund level
  - Transparency: investors get benefits
  - CIV gets proportional benefits
  - CIVs get benefits at fund level if high percentage of residents of other State
  - CIVs get benefits at fund level if high percentage of residents of other State or equivalent beneficiaries
  - Deferral issue

12

Options for CIVs

- Can we do better than this?
- Proportional benefits
  - Importance of TRACE
  - Deferral issue

13

Non CIV funds

- Sovereign wealth funds
- Pension funds
- Alternative funds (including private equity funds)
- May not be CIVs under 2010 Report because
  - Not widely held
  - Not diversified
  - Not regulated

14

Sovereign wealth funds

- Issues of treaty entitlement related to residence
- Issues related to the application of sovereign immunity doctrine
- SWF that is a resident would be a qualified person but LOB problem when invests through intermediary in third State
  - Wholly-owned sub
  - Private equity fund

15

Pension funds

- Issues of treaty entitlement related to residence
- Issues related to the EET system and the lack of source country exemption in most treaties
- Pension fund that is a resident, and resident entities owned by pension funds, would be qualified persons but LOB problem when invests through intermediary in third State
  - Wholly-owned sub
  - Private equity fund
- Non-portfolio investments by pension funds

16

Private equity funds

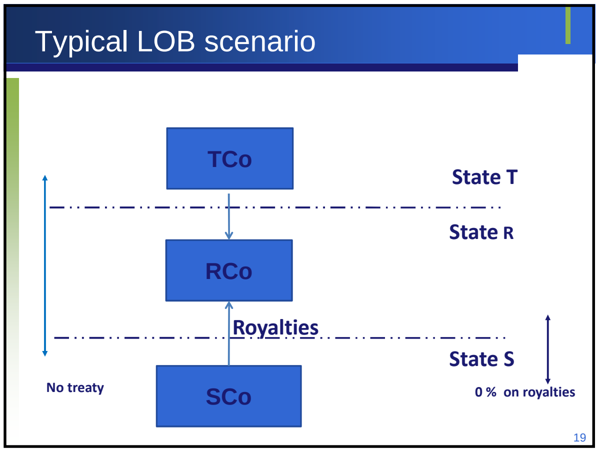
- Would like the CIV proportional benefits approach but
  - Not the same distribution requirement so deferral issue
  - Some countries very suspicious of private equity funds
  - Probably not an issue for funds investing in US

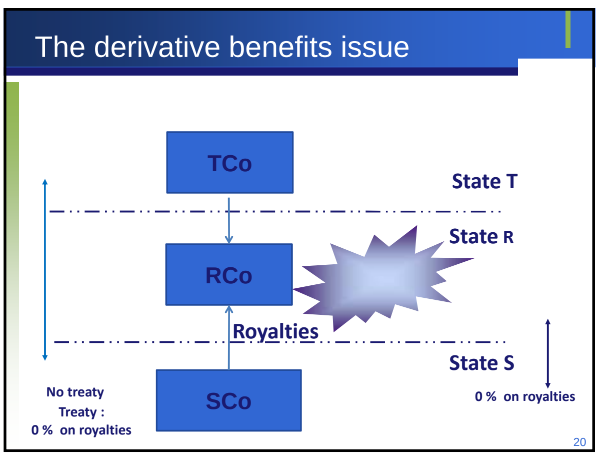
17

PE in third State

- Difficult technical issue
- Parallel with derivative benefits issue; upward and downward treaty shopping

18


Typical LOB scenario
TCo
State T
State R
RCo
Royalties
State S
No treaty
SCo
0 % on royalties
19


The derivative benefits issue
TCo
State T
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Royalties
State S
No treaty
Treaty :
0 % on royalties
SCo
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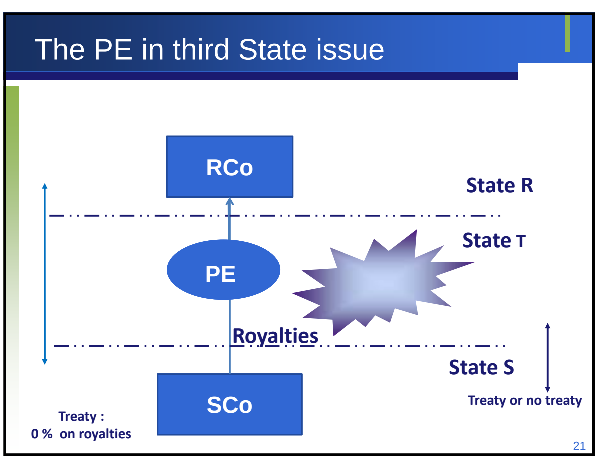
The PE in third State issue
RCo
State R
State T
PE
Royalties
State S
SCo
Treaty or no treaty
Treaty :
0 % on royalties
21

How do we address?

- US model: does not matter whether State R is exemption or credit; test is

  if the profits of that permanent establishment are subject to a combined aggregate effective rate of tax in the first-mentioned Contracting State and third State that is less than 60 percent of the general rate of company tax applicable in the [State R]
- Action 6 report: State R is exemption country; 60% test applies only to PE State tax

22

How do we address?

- Exceptions for
  - Royalties for intangible property produced or developed through the PE
  - Income connected with, or incidental to, the active business of the PE (other than investing – except for banks or securities dealers)
- Action 6 report: added insurance companies to the last exception

23

Action 15

- A two-step process:
  - “[a]nalyse the tax and public international law issues related to the development of a multilateral instrument...” (September 2014)
  - “[o]n the basis of this analysis, interested Parties will develop a multilateral instrument designed to provide an innovative approach to international tax matters...” (December 2015)

24

Report on Action 15

- Released on 16 September 2014
- Concludes that a multilateral instrument is desirable and feasible, and that negotiations for such an instrument should be convened quickly
- A mandate for the development of that multilateral instrument is currently being drafted for consideration by the Committee on Fiscal Affairs in January 2015

25

Multilateral instrument

- Objective: to expedite and streamline the implementation of the measures developed to address BEPS and amend tax treaties
- Will coexist with the existing network of bilateral tax treaties
- Flexibility, respect for bilateral relations, and a targeted scope are keys to the success of the negotiation of such an instrument

26

Possible provisions?

- Main candidates are treaty changes that will result from the work on
  - Action 6 (Prevent Treaty Abuse)
  - Action 7 (Prevent the Artificial Avoidance of PE Status)
  - Treaty provision or transparent entities (Action 2)
- More remote possibilities
  - Provisions for a multilateral MAP
  - Provisions for triangular PE cases
  - Legal basis for safe exchanges of country-by-country reporting information

27

[Draft -- please do not circulate without permission.]

Labor Rents and "Developing" Countries: Where's the BEPS?

Mitchell A. Kane*

Finalizing and Implementing the BEPS Agenda

Sydney University, November 17-18, 2014

This paper addresses the treatment under arm's length transfer pricing of the fairly common fact pattern in which a developed country multi-national enterprise outsources unskilled labor to a developing country with relatively low labor costs and performs such labor through a controlled production subsidiary. Although casual observation would seem to suggest that this fact pattern is fairly ubiquitous, it has drawn surprisingly little attention in the academic and policy literature.[1] The question, of course, is whether the production subsidiary should be allocated any part of the economic rent that might arise in virtue of the low cost labor input or whether that rent should instead be allocated entirely to other parts of the enterprise. I will examine the analysis of this question in more detail below under the guidance provided in the OECD Transfer Pricing Guidelines ("Guidelines"), U.S. Treasury regulations, and the U.N. Practical Manual on Transfer Pricing ("U.N. Manual"). But the simple bottom line is fairly clear.

At least in cases where there is a thick local labor market (such that an unrelated production subsidiary would be unable to bargain for part of the economic rent), the near uniform result is that the controlled production subsidiary will *not* be allocated any part of the rent. Rather, it will likely earn a simple cost plus return with the cost base determined by the (relatively low cost) local labor

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1. The two notable exceptions are Michael McKee and Michael McDonald, "Location Savings" in Competitive Markets, 9 Transfer Pricing Report 700 (2001) and Sébastien Gonnet, Pim Fris, and Tommaso Coriano, "Location specific advantages -- principles" Transfer Pricing International Journal (June 2011).

market. The OECD has just affirmed this basic result in its recently issued deliverable for BEPS Action 8 ("Action 8 Deliverable"), which for the first time added specific language to the Guidelines dealing with the general issue of "location savings."[2] Although individual countries that are frequent hosts to low cost labor operations have taken a contrary view and attempted to allocate a portion of the total rent to local subsidiaries, I am not aware of any sustained analytical argument that has been offered to justify that result under a proper interpretation of the arm's length standard.

Indeed, the arguments would all seem to run in the opposite direction. On the assumption of thick labor markets, this will be an instance where comparables should be readily available. Relatedly, departing from the preferred approach (by allocating part of the rent to the production subsidiary) would seem to invite organizational distortion insofar as unrelated third parties are unable to bargain for any part of that rent. And putting these points together, we would seem to have a clear and administrable rule that doesn't implicate BEPS at all. Where is the BEPS? What is the problem?

In this paper I question this basic line of analysis. I suggest that the low cost labor outsourcing problem should be understood to present a substantial issue of BEPS and that the best way to counteract this is to implement arm's length transfer pricing in a way that does attempt to allocate labor rents to controlled subsidiaries in low cost labor markets, even where those markets are thick and provide readily available comparables. The argument will be multi-pronged, in that I suggest the proposed result can be defended in terms of efficiency, inter-nation distribution, and as an acceptable doctrinal interpretation of the arm's length standard.

2. See OECD, Guidance on Transfer Pricing Aspects of Intangibles pp. 12-14 (2014) (adding para. 1.80-1.84 to the Guidelines). The Guidelines had previously dealt with "location savings" only within the specific context of business restructurings at para. 9.148-9.153. I discuss these provisions further below.

I will divide the discussion into four parts. In the first part of the paper I describe current approaches to this basic problem under (i) the OECD Guidelines (including recent guidance in the Action 8 Deliverable which amends the Guidelines in relevant part); (ii) the U.N. Manual; and (iii) the U.S. Treasury regulations. In the second part of the paper I set out some general assumptions about the nature of the problem I am attempting to analyze and suggest why I think that under the current approach this type of problem presents an issue of BEPS. In the third part of the paper I describe and develop normative criteria that underly the allocation of labor rents defended in this paper. Finally, in the last part I deal with various implementation issues, complications, and likely objections.

I. The Standard Analysis

To get the analysis underway we can begin with a simple example that appears in the business restructuring provisions of the Guidelines. In particular, par. 9.150 of the Guidelines describes the case of an enterprise that manufactures and sells clothes under a valuable brand name. Initially the enterprise establishes its enterprise in Country A, where it manufactures clothing through facilities that have relatively high labor costs. Subsequently, the enterprise shifts manufacturing of the clothes to an affiliate in Country B under a contract manufacturing arrangement. That affiliate will sell the clothes to the Country A affiliate, which will then sell the clothes to third parties. Because the labor costs in Country B are lower than the costs in Country A, overall the group is able to realize significant "location savings." The question posed is whether these savings are to be allocated at all to the Country B affiliate.

The Guidelines dispatch that question in just a few sentences. In particular, under para. 9.151 the Guidelines conclude that so long as the labor input arises in a competitive market (call it a thick labor market with generous supplies of unskilled labor), the Country B affiliate should draw "very little, if any, part of the location savings." The rationale is twofold and straightforward. First, in a thick labor market comparables regarding price terms that a third party would demand in the market will be easy to find. Second, and related, adopting any other approach would put the affiliated contract manufacturer in a different position than an unrelated party, flying in the face of the basic premise of the arm's length standard.

Although the result just mentioned appears in the portion of the Guidelines dealing with business restructurings specifically, it would seem to follow, as well, from general principles embodied in any functional approach to arm's length transfer pricing. One could take the U.S. Treasury regulations as illustrative. Under the U.S. Treasury regulations (and the Guidelines as well, of course), it is a hallmark that one must adopt a *functional* approach to transfer pricing. This reflects the (seemingly noncontroversial) idea that if one is going to benchmark related party prices by reference to unrelated ones, then the related and unrelated parties should be performing the same functions (taking account of assets used and risks assumed), or at least sufficiently similar functions such that appropriate adjustments can be made. Functional analysis reflects, then, the simple point that in competitive markets different functions command different compensation. For the arm's length comparisons to serve their proper role, a functional analysis would seem essential. Of particular relevance to the problem under consideration here, a functional analysis is supposed to take account of *geographic* or *locational* factors.[3]

As applied to the sort of labor outsourcing fact pattern discussed above, this has fairly predictable consequences. In the absence of data to apply the comparable uncontrolled price method to the finished product sales made by the enterprise in Country A (which is quite likely

3. U.S. Treasury regs. 1.482-1(d)(3)(iv)(E); see also OECD Guidelines, para 1.44, 1.57.

given the general difficulty of finding data to apply the comparable uncontrolled price method and the fact that the finished products here embed valuable intellectual property), the cost plus method for the contract manufacturer in Country B will naturally present itself as appropriate.[4] In applying the cost plus method under a functional approach that takes account of geographical or locational segmentation of markets (as must be the case here given the different labor costs), one produces the following ordering of preferences for comparables. The first best result would be to identify suitable comparables for the cost plus manufacturer in the Country B market, or perhaps a broader regional market, if one had evidence that this formed a single competitive labor market. This is the first best option because then the arm's length mark-ups could be used without adjustment. (To be clear, I mean no adjustment for considerations of geographic market; adjustments for other functional differences may, of course, still be necessary.) The second best option would be to identify an arm's length mark-up based on the experiences of producers in some other locale (perhaps Country A or perhaps some other country with relatively low labor costs) but then with adjustment to take account of the locational differences.

The U.S. treasury regulations elaborate upon the basic result here regarding adjustments with an important observation. Specifically the regulations tell us that adjustments based on geographic market must take account of the competitive positions of buyers and sellers in the respective markets.[5] Thus the fact that a controlled subsidiary enjoys cost savings will not justify the retention of profit at the subsidiary level based on such cost savings, unless an uncontrolled party could have been expected to bargain to retain the profit. As applied to the example this means simply that the Country B affiliate could defensibly be compensated under a cost-plus mark-up applicable to *Country*

4. See U.S. Treas. reg. 1.482-1(d)(4)(ii)(B) (providing example with a foreign manufacturing subsidiary where cost plus is applied in the absence of reliable data to apply a comparable uncontrolled price method).
5. Treas. reg. 1.482-1(d)(4)(ii)(C).

A manufacturers *if* we could expect an *unrelated* Country B manufacturer to be able to bargain at arm's length to retain the profit from the labor cost savings. But in this fact pattern, and in the more general case of labor outsourcing it is meant to capture, we do *not* expect such a result precisely because of the likelihood of a thick market for unskilled labor which will result in rival labor suppliers competing this profit away. The bottom line outcome is thus fairly clear under a general functional analysis. *None* of the cost savings on labor inputs, as a general matter will ever be allocated to a developing country affiliate that provides such low cost labor.

This basic result has just recently been affirmed in the OECD's modification to the Guidelines in the Action 8 Deliverable. That document added four new paragraphs to the Guidelines (para. 1.81-1.84) dealing generally with the issue of "location savings." The approach therein explicitly follows the provisions on business restructurings (para. 9.148-9.153) just discussed. Further, the new provisions in the Guidelines state two important principles of relevance here. Specifically, in instances where "location savings" are not passed on to consumers or suppliers, (i) *local* market comparables are to be used and (ii) such comparables do not need to be adjusted to take account of location savings. The bottom line is thus as above. Developing country affiliates will be allocated profits in accord with prevailing local market conditions and will not realize any of the location savings.

Although one might have expected a different result in the U.N. Manual, it too essentially hues to this basic line of analysis. Thus regarding the split of location savings across controlled affiliates, the U.N. Manual indicates that "the bargaining power of the associated enterprises which reflects the arm's length nature of two independent parties negotiating over their respective shares of savings/rents may be well suited as the key metric for this."[6] Once again, then, in any case with a

6. See U.N. Manual para. 5.3.2.45.

thick local labor market, the result under the arm's length standard is that the local affiliate is not entitled to any of the "location savings."

Importantly, there are substantial departures from this basic approach in the country-specific materials in the U.N. Manual. The most far reaching approach is that espoused by China.[7] Under that approach an appropriate mark-up for a local affiliate would be determined by reference to developed country comparables (on the grounds that comparables are difficult to locate locally). More crucially, though, that markup is applied to both the local cost base *and* to the difference in cost bases. In the example provided, a local Chinese affiliate has costs of 100, even though comparable services provided in developed countries would involve costs of 150. The local affiliate in this case is entitled to an 8% markup (determined by looking at developed country comparables, as just mentioned) on the 100 base *and* on the 50 differential. The mark-up applied to that difference (i.e., .08 * 50 = 4) is the entirety of the profit attributable to "location savings" and it is all allocated to the local subsidiary. Although this is claimed to be consistent with the arm's length standard, it is not clear exactly how this is the case, especially in light of the basic arguments under a functional analysis described above.

A similar issue is present in the country-specific materials regarding India.[8] India takes the position that resort to local market comparables will not allocate any of the location savings to the local subsidiary -- *and* that this is in conflict with an arm's length result. The argument is that at arm's length no transaction would even occur unless each party enjoyed some benefit from the mutual gains from trade. This would not, however, seem to rebut the basic line of analysis presented in the Guidelines and the U.N. Manual. At least under the assumption that there is a thick local labor market a local company could be presumed to conclude contracts in any case where it can earn the

7. See U.N. Manual para. 10.3.3. et seq.
8. See id. para. 10.4.7.4.

market-clearing price for the market to which it is constrained. This is just another way of putting the bargaining power point, which is reflected in the U.S. regulations. If there is sharing of the gains from trade at arm's length, this means there must be some bargaining power at the level of the local production company. If that is the case, then all authorities seem to agree that part of the profit should be allocated to a local production affiliate under an arm's length standard. Where the authorities divide is when there is no such bargaining power. The Guidelines and U.N. Manual conclude no allocation to the local production subsidiary in such circumstances. India would appear to take a contrary view, but again it is not clear how this should be squared with an arm's length approach.

The basic proposal advanced in this paper reaches the same specific result defended by China and the same general result defended by India. What the paper does, though, is to attempt to ground that result within the broader context of BEPS and a sound analytical approach to the arm's length standard. In addition, the analysis here attempts to grapple with the various complications that arise in the common, possibly universal, situation in which there are are local cost savings *ab initio* but such savings are ultimately passed on to customers through competitive product markets.

II. Where is the BEPS?

To this point I have described the general problem at issue as involving outsourcing of low cost labor inputs. I should now be more precise about the exact nature of the problem I have in mind. First, one must assume that there are segmented labor markets to some extent or clearly there would be no space for low cost labor inputs in the first place. In the real world there are likely to be a range of different, segmented labor markets. Thus India and China almost certainly function as essentially two distinct labor markets for unskilled labor, each with a cost advantage over a range of more economically developed countries and one with a cost advantage over the other. I will return to this complexity, regarding distinct developing country labor markets, later in the paper. For now, in order to motivate the basic concern, however, I have in mind a model in which there are simply two labor markets, one high-cost and one low-cost. Second, I assume that there is competition in the product markets where the goods produced by the low-cost labor inputs are sold. In this simple sort of model one should expect that the economic rents from employing low cost labor inputs will be dissipated in the product markets over time. However, in the short run (which may well be a substantial amount of time) product markets will not yet have reached equilibrium and at least some firms will be earning economic rents with respect to the low cost labor inputs. Although one could model the problem with perfect competition in the product markets, with rents immediately dissipated and reflected in consumer prices, it makes very little sense to analyze the real world in such a fashion. With such perfect competition in product markets firms would have no incentive to outsource in the first place, which is clearly not an accurate description of reality.

I thus follow here the analysis in the paper by McKee and McDonald, where they point out that in the short run firms' cost structures will vary.[9] This will happen, for example, where demand cannot fully be met by firms that have achieved a low cost structure (as through labor outsourcing in the case I am centrally concerned with). In such a circumstance the marginal supplier's costs will determine the market price and that supplier will earn a competitive return. Any firm with a lower cost structure will earn economic rents -- labor rents -- until the cost structure equalizes.[10]

Reflecting the possibility of imperfect competition and dynamic dissipation of economic rents is also consistent with the basic setup in the Action 8 Deliverable and the U.N. Manual. Regarding the former, the amended Guidelines refer to "location savings" in new section D.6.1. The

9. See McKee and McDonald, supra note 1.
10. See id.

reference to "savings" here might make it sound like the relevant quantity is a fixed amount determined by the difference on the cost side between labor costs in the jurisdiction of labor supply prior to outsourcing and the labor costs in the jurisdiction where the labor is outsourced. On that approach one would realize "location savings" (so long as the labor markets remained segmented) even if there are no profits from such savings because they are competed away in product markets. It seems clear, however, that the amended Guidelines are concerned with allocating a quantity demarcated as "net location savings." That would be "location savings" reduced by the amount of any savings passed on to customers or suppliers.[11] One should thus take "net location savings" and "location rents" to be getting at the same phenomenon. From here out, I will refer to the relevant concept I am concerned with simply as "labor rents," which reflects the economic rents from the particular type of location savings related to a local low wage labor market. Regarding the U.N. Manual the relationship between location rents and competition is even more explicit. Thus the U.N. Manual states, "The extent to which [location savings] will lead to location rents depends on competitive factors relating to the end product and to the general access to LSAs. It is possible that in a particular case, even though [location savings] exist, there are no location rents."[12]

In order to make the case that labor rents present an issue of BEPS it is necessary to expand on the simple two country example drawn from the Guidelines' treatment of business restructurings discussed above. The crucial shortcoming in that example, as an analytical tool, is that it makes the overly broad assumption that the intangibles that drive the value of the branded goods are all held in the jurisdiction of sales (Country A). In such a two country model, the decision to compensate the low labor cost affiliate at the rate prevailing in the local labor market necessarily moves all of the

11. An alternate interpretation of "net" here would be gross cost savings from outsourcing less the incremental costs of outsourcing, such as from building a new factory. However, given that the reference to "net" savings follows the introductory clause "where location savings are not fully passed on to independent suppliers", it would seem that the "net" concept is attempting to measure the degree to which any savings are dissipated by competition.
12. U.N. Manual para. 5.3.2.43.

labor rent into the jurisdiction of sales. As the rent is dissipated through competition, it would be perfectly measured in the tax base of the jurisdiction of sales. There is no BEPS in such a case. The prospect of migration of intangibles, however, should change the analysis drastically.

To see how, one can consider a somewhat more realistic example. Consider a basic U.S. manufacturing operation which has all of its production, valuable intellectual property and management in the United States. The firm sells a majority of its output in the United States but also sells a substantial amount of its output to Canada, either through a local sales subsidiary or through a sales branch. For simplicity and to emphasize the distinctions I seek to draw here, let us assume further that the U.S. and Canada impose approximately equivalent corporate taxes, so that there is no real incentive for the taxpayer to shift profits in the corporate tax base across Canada and the United States. The analysis of this particular fact pattern presents no particular complications. Canada will tax the return to the sales function that takes place in Canada, either by taxing the local subsidiary or the branch, which we can assume here surpasses the treaty PE threshold. Under the assumption of equivalent rates there should be no profit shifting incentives but in any event each country can protect its base by adjusting stated profits to the extent the sales subsidiary or branch is earning more or less than an arm's length return. That determination, in turn, should involve a relatively simple application of the resale minus method.[13]

Now modify the structure in two ways. First, suppose that labor costs are substantially lower in Mexico than in the United States so that the U.S. firm decides to establish a manufacturing subsidiary in Mexico where all production will take place.[14] Further, suppose that the firm has

13. I do not mean to suggest there are *no* complications. The analysis, for example, should take account of inventory risk borne by the sales operation. This presents immediate difficulties for likening the branch case to the subsidiary case, as the branch cannot bear independent risk as a legal matter. This leads to a series of problems that the OECD has grappled with in its articulation of the so-called authorized approach to profit attribution. I put these issues to the side, as my focus here is really on the relative treatment of the labor services across the two structures discussed in the text.
14. The choice of Mexico in this example is deliberate. Without getting into the perennial debates about what constitutes

migrated its valuable intellectual property to an IP holding company in Bermuda. The Mexican manufacturing affiliate will sell unbranded goods to the U.S. parent and the Canadian affiliate. Those entities in turn will pay royalties to the Bermuda IP holding company, under a license allowing the right to sell the branded goods in their relevant territories. Broadly, this should achieve two sorts of cost savings. There will be a pre-tax savings on reduced labor costs (which must, of course, be considered on a net basis reflecting incremental costs from moving such continuing production abroad). In addition there will be a tax savings to the extent that the royalties strip part of the base out of the United States and Canada and place such profit in the relatively low-taxed IP holding company in Bermuda. From the standpoint of the various tax administrators the chief focus is very likely to be on the migration of the IP and the subsequent payment of royalties. Thus the tax administrator in Canada might challenge the amount of royalties paid under the asserted IP holding company structure. From the U.S. perspective the focus will be either on the terms of the initial migration of the IP out of the United States, the level of the royalty, or on the U.S. controlled foreign corporation rules with respect to royalty income of foreign subsidiaries (which could have the effect of bringing royalty income back into the base currently rather than on a deferred basis). The aspect of the structure that is likely to capture far less attention from tax administrators is the appropriate compensation for the labor services provided by the Mexican subsidiary. Under the standard analysis presented in part I that subsidiary will simply be allocated an amount based on prevailing labor market competition in Mexico. So what has happened to the labor rent?

a "developing" country in the first place, the more general point to observe is that the phenomenon described in this paper can certainly arise across OECD member countries. The only pre-condition is segmentation of labor markets, which is surely the case across at least some member countries. The phenomenon likely has greater magnitude with respect to outsourcing to non-member countries, with India and China being the obvious two cases of greatest relevance. To that extent the analysis herein has substantial bearing on relations between OECD member countries and non-members countries.

At least in the type of stylized facts presented here the answer seems fairly clear. The labor rent, pending dissipation, will end up being booked in Bermuda and thus will escape taxation. This result follows from the current approach under the Guidelines, under which there is no good way to bring profits associated with the labor rents back into the base of the sales affiliates, as occurred naturally prior to the migration of the valuable intangibles. Broadly, there are two scenarios of interest.

First, in the most troubling case, suppose there is no plausible claim that any part of the profit associated with the IP should be attributed to the sales jurisdictions. In that case the relevant affiliates in the U.S. and Canada really are performing only routine sales and distribution functions. Any royalty that leaves behind at least a routine return on the sales/distribution function will likely be defensible. All of the labor rent ends up in Bermuda and is untaxed. Observe that there is no way to get at this problem by challenging the terms of the migration of the IP. Suppose that migration occurs well before the labor outsourcing decision and the IP holding company really has paid full arm's length compensation for any IP rights that it claims. The complexity one faces here is that the labor rent is analytically distinct from the IP value. If the Bermuda IP holding company begins to book profits associated with the labor rents after the outsourcing decision, there would be no basis to use those profits as grounds on which to challenge the terms of the initial migration of IP.

Second, there is a more nuanced scenario, in which the affiliates in the U.S. or Canada retain rights to IP related returns, notwithstanding the attempted migration of the IP to the IP holding company. For example, suppose that the Canadian affiliate has borne the cost of developing marketing intangibles that would not have been borne at arm's length. Under the current approach in the Guidelines (as stated in the Action 8 Deliverable) there will be a prospect of attributing to the

Canadian affiliate a portion of the profit attributable to the IP.[15] But now one would encounter the exact same problem as just discussed with challenging the terms of the IP migration in the first instance. The analytical structure of the amended Guidelines regarding intangibles is designed with the goal of determining a proper allocation of the profit from the intangible brand value. But the profit from the labor rent does *not* derive from brand value. Indeed, the causal relationship may well run in the opposite direction and with the opposite sign, to the extent that firms incur reputational costs and brand degradation when they outsource labor to jurisdictions with low wages -- but also lax regulation and poor records on worker safety. Put another way, the return to the IP in this sort of case is reflecting the labor rent not because of anything about the underlying IP but because the IP is the one item in the model that is picking up residuals that we are not otherwise pricing when examining the routine production and sales functions of the enterprise. Given this residual feature, it is true that to the extent one allocates a portion of the IP-related profit back to the jurisdictions of sales, this may well pull some of the profit associated with labor rents along with it.

This is necessarily a partial solution, however, at best. Specifically, the general proposition one could state here is that so long as there is *any* IP profit attributed to the low tax jurisdiction, then it seems likely that some portion of the profits associated with the labor rent is also being attributed to such jurisdiction and accordingly is being left untaxed.

Under the current analytical frame of the Guidelines I can see no good or defensible way to pull that element of profit back into the tax base. I don't think this particular conclusion about the analytical frame under the Guidelines will be controversial. Observe that under the BEPS Action 8 Deliverable, market specific characteristics, like "location savings", are *not* treated as "intangibles" at all.[16] A different outcome might have arisen under Action 8 but the ultimate conclusion on this was

15. See BEPS Action 8 Deliverable at p. 54 (setting forth amended Guidelines para 6.75).
16. See BEPS Action 8 Deliverable at pg. 31 (setting forth amended Guidelines para 6.31).

that because the relevant market characteristics are not capable of being "owned or controlled", they are not "intangibles" for these purposes. This is precisely why the amendments regarding "location savings" are amendments to Chapter I of the Guidelines (regarding general provisions) rather than Chapter VI of the Guidelines (regarding intangibles specifically). Put another way, the detailed elaboration and amendments to Chapter VI flowing out of the BEPS Action 8 Deliverable will not, by design, ever touch the labor rents problem.

III. An Alternative Approach and Normative Analysis

To this point my analysis has emphasized two basic points. First, according to the near universal approach to the problem of labor rents under a functional transfer pricing analysis local production subsidiaries will be compensated only based on the prevailing wage rate in the jurisdiction of labor *supply*, thus allocating none of the labor rent to such subsidiary. Second, this approach presents a substantial possibility of BEPS as the rents are likely to be absorbed as residual profits associated with mobile intangibles, which rents cannot adequately be dealt with under existing approaches to the transfer pricing of intangibles.

In this part of the paper I propose and explore an alternate approach to the labor rents problem. The proposal is fairly simple. If the current approach is grounded in basing the search for labor comparables in the jurisdiction of labor supply (often referred to as the "local" labor market), the basic proposal is that labor comparables (and associated compensation) be based on the juridiction of labor demand.[17] In the paradigmatic case of outsourcing of labor from a developed to a developing country, the basic result, then, would be that arm's length transfer pricing would result in the developing country subsidiary being compensated as a labor input provider would have been

17. The proposal thus tracks the position defended by China, as described in the U.N. Manual and discussed in part I.

compensated in the same fashion prior to the decision to outsource. Below, I evaluate this proposal with respect to three criteria: efficiency consequences, doctrinal implications of existing treaty text under Article 9, and inter-nation distribution.

A. Efficiency Consequences.

1. <u>Tradeoffs between organizational neutrality and non-distortionary rents taxes</u>.

From an efficiency standpoint the almost certain response to the proposal is that it would invite substantial distortions of organizational form. As we have seen in part I, the standard result for a thick local labor market is premised on the idea that a production subsidiary at arm's length would not be able to bargain for any part of the labor rent. Thus in order to equalize the commonly controlled and arm's length cases one must likewise not allocate any of the labor rent to the commonly controlled subsidiary. Any alternate approach, under which one attempts to tax part of the labor rent in the juridiction of labor supply, would seem to simply invite taxpayers to contract instead with unrelated parties. That result would fly in the face of the basic commitment to organizational neutrality across commonly controlled enterprises and unrelated enterprises, which is a bedrock principle of the arm's length standard in the first place. Why is this not a disqualifying critique of the proposal? Why would one ever define the relevant market for comparables as anything other than the market where the labor is in fact supplied?

The answer to that question begins with a reminder that the entire analysis in this paper is premised on some degree of segmentation in the international markets for unskilled labor. Thus we do not even come close to equalization of after-tax wages on an international basis. With the assumption of segmented markets one can now introduce an important distinction between the case where units of a multi-national enterprise are operating *within* a segment of a segmented market versus the case where the units are operating *across* segments.

The former instance presents a quite strong case for resort to local market comparables on the grounds of organizational neutrality. Further, although extension of the argument to the case involving intra-firm trade across segments is very tempting (and consistent with the standard analysis adopted under the Guidelines and the U.N. Manual), this case actually presents a range of further complications which have not, to date, been adequately analyzed. These points will come across readily through consideration of an example.

In order to capture the case of a multinational enterprise operating within a segment, consider a variation of the example discussed above. Assume at the outset that a U.S. manufacturing firm produces branded goods that it is selling in Canada through a local Canadian distribution subsidiary. The U.S. firm then moves the manufacturing function inside the Canadian subsidiary (but retains the valuable intellectual property in the United States). To complete the example we need two further factual assumptions. First, suppose that the U.S.-Canadian labor market (unskilled) is essentially integrated because barriers to immigration, language acquisition, relocation costs, etc. are sufficiently low that any differences in after-tax wages can be expected to dissipate in equilibrium. Second, assume that the Canadian corporate tax rate is higher than the U.S. rate. With these assumptions there is very good reason, when determining the profits of the Canadian subsidiary, to define the market for labor services based on the integrated market of which the U.S. and Canada are components. For example, consider the likely result if one did not take that approach. The taxpayer would have an incentive to minimize the allocation to the return to labor inputs in Canada, where, the tax is higher. It could attempt to do so by basing the Canadian subsidiary's cost-plus mark-up on a sample of labor inputs that included a non-integrated labor market, say Mexico, where the returns to labor are lower. This would give the combined group a competitive advantage, strictly from a tax perspective, over similarly situated parties operating at arm's length. In the arm's length case, that is, an unrelated Canadian manufacturing company would demand the (higher) return to labor commanded by the Canadian market thereby driving up tax burden. This would provide a pure tax reason to bring the firms under common control, thus violating the basic principle of organizational neutrality that supports adoption of the arm's length standard in the first place.

Now let's consider the case where the U.S. enterprise in fact operates *across* segments of a non-integrated market. To be sure, one *can* construct an entirely parallel fact pattern, which would demonstrate the same prospect of organizational distortion in cases where comparables are based on a sample that includes data from a different market segment. Consider the basic fact pattern discussed above (manufacturing in Mexico, intellectual property in Bermuda, sales/distribution in the U.S. and Canada). If we were to assume that Mexico has a relatively low corporate tax rate, then we would produce the mirror image of the Canadian case. The integrated firm would have the incentive to benchmark the return to the labor inputs of the Mexican subsidiary by reference to the relatively high cost labor inputs in Canada. This would shift profit to Mexico, lowering the tax burden. By contrast, at arm's length the U.S. company would likely bargain for a Mexican production counterparty to earn only what the segmented Mexican labor market would bear. Here too, then, we would have a tax-motivated reason to favor common corporate control over contractual arrangements between unrelated parties, seemingly once again in violation of the foundational premise of arm's length transfer pricing.

The assumption of segmented markets is crucial to the analysis, however, because it tells us that, at least in the near term, the firm can earn not only normal returns but also economic rents from buying labor in one segment of the market and selling finished products in another. Such rents were not available, of course, so long as the firm was operating within a segment of the market, as opposed to across segments. This factor is central to the efficiency analysis because in such circumstances it is far from clear that one should view the efficiency costs of organizational distortion in isolation.

As we saw in Part II achieving organizational neutrality in these circumstances comes at a very real cost -- namely, it implicates the prospect of BEPS and the non-taxation of at least a portion of labor rents generated by the outsourcing. Such non-taxation of rents is an unequivocally bad outcome from an efficiency standpoint. For a given revenue constraint the non-taxation of rents implies the unnecessary use of some fiscal instrument with distorting effects (assuming, as is always the case, that at least some such instruments are actually in place).

In short the efficiency consequences of the case where multinationals operate across segmented markets is importantly incomplete if we look *only* at the organizational consequences, as under current law. A more complete analysis would examine the cost of potential distortions to organizational form compared to the benefits from incremental taxation of rents (and reduction of otherwise distortionary taxes). In general one confronts an important tension in this context. It is possible to follow the status quo and eliminate organizational distortions, but this likely comes at the cost of undertaxation of the relevant labor rents. Or, one could divert from the status quo and attempt to tax a greater portion of the labor rent, but this would seem to come at the cost of inviting organizational distortion.

How could one possibly balance these two effects across the range of real world scenarios where they are likely to be implicated? This would be wildly difficult, to say the least. However, what I would like to suggest in the next two subsections in the analysis of efficiency considerations is that there are two factors (from an efficiency standpoint) pushing towards adoption of my proposed approach which would attempt to bring labor rents into the tax base.

First, the organizational distortion that would seem to arise under my proposed approach is a creature of the *combined* effect of the rules regarding the commonly controlled scenario and the unrelated party scenario. The tax rules regarding the unrelated party scenario, though, are themselves contingent and could be revisited. Second, even if we did not change such rules, imposition of tax on a portion of the labor rent would not automatically drive firms to adopt an unrelated party structure, thus yielding all cost (distortion to organizational form) and no benefit (i.e., zero tax on rents because nobody elects the form that bears the extra tax). Such a result is unlikely because we suspect there are further (pre-tax) rents to be earned strictly from firm integration (particularly where we have exploitation of valuable intellectual property). Those rents may well *also* go untaxed currently for much the same reason as with respect to labor rents. This suggests there may be some cushion to tax labor rents without driving firms out of the preferred organizational form. I develop each of these two points in more detail immediately below.

2. <u>Rethinking PE with production through unrelated contractual counterparties</u>.

Part II above was devoted to demonstrating that labor rents present a problem of BEPS under current approaches to arm's length transfer pricing. One should remember, though, that the very prospect of organizational distortion (in the case where there is an attempt to tax the rent) presumes that taxpayers can also achieve low to zero tax on labor rents in the *unrelated* party context. That seems almost certain to be the case. To take the example I was working with in part II, if we imagine the U.S. parent company contracts with an unrelated Mexican counterparty for provision of low cost labor inputs and is able to bargain for a price reflecting the local conditions in the Mexican labor market, then of course the U.S. company could avail itself of all of the same intangible migration strategies already discussed. Efforts to combat such strategies through legal instruments on the transfer pricing of intangibles would be ineffective, also for the reasons already discussed.

The crucial point to observe, though, is that the taxation of the commonly controlled case and the unrelated party case arise under two completely different sets of doctrine. To assert organizational distortion when one alters *one* body of doctrine (as I propose to alter interpretation of the arm's length standard in this paper) is to ignore the fact that the distortion is a product of the simultaneous operation of *both* bodies of doctrine. Moreover, although there may be reasons grounded in inertia to hold treatment of the unrelated party case constant, there is no good reason as an analytical matter to ignore the possibility of the doctrine in that area evolving as well.

Moreover, we confront a general problem here: How should one deal with the taxation of labor rents in the case of segmented labor markets and (imperfectly) competitive product markets? That general problem transcends organizational form, precisely because the rent can arise in both the related and unrelated scenario. Figuring out the proper taxation of the labor rents should thus take analytical priority. In other words, it is unambiguously true that from an efficiency standpoint one should impose a tax on the labor rents, if possible, and use such revenues to reduce other distortionary tax instruments. It is then a secondary question whether one can achieve taxation of the labor rents in an international setting in a way that does not introduce a different type of distortion, namely a distortion to organizational form. Answering that secondary question requires that one pay attention to the relevant doctrine for each organizational form.

My proposal regarding the basing of comparables on the jurisdiction of labor demand is my doctrinal response regarding the commonly controlled case. What is the analog in the unrelated party case? Of course, the mere fact that at arm's length the firm that is contracting for labor inputs has market power to bargain for the labor rent does *not* solve the question about which *jurisdiction* should be allocated the rent for tax purposes. Rather, it means simply that the jurisdiction of labor supply will not be able to tax the rent in the hands of a local production company under a residence theory of taxation. But it tells us nothing about whether it should be able to reach the rent in the hands of the foreign firm under a theory of source-based taxation.

To be sure, there is no prospect of reaching labor rents under a source theory with current instantiations of double tax conventions. And amending the current regime in a way that would allow this is not likely contemplated by anything in the (very expansive) charge under the BEPS project.[18] But it remains important to pose the question, even if the modifications to the current rules would be viewed as radical. Further, it is fairly straightforward to state what the modified rules would have to look like. Reaching the labor rent in the hands of the purchaser of the labor inputs under a source theory would require two basic doctrinal modifications.

First, it would be necessary to relax the standard for what constitutes a permanent establishment under Article 5. Specifically, the basic change from current law would be that a permanent establishment could arise merely in virtue of purchasing activity, where such purchasing activity generates labor rents from labor inputs.[19]

I should also say that although the context is a familiar one, my proposal goes quite a bit beyond historical arguments raised by jurisdictions that are prominent hosts to labor outsourcing arrangements. For example consider the litigation that culminated in the decision before the Indian Supreme Court in *DIT v. Morgan Stanley* (2007). In that case the Indian tax authorities attempted to argue that the taxpayer, Morgan Stanley, had a permanent establishment in India in virtue of outsourced back office functions performed by a controlled subsidiary in India. This was argued both under a theory of fixed place of business and under the theory that the subsidiary gave rise to

18. Admittedly, Action 7 in the BEPS Action Plan deals with the "artificial avoidance of PE status." The core of that action item, however, deals with matters such as the use of commissionaire structures to plan around the agency rules in Article 5. My proposal in the text goes much beyond this as it would implicate PE status in the absence of anything that remotely resembles an agency relationship. It would thus require revisions to Article 5 that would seem to go well beyond what is contemplated by Action 7 (or anything else in the BEPS Action Plan).
19. In principle, one could consider adopting a similar approach to other locational savings as well but put that to the side here given the focus of the paper on labor rents specifically.

an agency PE. Both theories were rejected by the Indian Supreme Court. A decision running in the other direction would have likely destabilized the general understanding and interpretation of Article 5, under which the circumstances in which a controlled subsidiary creates a PE are relatively rare. My proposal is really getting at something different, however. I am advocating a substantive change in which there would be a PE strictly in virtue of certain sorts of purchasing activity (namely those that give to labor rents) from an *unrelated* party. The proposal, though creating numerous complicated issues, would not destabilize the traditional understanding of when subsidiaries function as PE's. In other words, I would not advocate also treating the controlled subsidiary as giving rise to a PE in the labor rents context. The rent, in that case, would be taxed in the hands of the controlled subsidiary under the proposed transfer pricing rule that looks to the jurisdiction of labor demand for appropriate comparables. More specifically in the case of the controlled subsidiary, that subsidiary should be viewed as purchasing low cost labor inputs (from its employees) and then providing such labor on to the parent at the higher labor cost associated with the parent's labor market. The spread is thus booked at the controlled subsidiary level. In the unrelated party case, such unrelated corporation would be viewed as purchasing the low cost labor inputs and passing them on to the foreign counterparty at a relatively low price (i.e., at the price reflecting actual market conditions). The very fact that the foreign counterparty can acquire at this deflated price is the element that would drive the PE determination.

If this strikes the reader as a vast, unjustified expansion of the PE concept, it is worth considering the fact that the original architects of the PE concept were almost surely not thinking about this general class of problem. It is by now a stale truism to observe how much the economy has changed since the original formulation of the concepts that underly the current international tax framework. As international tax lawyers confront this ever-evolving space, we should be mindful that the appropriate normative source taxation base should generate the boundaries of the PE concept, not vice versa. Finally, I should mention a more mundane point, which ties the proposal more closely to existing understandings of PE than might have seemed to be the case. Specifically, if one considers the basic notion of "permanency" embedded in the general concept, it is worth observing that the relevant locational savings could well have temporal duration far in excess of the temporal cutoffs that would push a taxpayer outside of the various safe harbors under Article 5.

Second, it would be necessary to change the approach to attributable profits under Article 7. Consistent with the basic goal of organizational neutrality, one could tailor the approach to that described above for commonly controlled parties. Thus the PE could be treated as if it were a separate entity purchasing the labor inputs at the price stipulated in the arm's length contract and then selling the labor inputs on to the developed country parent at a mark-up reflecting the price of the associated labor in comparable transactions in the jurisdiction of labor *demand*. There are some obvious pitfalls here that would likely generate objections. Perhaps most problematically, the approach would require a search for comparables where currently there is none because current rules would not generate a PE on these facts. But the proper response here is that the PE threshold should be set independently, based on an appropriate theory of source taxation. The need for comparables flows from that determination; potential difficulties with comparables should not themselves determine the appropriate extent of the source tax. Thus companies may like that there is no comparables analysis under current law but to let that point dictate the substantive PE standard seems to get things exactly backwards. Further, it might seem odd under Article 7 that one would have to search for comparables (in the jurisdiction of labor demand) when one seems already to be sitting on a perfect benchmark -- the actual contract concluded at arm's length. But this just reflects the fact that Articles 5 and 7 have not, to date, been put to the acid test of dealing with the very difficult problem of segmented markets for factor inputs.

3. Organizational distortions and the cushion to tax organizational gains.

In the absence of modification to Articles 5 and 7 in the way just discussed, the chief criticism of my proposal would likely continue to be its creation of organizational distortions. Here I would like to say something more about the magnitude of this organizational neutrality issue, as the problem may not be as large as appears upon first investigation. Specifically, one must take account of the relevance of organizational rents under arm's length transfer pricing. An incremental tax on labor rents earned *solely* through an organizational form of common control (as would be the case with modification of the geographic market definition under a functional analysis without corresponding modification of Articles 5 and 7) would lead automatically to shifts towards the unrelated form only if the organizational forms are otherwise equally profitable. But this will often not be the case. It is a basic lesson from the literature on the theory of the firm that ownership or common control should be understood to arise when this is more profitable than operating at arm's length by contract. In the literature on multinationals it is common to explain ownership of foreign subsidiaries under a transaction costs story. This is often the case, for example, where a firm uses valuable intellectual property in its production processes. A firm with valuable intellectual property may thus identify a jurisdiction with low labor costs but be unwilling to contract with unrelated service providers because of expropriation risk. Put another way the firm can earn profits through common control that it could not earn at arm's length. We could refer to this amount as the organizational or synergy rent. It is a now very familiar critique of the arm's length standard that it is inherently flawed because no comparables-based approach could ever capture elements of profit that literally cannot be earned at arm's length.[20]

In prior work I have argued that the issue of synergy rents does not amount to an inherent flaw in arm's length transfer pricing.[21] Whether one accepts the standard "inherent flaw" critique or not, however, there is a very real possibility that synergy rents arising from organizational form remain lightly taxed. The mechanic whereby firms can achieve that result is much the same as with labor rents. That is, under current transfer pricing approaches, there is no meaningful way to capture such value through an analysis of comparables. The value can only be captured through a focus on residuals and this creates the likelihood that such residual value will be absorbed into other difficult to value, mobile intangibles.

This is not the place to go into a full discussion of the best solution to the broader problem of organizational rents. Many scholars take the problem as occasion to reject the arm's length standard full stop. A less radical approach (working within the parameters of the arm's length standard) might seek to introduce further defined intangibles into the analysis in an attempt to better reflect the gains from organization. I reject the approach of introducing specific synergy intangibles, a position which mirrors the view presented in the Action 8 Deliverable.

To the extent that organizational rents remain undertaxed, then the best approach would be enhanced rules on the migration of intangibles and/or the strengthening of controlled foreign corporation rules. Even this approach will not be perfect as CFC rules can be difficult to enforce. Further, absent the unlikely coordination of national level CFC rules, stricter approaches to inclusion of foreign source intangibles income will lead to predictable migrations of corporate

20. See Guidelines para. 1.10.
21. See Mitchell A. Kane, Transfer Pricing, Integration and Synergy Intangibles: A Consensus Approach to the Arm's Length Standard (forthcoming World Tax Journal).

residence in order to benefit from less stringent CFC rules. The bottom line here would seem to be that synergy rents from organizational form are almost certainly undertaxed as matters currently stand and will likely remain undertaxed for the indefinite future. The relevance of this to the labor rents problem under consideration here should be clear. If there are untaxed organizational rents, then there is some cushion to impose relatively more onerous taxation of labor rents earned by integrated firms compared to those operating at arm's length without generating an organizational distortion. To be more concrete, if a firm fears piracy when outsourcing with an unrelated provider of labor, then the amount of surplus value it places on the commonly controlled form can be taxed (in the guise of a tax on labor rents) without leading to switches in organizational structure.

To be clear I do not mean to suggest that one could plausibly measure the organizational premium, and tailor the taxation of labor rents accordingly, with any precision. Nor do I mean to ignore the fact that the rents from organizational form could be expected to be competed away over time, thus rendering the cushion a diminishing quantity. As a first best option one would want to measure the organizational rents directly and accurately, and formulate a non-distortionary rents tax on that basis. What I am suggesting is two steps removed from this, as I am not proposing an attempted quantification of the organizational rents and the thing to be taxed (labor rents) is, as I have set up the problem, conceptually separate from the organizational rents (insofar as I presume the rents *could* as well be earned by parties contracting at arm's length.) Even so, I believe there is substantial merit to the point I make here, which is offered in a qualitative vein rather than demanding strict quantification. I surmise there likely is *some* cushion. In this way the argument to tax labor rents becomes less of an implausible option than it appears at first.

There is an appealing conceptual purity to the strong claim for geographic market limitation and strict adherence to organizational neutrality, at it exists in the Guidelines. But it is also helpful to step back and remind ourselves of the big picture here. One currently confronts a situation where numerous multinational enterprises hold valuable intellectual property and benefit from low cost labor inputs which are used with the retention of intellectual property in-house. Further, many of these firms would seem to bear relatively low overall tax rates. Against this backdrop it would seem quite plausible that there is space to increase the tax burdens on these firms without thereby inviting some wholesale shift into less efficient organizational forms. If this looks like an unappealing ad hoc approach, it is worth remembering the various defects under the current approach.

B. Doctrinal Analysis Under Article 9

The above subsection analyzed the efficiency case for the proposal advanced in this paper regarding allocating labor rents to controlled production subsidiaries. In particular it dealt with ways of minimizing the efficiency costs from distortions to organizational form that would seem to result under the proposal. In this subsection I take up the relevant doctrinal analysis under Article 9. In particular, is it consistent with Article 9 to interpret the arm's length standard in a way that would seem to lead to disparity of treatment as between the commonly controlled taxpayers and unrelated taxpayers?

I begin with an initial observation, which is that the foundational reason to adopt an arm's length standard in the first place is not limited to the fact that it helps to achieve non-distorted choices regarding organizational form. To be sure, if commonly controlled entities are required to implement prices and report profits in the same fashion as unrelated parties then there will be no *tax* advantage to taking on the organizational form reflecting common control. Such decisions, rather, would reflect pre-tax gains to organization.[22] But there are other reasons to adopt an arm's length standard, most importantly that an arm's length standard supplies access to undistorted information

22. See OECD Transfer Pricing Guidelines at para 1.8.

that can be used to check taxpayer incentives to shift profit.[23] This can overlap with the first consideration but it is very important to see that the organizational neutrality aspect of the arm's length standard and the information aspect of the arm's length standard are analytically distinct. Consider, for example, the many cases that will arise in practice where commonly controlled firms realize a (pre-tax) premium from organizational form and also potentially realize further (after-tax) premia through the manipulation of inter-company prices. There may be a wide range of adjustments the tax administrator could make which would be consistent with leaving organizational incentives in place. Arm's length pricing is one such approach but why is this elevated above other possible approaches? The information aspect of the arm's length standard provides an answer. Specifically, this accords with the way in which the tax administrator treats market prices as sound, non-manipulated information as a *general* matter in questions of administering the income tax.[24] In light of these two aspects driving the arm's length standard (organization and information) it would be wrong to conclude that issues of organizational neutrality must always be paramount in application of the standard.

Moreover, there is nothing in the language of Article 9 itself that provides any meaningful guidance on how to deal with the problem of locational savings, or locational rents. One imagines that the original drafters of Article 9 were not really focussed on the problem of segmented markets in the first place. Even within an integrated market the problem of locating suitable comparables will loom large. Thus it is plausible to think that from the outset the issue of the arm's length

23. See Surrey, Treasury White Paper at pg. 483.

24. A third justification for the arm's length approach is the argument from consensus, which is really a point about path dependency. The point here is that there is good reason to implement arm's length transfer pricing because most countries have already coordinated around this approach and it would be costly to forge consensus on some other basis. See Guidelines at para 1.9. As a practical matter this may be the most important consideration of all. However, I ignore it here because it is not a substantive argument in favor of the standard and thus cannot be used to inform the content of specific prescriptions, such as that regarding market definition.

standard producing a range of results was recognized. And the need to deal with such ranges would have been apparent from the earliest attempts to administer the arm's length standard.

The issue here, though, is different. With segmented markets a comparables based analysis could produce either multiple discrete ranges (if we keep the markets separate) or a single, particularly intractable range (if we simply combine the markets). I can see that it would be a natural result and interpretation to avoid the latter result. Working on the assumption that the markets should be kept separate, though, to which market should one look? The relevant treaty text would seem to provide no guidance. The comparables I suggest under my proposal (based on the jurisdiction of labor demand), after all, certainly *are* arm's length prices. They just happen to be the wrong arm's length prices *if* one elevates the principle of organizational neutrality above everything else. While granting that issues of organizational neutrality are crucially important, as suggested above it is a stretch to say that organizational neutrality should necessarily be the dominant interpretive consideration. To the contrary, taken against the backdrop of the broader function of double tax conventions, of which the rules on arm's length transfer pricing obviously form only one part, the goal of organizational neutrality should plausibly be subordinated to the broader goals of elimination of double taxation and preservation of the tax base.

On this score it is plausible that my proposal does *better* than the standard approach. As it would rely on arm's length prices from a single, segmented labor market, it stands as good a chance as the current approach in reaching coordinated agreement to avoid double taxation. In terms of preserving the tax base, the basic argument is that my proposal does *better* than the current approach, which, as discussed in part II, is likely to result in the value from the labor rent being absorbed into other firm intangibles, with the increased likelihood that this portion of the base will face low or zero tax. Given the character of the portion of the base under consideration as a rent this is a particularly harmful result. There should be room to tax this rent without discouraging efficient relocation of labor services. Under current approaches, however, we are unlikely to achieve this.

There is one final argument I would like to take up here regarding the range of permissible interpretations of the arm's length standard under Article 9. I believe the arm's length standard under Article 9 is often read erroneously as if it said that each contracting state may only tax resident enterprises up to the amount that they would have earned had the enterprise been operating at arm's length. *If* that were the actual meaning and function of Article 9, then one might argue as follows. A controlled subsidiary operating in a jurisdiction of low labor costs would not be able to bargain for any portion of the labor rent given the dynamic of the segmented labor markets. Thus the proper reading of Article 9 would be that it functions as a substantive limit on the ability of the jurisdiction of labor supply to tax the labor rent.

Under what I have called a "fractional" interpretation of Article 9 in prior work, this is not a convincing reading of Article 9.[25] As a functional matter the arm's length standard performs two basic roles regarding allocation of the tax base in the treaty context. First, it grants contracting states the right to restate reported profits, leading to tax liabilities that would *not* have been permissible under the treaty absent restatement (because of limits under Articles 5 and 7 on the ability to tax the party initially reporting the profits). Second, it functions as a *limit* on the ability of a state to restate profit. Reference to an arm's length standard, then, should be viewed as an effective means of coordinating one state's adjustment to stated profits and the other jurisdiction's acceptance of that restatement. What matters then is coordination -- not the use of an arm's length standard to allocate profits that could not have been earned at arm's length. But once one views the matter as about

25. Kane, supra note 21. In that paper I linked the faulty interpretation with the mistaken view that the arm's length standard is conceptually flawed because it cannot give a substantive allocation of the gains from organization which cannot (by definition) be earned at arm's length. That criticism fails because under the best reading of what the arm's length standard is doing, it is not meant to achieve substantive allocation of that premium.

coordination over arm's length profits only, there is no immediate reason to assume that greater coordination occurs with a benchmark that looks to comparables based on the jurisdiction of labor supply rather than the jurisdiction of labor demand. The bottom line then is that as an interpretive matter there is no clear indication from the text of Article 9, or the broader function of double tax conventions, of how to treat the problem of labor rents (or locational savings more generally). Any approach is likely to involve tradeoffs of items that are important goals of the overall framework. I suggest one needs to countenance those broader tradeoffs rather than falling back upon doctrinal interpretations that would emphasize only a subset of the relevant considerations.

C. Inter-nation distribution

The previous two subsections have argued that (i) taxation of labor rents can be defended on efficiency grounds and (ii) my proposal to allocate labor rents to local production subsidiaries is doctrinally consistent with Article 9. Under that proposal tax base would be allocated to developing countries where labor outsourcing takes place. In this subsection I discuss the defensibility of that result from the standpoint of inter-nation distribution.

Supposing it is a desirable outcome to tax labor rents, the question of which jurisdiction should be accorded that part of the tax base is somewhat complicated. Since we are talking about a species of "location savings" there is a natural impulse to conclude that the jurisdiction where the savings arise should tax the rent. But what is the actual basis for this? After all if the question were simply a matter of efficiency in the sense of reduction in worldwide deadweight loss we could generate other prescriptions. For example, if Country A has a very high marginal cost of funds and Country B a very low marginal cost of funds, then one could increase efficiency by having Country A tax a rent that is location specific to Country B and removing one of its relatively distortionary instruments. I would not favor such a line of analysis, though. Whatever the potential for worldwide reduction in deadweight loss, we are so far removed from a situation which takes equalization of marginal cost of funds across jurisdictions to be a goal that it is near impossible to consider forming international tax policy around such an outcome.[26]

From a realistic point of view, then, the best one could hope to do is assess how the implementation of a rents tax would improve the marginal cost of funds of a given jurisdiction. But if we may not use a standard of *relative* reduction, then on what basis should one determine *which* jurisdiction is entitled to tax? Not all rents are alike for these purposes. Some rents are not location specific in which case it is difficult to say much of anything about which jurisdiction should collect the tax. That situation presents a problem of pure, arbitrary coordination. It makes sense for *some* jurisdiction to tax the rent but typical tax competitive pressures will drive the rate of tax to a suboptimal level.

In other cases, though, rents might reflect the effects of prior state investment. In this case it is sound policy for the jurisdiction that incurred the cost of the investment to have the entitlement to the tax. The existence of the rent here essentially reflects some unpriced governmental provided benefit and granting the tax right to the jurisdiction providing the benefit will preserve the incentives to make the investments in the first place.

This provides a potential basis for according the jurisdiction of labor supply the entitlement to tax labor rents. In the case of unskilled labor rents it may be fairly difficult to identify the nature of the investment that makes the rent possible. (With skilled labor, by contrast, matters may be clearer to the extent that the skilled labor force represents obvious investment in human capital through, for example, state provided education.) However, one plausible story is that developing

26. Consider, for example, just how radical a world like that would look. Given the increasing distortionary costs of tax with increasing marginal rates, countries with systematically smaller public sectors would have to collect tax on behalf of countries with systematically larger public sectors.

countries that are able to attract buyers of outsourced labor are those jurisdictions where labor is relatively less costly compared to the case in other developing countries precisely because some state investment in infrastructure and institutions relieves foreign enterprises of the need to incur certain costs privately. If that is the case, then one could characterize jurisdictions that supply relatively low cost labor as enjoying a sort of return on state investment. (A less happy story, though, is that the low labor cost reflects not so much state decisions about investment as state decisions to compete downwards on regulatory standards.)

IV. Problems and Challenges

In this part I address potential issues with the proposal I offer in this paper. The first set of issues relates to measurement of labor rents and the second set of issues relates to tax competition.

A. Measurement of Labor Rent

I consider in this section two practical measurement problems under my proposal. The first relates to the question of dissipation of the labor rent over time in the product market. The second relates to the determination of the appropriate labor demand market under my proposed comparables test.

1. <u>Dissipation of Rent</u>.

The overarching frame of this paper is that it would be desirable to shift the taxation of labor rents to the jurisdiction of labor supply. Within the context of arm's length transfer pricing this presents a very complicated problem of measurement. The reason is that the required information about the rate of dissipation of the rent, which is a phenomenon that arises because of competition in the *product* market, does not naturally appear in the arm's length analysis. That analysis, rather, will take account of two factors of relevance to the calculation of the rent. First, one will look to the actual costs of labor in the jurisdiction of labor supply. These are sound third party prices because they reflect amounts paid to individual employees. Second, one will have gross income from sale of the final product in the product market. This too is a good third party price. Ignoring other expenses and value creation from the sales function for the moment, the gap between these two should embed a normal return and the rent. The rent will disappear over time as there is downward pressure on gross income. But the particular question faced by an arm's length analysis is the compensation of the related party service provider. The reference price under arm's length principles will be other service providers.

Suppose that we have segmented labor markets, with a single integrated high cost segment and a single low cost segment. If we reference the low cost segment, as under current approaches, then the pricing captures none of the rent. If we reference the high cost segment, as under my proposal, then we accurately capture all of the rent at the outset but the measure will come to increasingly overstate the rent as product market competition drives prices downward. Put simply the problem is that the magnitude of the rent is dynamic, reflecting competitive pressures. But the seemingly available reference points to determine compensation for the related party services company are all static, reflecting market segmentation. (The labor markets may, of course, be internally competitive, but those competitive forces will not correctly capture the dynamics of the rent dissipation.) In this way it should be acknowledged that each of the current approach and my proposal are clearly second best options. The current approach has no mechanism to separate the labor rent from other elements of profit. Arguably this gets you to the correct result when the labor rent is gone in product market equilibrium. But in the dynamic process leading to equilibrium we have an undesirable result to the extent that the profit from labor rent is reflected as residual profit from mobile intangibles and thus faces little or no tax. My proposal faces something of the opposite problem. Arguably it separates and measures the rent correctly at the beginning of the competitive process but then begins to systematically overstate the rent as consumer prices begin to come down.[27]

It is very difficult to assess at a conceptual level the relative magnitude of the problem under the current approach versus those encountered under my proposal. To do so would involve empirical analysis of several important questions. The first is the nature of the competitive process in the product market. As a general matter, the more competition in the final product market the greater becomes the mismeasurement problem. But there is no generally applicable answer to this question across the universe of taxpayers. Results will vary across sectors and also within sectors. The second is the degree to which taxpayers are currently able to treat labor rents as embedded in other valuable intangibles and shift associated profit to low tax jurisdictions. For the reasons stated above, I have suggested that there is reason to believe this is a substantial problem but at present we lack any quantitative assessment of this effect.

Obviously lacking the empirical measures necessary to make the required comparisons, I would make a few observations. First, it is worth emphasizing that the current approach to labor rents under the accepted geographic market criteria is importantly flawed in ways that seem to be ignored in current treatments. Second, to the extent that one approaches transfer pricing policy as a part of the general project of development finance this should alter the nature of the comparative

27. As an aside I would observe that formulary apportionment does not achieve a first best solution to this problem either. It is true that formulary apportionment will never "overstate" the labor rent, as my proposal is bound to do. Because the approach begins by calculating the overall profit of the organization, such overall profit will always take full account of effects on gross income from competitive pressures in the product market. But it fails in two ways. First, the apportionment factors are not plausibly going to assign the labor rent portion of the profit to the "correct" jurisdiction, as understood by the argument presented above. For example, a formula that included any sales factor would allocate some portion of the labor rent to the jurisdiction of ultimate consumption. It is difficult to square that result with the preferred approach to the taxation of location specific rents. Second, and related, any approach that applies apportionment to overall group profit as a single category will fail to separate out the labor rent from the rest of the base. Necessarily, then, it will fail to achieve the first best benchmark defended in this paper, which demands accurate and separate measurement of the labor rent over time, which is then fully allocated to the jurisdiction of labor supply.

question. That is, one should consider not just the measurement of rents issue across the two approaches but rather how my proposal, with the acknowledged flaws, compares to other available (imperfect) means of development finance. Finally, it may be possible to address some of the measurement issues under my proposal. Here, I briefly suggest a few possibilities, all of which might be described as achieving a sort of middle ground between the current approach and my proposal for a jurisdiction of labor demand comparables test.

Thus one possibility would be to rely on a range of arm's length comparables derived from both the jurisdiction of labor supply *and* the jurisdiction of labor demand. On the assumption of segmented labor markets this range should evidence a low cluster and a high cluster. The idea would be that the taxpayer would be required to base arm's length pricing at some point in the middle of this distribution. As a splitting of the difference this would allow some taxation of the labor rent in the jurisdiction of labor supply at the outset. The amount would be suboptimally low to begin with but would reduce error cost, compared to my basic proposal, in the state of product market equilibrium. A variation of this approach would be to have a discrete shift at some point from using demand jurisdiction based comparables to supply jurisdiction based comparables. This would clearly never achieve perfection but if the discrete shift were tailored to information about speed of rent dissipation then it has the potential to perform better than an approach that just used a combined demand-supply jurisdiction range in perpetuity. Even without particularly detailed information on the rate of dissipation, it is possible that a discrete shift after, say, one or two tax years could well perform better than the current approach on my basic proposal. A further possibility to explore would be to incorporate the labor rent explicitly into profit splits. If nothing else the above discussion has likely demonstrated the range of problems with accurately measuring the labor rent as it dissipates. This calls into dispute the unquestioned fashion in which we tend to see this as clearly a part of "routine" profit. If one packaged the labor rents aspect in which other non-routine returns this would open the door to allocate this, at least in part to the jurisdiction of labor supply. This, of course, just brings the measurement issue back to the fore. This will remain a very difficult problem. Ideally, we would like to base the allocation of the profit split on a factor that tracks diminishing contribution of the labor factor over time. This will be very difficult in practice but there is at least conceptual space for approaching the correct answer in a way one cannot if we treat the matter simply as ordinary provision of labor services with segmented markets.

Finally, one should take account of the way in which the discretion of the jurisdiction to tax allocated labor rents could offer a powerful answer to the basic measurement problem. At least in the case where there is a single country that makes up a segmented labor market, that jurisdiction will have the incentive *not* to overtax allocated rents. Suppose rents start off at $\$x$ and a controlled subsidiary is allocated exactly that amount based on the labor cost savings. Over time imagine that the rent is dissipated to zero but that the jurisdiction of labor supply is still allocated $\$x$ of rent, because the labor cost fundamentals across the two segments of the market have remained the same. At this point, if the jurisdiction of labor supply seeks to tax a portion of the "rent" then this should have the effect of driving the labor production to another jurisdiction, as under the standard tax competition model. Thus the jurisdiction should have proper incentives not to overtax non-existent rents. This just pushes the informational problem onto the jurisdiction of labor supply, which may be ill-equipped to deal with it. On the other hand it does mean one is attempting to solve that problem with an additional source of information -- actual firm behavior regarding labor outsourcing. Those decisions, however, will be affected by other actors in the market. I discuss this issue in the section below on tax competition.

2. Defining the Labor Demand Market.

In the initial description of my basic proposal I described the proposed comparables analysis as resting upon examination of the jurisdiction of labor demand instead of the jurisdiction of labor supply. One important issue that I have not yet addressed is the fact that while the jurisdiction of labor supply will be readily identifiable, this may well not be the case for the jurisdiction of labor demand. In the simple model discussed above matters were relatively, though artificially, easy because all factors pointed to the United States as the jurisdiction of labor demand. But clearly actual implementation of any such approach would need to take account of more complex corporate structures (and the tax planning that might lead to such structures). For example, if in the simple fact pattern above, the U.S. parent had some intermediate subsidiary in a third jurisdiction acquire the labor (possibly also in a jurisdiction with low labor costs) then this should not have the effect of treating such third state as the jurisdiction of labor demand. Drafting the correct legal rule will thus involve necessary complexities. What I would like to do here is set out the basic conceptual frame that could inform the drafting of such rules.

We should begin by reminding ourselves that the basic measurement issue at hand regards the labor rent, which in turn is a function of labor cost savings. Such savings arise in virtue of comparison of labor cost in the actual jurisdiction of labor supply and the costs under some benchmark. Broadly, there are two possibilities for assessing that benchmark. Specifically, one could look to alternative own-labor costs or one could look to the labor costs of competitors. In the case of own-labor costs one is relying on a historical benchmark. This would be the preferred test for market determination where a firm has previously conducted labor in a given jurisdiction, prior to terminating such activity and shifting production to another locale. It would also be the preferred test where a firm continues to produce some output in a relatively high cost jurisdiction and then *expands* production into a low cost jurisdiction. In these sorts of cases it should be a relatively straightforward matter to identify the correct jurisdiction of labor demand on viewing all the facts and circumstances. What we seek here is the answer that firm managers would give to the following question, "If you currently realize labor cost savings because of the location of labor supply, these savings arise as compared to labor provision in *which* labor market?" (Recall here that this answer need not refer to a single country but rather only to a single integrated labor market.) I suspect that managers would be able to answer this question without much difficulty. Translating this into a legal rule with prospective effect will present various drafting challenges, but it is at least clear what target we are aiming for.

The second conceptual possibility is to look at competitor labor costs. If the taxpayer is earning labor rents at all then it must be the case that competitors are not also operating in the low labor cost jurisdiction, or at least not to the same extent. This provides another way to identify the conceptually correct jurisdiction of labor demand. Specifically, one would have to examine the final product market (to which the labor inputs relate), identify competitors in that market, and then finally identify the high labor cost markets where such firms source labor inputs. This sort of procedure is clearly more administratively complex than the first and should be favored only in those cases where the taxpayer has no current or prior operating history in relatively high cost labor markets.

B. Tax Competition

A further set of problems one must think about with respect to my proposal relates to the likely effect of tax competition. I have analyzed the problem so far as if there is a single country that comprises a segmented labor market with low cost labor inputs. However, it is likely that to some extent these segmented markets will be regional and transcend national boundaries. Consider a simply case, like the one analyzed earlier in the paper but with two jurisdictions of low cost labor supply that form a completely integrated labor market (though segmented from the high cost labor market). If one were to allocate the labor rent to the jurisdiction of labor supply in this sort of case then it would seem that each of these two jurisdictions might just end up competing the tax rate on those rents down to zero. Then we'd be back in the basic scenario described in part II of the paper above. Here I would make two observations.

First, it is possible that one faces a middle ground in the real world, where there are multiple segmented labor markets in developing countries, all of which have cost savings over labor supply in developed countries. In such a case the jurisdiction with the lowest labor costs really reflects a country-specific rent. That jurisdiction should be able to tax that rent without facing tax competitive pressures from other jurisdictions.

Second, with respect to rents that are available equally across jurisdictions of a particular segment of the labor market, we face a situation of something like a region-specific or segment-specific rent. Here we do face a problem of tax competitive pressures driving the rent tax down to zero. This is an unambiguously bad result from an efficiency perspective. This is not like the standard tax competition case, which can be read as a general argument against source-based taxation of capital income. In the standard case we are dealing with distortionary taxes that affect the location of capital, and thus are shifted onto local immobile factors. Where one has a segment-specific rent, however, it really is a rent. There is a prospect, with coordination of levying non-distortionary rents taxes. That is, there is the possibility of raising additional revenue without distorting the decision to locate labor within the region or segment. Although such coordination will be extremely difficult and not much discussed, its normative appeal is compelling.

* * *

Conclusion

The proposal advanced in this paper for a labor demand comparables test will likely meet considerable resistance. It takes an area (perhaps one of the few) where arm's length transfer pricing seems to work fairly well and invites instead a substantially more complex measurement exercise which, as I fully admit, we are very likely to get at least partially wrong. And yet, I have tried to show in this paper that the current approach, in spite of the appeal of simplicity, is flawed. With its single-minded focus on organizational neutrality, it systematically ignores the fact that labor rents, in the presence of general planning for mobile intangibles, may go largely untaxed. This is unfortunate. The current approach leaves on the table a non-distorting rents tax. Further, this operates to the detriment of developing countries. For the many countries that are capital poor and labor rich, one of the most valuable national attributes is the ability to offer low cost labor inputs. The extraordinary returns available from such inputs in a world with segmented labor markets are properly taxed in the developing world for a range of reasons. The returns may represent the equivalent of return to state investment; the developing countries may be the only ones that can plausibly tax this non-distorting base (as it will be near impossible to break out once co-mingled with other profit elements, which we already struggle to tax); and the tax revenues would seem to be relatively desirable sources of development finance on the margin. For these reasons I hope the proposal in this paper will at the least invite a broader and more thorough consideration of the particular place of labor rents in the interaction between transfer pricing and development finance.

Labor Rents and "Developing" Countries: Where's the BEPS?
Mitchell A. Kane

Discussant:
Michelle Markham, Bond University

Central question posed:

Should the production subsidiary be allocated any part of the economic rent that might arise in virtue of the low cost labor input?

Proposal:

Instead of basing the search for labor comparables in the jurisdiction of labour supply, labor comparables should be based on the jurisdiction of labour demand.

Would this proposal invite substantial distortions of organizational form, such that taxpayers would choose to contract with unrelated parties, rather than with related parties?

- there is a **degree of segmentation** in the international markets for unskilled labor
- focusing only on organization consequences does not give a complete picture
- look at the benefits from an incremental taxation of rents
- currently a possibility of BEPS as these labor rents are likely to be absorbed as residual profits associated with mobile intangibles

4

The mere fact that at arm's length the firm that is contracting for labor inputs has market power to bargain for the labor rent does not solve the question about which jurisdiction should be allocated the rent for tax purposes

Residence versus source-based theories of taxation?

Relaxation of the standard of what constitutes a permanent establishment?

Should the goal of organizational neutrality be subordinated to the broader goals of elimination of double taxation and preservation of the tax base?

5

Should Article 9 be reinterpreted?

- Should the emphasis be on **coordination?**
- Consider the **inter-nation distribution standpoint**
- Consider the **human cost of location savings**

6

Chloe Burnett*

Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach

Cross-border intra-group debt represents a significant proportion of total global monetary flows. Responding to tax base erosion from related party interest deductions, countries have introduced domestic rules against "interest stripping" but the heterogeneity of these rules leads to double taxation and double non-taxation. The OECD's 2013 Base Erosion and Profit Shifting (BEPS) Action Plan endorsed by the G20 identifies debt deductions as "Action Item 4", for reform by the end of 2015. This article surveys the existing approaches, from "stand-alone" to "worldwide ratio" rules. The author concludes that the worldwide approach is preferable, and recommends that more countries adopt such a rule, limiting the local leverage ratio to the third-party leverage ratio of the worldwide group. Such a rule is principled, given the fungibility and other unique features of finance, can draw upon existing rules in three countries and achieves the BEPS project aim of eliminating a large capacity for profit shifting.

Contents

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1. Introduction

The taxation of cross-border intra-group finance is a big issue, both in terms of the amount of money at stake and the attention directed to the topic. In recent years, domestic rules affecting the taxation of cross-border intra-group financing have proliferated, but the range of different approaches is wide. The consequence of this variability is double taxation, double non-taxation, and high compliance costs.

No international consensus has emerged. The Organisation for Economic Cooperation and Development (OECD) has long hinted that it may return to the topic.[1] The identification of base erosion through debt deductions in the Base Erosion and Profit Shifting (BEPS) project

1. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2010), para. 4.95; *see also* OECD, *Thin Capitalisation and Taxation of Entertainers, Artistes, and Sportsmen* (OECD 1987) (OECD Thin Capitalisation Report) and OECD, *Report on the Attribution of Profits to Permanent Establishments* (OECD 2010) (PE Report), which is only relevant by analogy as it does not apply to separate legal entities. The PE Report is discussed below at sec. 3.1.3.

endorsed by the G20 as Action Item 4[2] suggests that the issue is resurgent, although the primary focus of the BEPS project appears to be on transfer pricing of intangibles and supply chain innovations.

Addressing intra-group debt discretely presents an opportunity to realize some of the aspirations of the BEPS project more quickly and more effectively than is possible for the main subjects of the project. This is because debt finance is fungible, substitutable for equity and easily valued. Those descriptions do not apply to the high value intangibles at the heart of many multinationals, both in e-commerce and traditional industries. At least outside the financial sector, debt finance does not increase in value as it passes through a firm's internal supply chain; it is a cost centre rather than a source of economic rents. As such it is unnecessary, perhaps even inappropriate, to adopt a traditional transfer pricing approach. Further, most of the tools for addressing intra-group debt are in the existing toolbox of rules currently used by countries.

The different existing interest limitation rules can be grouped around two poles: a "stand-alone" approach and a "worldwide ratio" approach. A stand-alone approach asks how much the relevant subsidiary could borrow from third parties if it were a stand-alone entity rather than a member of a multinational group, and what interest rate would it be charged. A worldwide ratio approach considers the total third-party debt of the multinational group and compares this to, or allocates it amongst, the subsidiaries in the multinational's various jurisdictions. Most systems are a hybrid, pairing a fixed debt-to-capital or interest-to-profit ratio with an arm's length interest rate.

To weigh up the existing approaches and to make suggestions for the future, the author analysed four propositions:

(1) Intra-group debt is a close or perfect substitute for equity, pre-tax.

(2) A subsidiary has an identifiable arm's length amount of debt and an intra-group loan has an identifiable arm's length price.

(3) A multinational group's choice of location for its third-party debt is influenced (or even dominated) by tax considerations.

(4) For tax purposes, a multinational group should have the same level of leverage and interest rate in each jurisdiction in which it operates.

The author's conclusion after examining these propositions is that a worldwide debt-to-capital ratio rule which allows interest deductions only to the extent that the local subsidiary's debt-to-capital ratio equals or is less than that of the worldwide consolidated group, is the better form of the interest limitation rule. A form of this rule exists within the German, Australian and New Zealand interest limitation regimes at present. It is a rule suited to international convergence and can be defended as non-discriminatory under the law of the European Community and bilateral tax treaties. Its effect, for tax purposes only, is to disregard intra-group debt and to allocate third-party net interest costs (or income) based on assets. The interest rate can still be calculated using a traditional transfer pricing approach,

2. OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013), available at http://www.oecd.org/ctp/BEPSActionPlan.pdf (BEPS Action Plan).

but the natural extension of the rule (and a vastly simpler approach) is to use the group's average third-party interest rate.

A worldwide ratio approach is a principled neutral allocation rule for interest expense. It is also powerful in removing tax avoidance opportunities, as it is based on the actual third-party debt amount, not the hypothetical debt amount that can be justified on arm's length terms. Corporate finance has long recognized the reserve debt capacity of firms.[3] This, along with the wide range of potential arm's length leverage ratios,[4] means that a multinational's aggregate interest deductions can be much higher under a stand-alone approach than a worldwide ratio approach, and can be located where they generate the largest tax advantage. As a principled rule, it can be applied consistently across countries, on both the deduction and income sides. A consistent approach is important, given the double taxation and non-taxation under the current cacophony of rules.

The same principles apply to interest income earned by multinationals. Many multinationals, even outside the financial sector, have large cash reserves earning substantial interest; fungibility allows these to be placed in the most tax-efficient jurisdiction. Accordingly, the worldwide leverage ratio rule recommended in this article can apply to the net interest (or net debt) of the group, although the principal focus of this article is interest cost.

After discussing transitional measures and the future development of this rule, the article concludes with a recommendation that a worldwide debt-to-capital ratio interest limitation rule be considered and endorsed in the work on BEPS Action Item 4.

2. Scope of this Article

2.1. Terminology and limits

This article focuses primarily on the international tax consequences of cross-border intra-group debt.

The word "intra-group" is generally used as shorthand for a transaction between a parent and a wholly owned (direct or indirect) subsidiary or between subsidiaries (direct or indirect) of a common parent company. One hundred per cent control is the base case, but groups with common majority ownership can be susceptible to the same analysis. In a similar context, Benshalom has suggested a sophisticated model for delineating the borderlines of a multinational group.[5]

In this article, the term "interest limitation rules" is used to refer to rules which restrict interest deductions, usually by reference to a debt-to-capital (leverage) ratio, an interest-to-profit ratio or an arm's length comparable. Other synonyms are "interest barrier rules", "thin capitalization rules" and "earnings stripping rules". Some commentators have drawn distinctions between these labels for the purpose categorizing the various rules around the world, but the terms are often used interchangeably. In this article, when describing the rules

3. F. Modigliani & M. Miller, *Corporate income taxes and the cost of capital: a correction*, 53 American Economic Review 3, p. 442 (1963); S. Myers, *The capital structure puzzle*, 39 Journal of Finance 3 (1984); M. Leary & M. Roberts, *The pecking order, debt capacity, and information asymmetry*, 95 Journal of Financial Economics (2010); D. Allen, *Spare Debt Capacity: Company Practices in Australia, Britain and Japan*, 25 Australian Journal of Management 3 (2000).
4. *See*, for example, PE Report, *supra* n. 1, p. 134.
5. I. Benshalom, *Taxing the Financial Income of Multinational Enterprises by Employing a Hybrid Formulary and Arm's Length Allocation Method*, 28 Virginia Tax Review (2009).

of countries which use a particular description ("interest barrier" in Germany and "earnings stripping" in the United States), that term is used, but otherwise the general term "interest limitation rules" is used for ease of reference. The other set of rules examined is transfer pricing, usually based on the "arm's length principle" in Article 9 of the OECD Model Tax Convention on Income and on Capital (OECD Model) – its role is generally to set the interest rate, although in some countries it determines the permissible debt amount as well.

The reason for the cross-border focus in this article is that it is in this situation that differences between corporate tax rates, and tax systems generally, can be taken advantage of (or suffered from). Domestically, intra-group finance usually nets out or disappears in the tax consolidation regime. However, a rule which is effective and non-discriminatory should probably extend to domestic debt, so to that extent the recommendations of this article can impact upon domestic debt as well.

Only non-financial industry multinationals are considered in this article. Multinationals in the financial sector have a different relationship with intra-group debt, and with debt and equity finance generally. Loans are their "stock-in-trade"[6] so the non-tax reasons (including those relating to prudential and other financial regulation) for having differing leverage ratios and interest rates in different jurisdictions are likely to be greater than for non-financial firms. The reform proposed in this article is a relatively modest one which can be achieved progressively using existing tools relating to interest deductions. It could be a precursor to a more ambitious model which also applies to net interest of financial institutions (that is, spreads the group's interest income among jurisdictions proportionate to total assets, in the manner of a multilateral controlled foreign corporation (CFC) system).[7] But even if that cannot be achieved, a worldwide ratio interest limitation rule for non-financial institutions is a worthwhile reform on its own.

While the focus of this article is on intra-group debt, third-party debt also enters the picture because of the "fungibility" of finance: firms can respond to restrictions on intra-group debt deductions by substituting and shifting third-party debt, and evidence suggests that they do. Consequently, this article's proposal addresses both the creation of intra-group debt and the shifting of third-party debt.

A topic which this article does not explore is whether tax rules should be used to discourage a multinational from having an excessive total amount of third-party debt (as opposed to controlling in which jurisdictions it locates that debt). The negative externalities and other disadvantages of excessive third-party debt[8] are probably best addressed by initiatives outside the tax system. Interest payments to an unrelated lender represent money permanently lost to a multinational enterprise and as such should be deductible as a business cost (albeit under a worldwide rule the deductions are spread across the jurisdictions in which the multinational is present).

6. J. Breen, *Evaluating the Arm's-Length Price of Financial Guarantees: A Review of the OECD Framework*, Tax Notes International (13 September 2010), p. 871.
7. I. Benshalom, *The Quest to Tax Financial Income in a Global Economy: Emerging to an Allocation Phase – Taxing Global Financial Institutions*, 28 Virginia Tax Review (2008); Benshalom 2009, *supra* n. 5.
8. *See*, for example, R. de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, 33 Fiscal Studies 4 (2012) p. 489; US Treasury Staff of the Joint Committee on Taxation, *Present Law and Background Relating to the Tax Treatment of Business Debt*, Report to Joint Committee of Taxation, 11 July 2011.

2.2. Objective: Anti-avoidance or neutral allocation?

In terms of tax consequences, this article focuses mainly on the deduction in the source country for interest and interest-like payments, although source country withholding taxes, and taxability in the residence country, come into play as well.

The impetus for interest limitation rules has generally been a concern about base erosion through "interest stripping": a multinational reducing its taxable profits in high (and medium) tax jurisdictions by increasing the debt levels and consequential interest deductions in those jurisdictions. Intra-group cross-border debt is easy to create; it does not require any goods or services to physically move, or business conduct to change, just the entry of figures into a spreadsheet and the execution of a loan agreement (if that). Third-party debt is not quite as malleable, but in many situations it is relatively easy to change its source. There is significant empirical evidence that multinational groups manipulate intra-group debt, and the location of third-party debt, to minimize taxes through interest deductions.[9] Similarly, interest inclusions are shifted to low tax jurisdictions or eliminated entirely.[10]

Debt financing can facilitate tax advantages beyond a mere deduction in the source state. For example, the third case study in the OECD's 2013 BEPS Report features "double dip" interest deductions and a debt/equity classification arbitrage.[11] However, the other effects are usually due to the interaction between the rules for taxation of debt finance and another set of rules. However, most structures seeking additional tax benefits of this nature still have as a fundamental component the use of intra-group debt,[12] and to that extent this article bears on them as well.

Revenue preservation aside, the interest limitation rule recommended in this article, a worldwide debt-to-capital ratio rule, also operates as a neutral allocation rule, at least for non-financial firms. It is justified from a policy perspective because of the fungibility and mobility of debt and its substitutability with equity. It is imperfect where there are strong non-tax reasons for locating unguaranteed and unsupported third-party debt in a subsidiary, but this is a relatively minor imperfection; the excess deductions are not lost, rather, they are spread, and the debt keeps its character for all non-tax purposes. Brown suggests that interest limitation rules "are not 'targeted anti-abuse rules' but structural changes intended to mitigate the effects of the deduction for interest on debt",[13] and observes that it is unfortunate that they are "cloaked in anti-abuse language".[14] The author agrees with these comments,

9. M. Desai., C. Foley & J. Hines, *A Multinational Perspective on Capital Structure Choice and Internal Capital Markets*, 59 Journal of Finance 6 (2008) and studies cited therein; H. Huizinga, L. Laeven, & G. Nicodeme, *Capital structure and international debt shifting*, 88 Journal of Financial Economics 1 (2008) and studies cited therein; M. Arena, & A. Roper, *The effect of taxes on multinational debt location*, 16 Journal of Corporate Finance (2010) and studies cited therein; P. Egger, et al., *Corporate Taxation, Debt Financing and Foreign Plant Ownership*, 54 European Economic Review (2010); OECD *Addressing Base Erosion and Profit Shifting* (OECD 2013), available at http://dx.doi.org/10.1787/9789246192774-en (BEPS Report) and studies cited therein.

10. Benshalom 2008, *supra* n. 7, and studies cited therein.

11. BEPS Report, *supra* n. 9, pp. 79-80.

12. Benshalom 2009, *supra* n. 5, describes financial assets as the "spinal column of many tax planning transactions", p. 625.

13. P. Brown, *General Report: The Debt-Equity Conundrum*, 97b Cahiers de Droit Fiscal International (2012) p. 40.

14. Brown, *supra* n. 13, p. 41.

while further noting that a general structural rule can also have the effect of removing the tax advantages of structures which have little purpose other than tax.

3. The Conflicting Approaches – Stand-Alone versus Worldwide

Countries concerned about base erosion through interest stripping (mainly but not exclusively OECD countries) have developed interest limitation rules restricting tax deductions for intra-group interest and in some cases third-party interest, with renewed impetus after publication of the OECD's Thin Capitalisation Report in 1987. Most of these rules date from the 1990s or later. The (generally) longer-standing transfer pricing rules in these countries usually also play a role. On the interest income side, most high tax countries rely on separate CFC rules.

No two countries have identical rules and the wide variety of rules is remarkable. Further, interest limitation regimes appear to be rather unstable – most countries have rewritten theirs at least once. Despite the variability, most countries' rules sit somewhere along a spectrum which has at one end a stand-alone entity approach, and at the other end a worldwide ratio approach.

In essence, the stand-alone approach considers leverage and interest rate at the entity level: the level of the local subsidiary. How much could that entity borrow, and at what interest rate, from an arm's length borrower? This enquiry is similar to the approach referred to by the OECD as the "thin capitalization approach" to determining deductions of a branch relative to the head office, based on a transfer pricing functional analysis.[15] Most stand-alone approaches still take account of the fact that the subsidiary belongs to a multinational group; others such as that in the United Kingdom impose a more stringent "stand-alone" assumption, hypothesizing away the parent and any sibling companies.

In contrast, the worldwide approach zooms out. It looks first to the worldwide consolidated group, measuring the total third-party leverage ratio and interest cost. This leverage ratio is then compared to the leverage ratio of the local subsidiary; if the latter is higher then debt deductions are disallowed to that extent. Another way of achieving this outcome is by disregarding all intra-group debt and notionally spreading the total third-party interest deductions amongst the multinational's jurisdictions according to assets, regardless of where the interest is actually incurred.

3.1. Stand-alone approach

3.1.1. UK system

The UK thin capitalization regime, which is part of the transfer pricing rules,[16] is probably the closest to a pure stand-alone approach. It applies only to related-party debt (although it applies domestically as well as cross-border due to requirements set out by the European Court of Justice).[17]

15. PE Report, *supra* n. 1, pp. 39-40: *see infra* sec. 3.1.3.
16. Paragraph 1, Schedule 28AA, Income and Corporation Taxes Act 1988 (UK).
17. UK: ECJ, 13 Mar. 2007, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*, ECJ Case Law IBFD; NL: ECJ, 18 Sep. 2003, Case C-168/01, *Bosal Holding BV v. Staatssecretaris van Financiën*, ECJ Case Law IBFD.

Under the UK administration of these rules, the UK borrower is treated as if it is an "orphan"; that is, its parent and sibling companies are disregarded.[18] Any subsidiaries of its own, however, are not disregarded. This notional orphan or orphaned group is then subjected to a transfer pricing analysis, to ascertain both the amount of debt that it could borrow from unrelated lenders and the interest rate that should be charged on this amount. That is, the "arm's length principle" is applied, although it is applied to a modified reality.

There is no safe harbour leverage ratio under the UK system. Instead, the UK subsidiary can be leveraged with related-party debt up to the maximum debt amount (and interest rate) which it can justify on an arm's length basis. This is regardless of whether the multinational group of which it is part has third-party debt levels and interest costs of a similar proportion. However, the requirement to assume orphanhood would, it might be assumed, in most cases put some upper limit on the amount of debt that a hypothetical third-party lender would advance.

The UK system also has one "worldwide" feature, the "worldwide debt cap". It is intended to counter highly leveraged UK acquisitions[19] and disallows interest deductions in the United Kingdom if they exceed the gross interest expense of the worldwide group. This is not a ratio enquiry; rather, it compares the absolute amount of United Kingdom versus total worldwide interest expense. For most multinationals, a great deal of debt would have to be shifted to the United Kingdom, plus extra amounts borrowed intra-group in the United Kingdom (essentially converting equity into intra-group debt), before this rule would kick in. Before the introduction of this rule, some multinationals actually had more debt in the United Kingdom than their worldwide third-party debt; to that extent the rule has been effective, but it merely puts a cap on very high levels of intra-group leverage and debt shifting to the United Kingdom.

3.1.2. Transfer pricing of interest rates

A stand-alone analysis also characterizes the transfer pricing rules applied by most countries to ascertain the interest rate for intra-group debt. In contrast to the United Kingdom, in many countries the transfer pricing rules are separate from (or additional to) the interest limitation rules, with the latter determining the maximum debt amount in the local jurisdiction and the former pricing that debt.

At the pricing stage, most countries apply their general transfer pricing rules, treating the intra-group loan like any other transfer of goods or services between related entities. Most of these transfer pricing rules are based on article 9 of the OECD Model and the Transfer Pricing Guidelines (OECD Guidelines), which adopt the "arm's length principle".

The OECD Guidelines describe the arm's length principle as "the separate entity approach",[20] which "treats the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business".[21] This could be seen as requiring the strict "stand-alone" approach used in the United Kingdom, where the local subsidiary is deemed

18. Her Majesty's Revenue and Customs (UK), *Transfer Pricing Manual*, Chapter INTM 586180, available online at http://www.hmrc.gov.uk/manuals/intmanual/intm586180.htm.
19. D. Southern, *UK Report: The Debt-Equity Conundrum*, 97b Cahiers de Droit Fiscal International (2012), pp. 767-768.
20. OECD, Transfer Pricing Guidelines (2010), para. 1.6.
21. Id.

to be an orphan. However, the balance of the OECD Guidelines and the Canadian Courts' decisions in *General Electric Capital*[22] tend against that view.

Article 9 of the OECD Model says nothing specifically about transfer pricing of loans and other financial transactions, and the OECD Guidelines say very little. What the OECD Guidelines (2010 version) have to say about the arm's length price of an intra-group loan is the following:

– Paragraph 1.9: The arm's length principle works effectively "in the vast majority of cases", by reference to two examples, one of which is "the lending of money where an arm's length price may readily be found in a comparable transaction undertaken by comparable independent enterprises under comparable circumstances".

– Paragraph 1.65: "there are two particular circumstances in which it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction. The first circumstance arises where the economic substance of a transaction differs from its form. In such a case the tax administration may disregard the parties' characterization of the transaction and re-characterize it in accordance with its substance. An example of this circumstance would be an investment in an associated enterprise in the form of interest-bearing debt when, at arm's length, having regard to the economic circumstances of the borrowing company, the investment would not be expected to be structured in this way. In this case it might be appropriate for a tax administration to characterize the investment in accordance with its economic substance with the result that the loan may be treated as a subscription of capital."

– Paragraph 4.95: The relationship between transfer pricing and thin capitalization safe harbours "will be the subject of subsequent work".

– Paragraph 4.125, which provides guidance on making predictions for the purposes of Advance Pricing Arrangements (APAs): "The reliability of any prediction used in an APA depends both on the nature of the prediction and the critical assumptions on which the prediction is based. For example, it would not be reasonable to assert that the arm's length short-term borrowing rate for a certain corporation on intra-group borrowings will remain at 6% during the entire coming 3 years. It would be more plausible to predict that the rate will be LIBOR plus a fixed percentage. The prediction would become even more reliable if an appropriate critical assumption were added regarding the company's credit rating (e.g. the addition to LIBOR will change if the credit rating changes)."

More detailed practical guidance on how to apply the arm's length standard to loans has mainly come from tax authorities and from specialist consultants who advise taxpayers (and tax authorities) in this area,[23] or by analogy from the OECD PE Report.

22. *General Electric Capital Canada Inc v. The Queen* 2009 TCC 563 and CA: Case 2010 FCA 344, *General Electric Capital Canada Inc. v. Her Majesty the Queen*, ECJ Case Law IBFD.

23. For example, Australian Taxation Office Taxation Rulings TR 92/11 and TR 2010/7; Her Majesty's Revenue and Customs (UK), *Transfer Pricing Manual*, *supra* n. 18; A. Tarassov & T. Tsiopoulos, *Transfer Pricing and the Halo Effect*, 20 Transfer Pricing Report (2012); A. Russo & M. Shirazi, *Transfer Pricing for Intercompany Financial Transactions: Application of the Arm's Length Principle in Theory and Practice*, 19 Transfer Pricing Report 43 (2010).

Different methodologies for applying the arm's length standard to a loan exist, but the one most commonly put forward is the following exercise. The intra-group loan under scrutiny is compared to a hypothetical loan to the borrower from a third-party lender. Under the hypothetical inquiry, the credit rating of the borrower is estimated. This usually involves a fact-intensive examination of the borrower's financial metrics as well as the qualitative features of its business and that of the overall group, similar to that done by ratings agencies or bank lenders. The market interest rate (the margin above the relevant base rate, e.g. LIBOR) which corresponds with this estimated credit rating and the other terms of the loan is then applied. References to existing comparable third-party loans may also be made. If the interest rate on the actual loan does not exceed the interest rate on the hypothetical or comparable third-party loan, it will usually be respected under the relevant transfer pricing rules. The references in paragraph 4.125 of the OECD Guidelines to "LIBOR" and the "company's credit rating" appear to reflect this methodology.

3.1.3. Balance sheet reconstruction under transfer pricing

Paragraph 1.65 of the OECD Guidelines suggests that transfer pricing rules can be used to limit the amount of debt of the local subsidiary, not just the interest rate. It invokes the concept of the arm's length amount of debt, or arm's length leverage ratio. As discussed above, the UK uses this concept as well (albeit under the "orphan" assumption). In so doing, it recognizes that debt amount and interest rate usually have a positive relationship: all other things being equal, more highly leveraged borrowers usually face higher interest rates.

Some other countries also assess the arm's length leverage ratio under their interest limitation rules. For example, in China a company's deductible debt can exceed the safe harbour leverage ratio of 66.67% if it can prove its related-party debt complies with the arm's length principle.[24] Australia and Denmark have a similar rule, alongside fixed ratio limits and other rules. Japan's thin capitalization rules have a safe harbour leverage ratio (75%) and interest as a proportion of the EBITDA cap (50%). The taxpayer can justify a higher leverage ratio on the basis that a company in the same industry has a higher arm's length leverage ratio.

In the context of branches rather than subsidiaries, the OECD Report on the Attribution of Profits to Permanent Establishments (2010) (PE Report) enters into a much more detailed discussion of arm's length leverage and interest rate than is found in the OECD Guidelines. A large part of the report is given over to the question of how to work out the arm's length "free capital" (non-interest bearing funding, i.e. equity) of a branch, expressed as a proportion of the branch's assets. This is the counterpart of the arm's length leverage (debt to assets) ratio; that is, when they are added together they equal 1.

While the majority of the PE Report is addressed towards the financial sector, it does discuss non-financial institution branches. In that context, two of the alternative approaches for calculating the arm's length amount of capital (and therefore debt) of a branch can be contrasted. One is the "capital allocation" approach, where the branch adopts the capital (and debt) of the legal entity of which it is part in proportion to the branch's assets and risks. The other is the "thin capitalisation" approach, under which the branch is hypothesized to

24. Article 89 of Chapter IX Administration of Thin Capitalisation of Chinese tax legislation (*see* OECD *Thin Capitalisation Legislation – A Background Paper for Country Tax Administrations (Pilot version for comments)* August 2012, available online at: http://www.oecd.org/ctp/tax-global/5.%20Thin_Capitalization_Background.pdf, p. 38).

be a separate entity and a fact-intensive functional analysis determines the amount of free capital it would need and hence the amount of third-party debt it could borrow. This echoes the "worldwide" versus "stand-alone" approaches discussed in this article in the subsidiary context.[25]

The PE Report states, however:

> a weakness of a thin capitalisation approach is that the aggregate amount of "free" capital it attributes to individual PEs may be greater than the amount of free capital in the enterprise as a whole.[26]

Equally, it could result in more aggregate debt being allocated to individual PEs (or subsidiaries, if applied to separate legal entities too) than the worldwide third-party debt of the enterprise – and a corresponding enlargement of total interest deductions.[27] The Report also recognizes a related drawback:

> One concern with such an approach is what appears to be the wide range of debt-to-equity ratios observable at arm's length and whether, given the diverse range, it is possible to apply a thin capitalisation approach outside the financial sector.[28]

The discussion of Propositions 2 and 3 below also queries whether there is such thing as a single arm's length leverage ratio or interest rate for a given subsidiary, or even a workable range of ratios and rates. However, the transfer pricing rules in most countries (and the thin capitalization rules in some countries) assume that it is possible to estimate these measures.

The more useful question, perhaps, is whether all the effort involved in undertaking a functional analysis from scratch for every intra-group loan is worthwhile, particularly if there is an available alternative. Does it lead to a result that is any better from a policy perspective? These questions are valid even before the profit shifting opportunities of the separate entity approach are taken into account. In terms of an available alternative, the author suggests that the traditional "stand-alone" functional analysis approach actually ignores a rich source of arm's length information which is right at hand, and which also denies profit shifting opportunities: the third-party debt-to-capital ratio and interest expense of the multinational group as a whole. This is discussed in more detail in the last two sections of this article, and examples are explored immediately below.

3.2. Worldwide approach

3.2.1. German system

The closest exemplar of a "worldwide ratio" approach is Germany, given an aspect of the interest barrier rule it introduced in 2008. A rule of this variety was first adopted by New Zealand in 1996, but it was accompanied by a 75% leverage safe harbour, which the overwhelming majority of taxpayers applied in preference to the worldwide ratio, even though the latter had a 10% buffer.[29]

25. However, the "capital allocation" approach would more closely resemble the worldwide debt-to-capital ratio approach recommended in this article if the starting point was the third-party capital and debt of the total group, not just the capital and debt of the single legal entity of which the branch is part.
26. PE Report, *supra* n. 1, para. 134.
27. *See* sec. 5., regarding the "residual".
28. PE Report, *supra* n. 1, para. 132.
29. G. Richardson, D. Hanlon, & L. Nethercott, *Thin Capitalisation Rules: An Anglo-American Comparison*, 24 International Tax Journal (1998), p. 50.

The worldwide aspect of the German interest barrier rule is the worldwide equity-to-assets ratio "escape clause". The basic rule is that a German company may not deduct net interest expense in excess of 30% of its earnings before interest, taxes, depreciation and amortization (EBITDA).[30] This rule has a number of escape clauses, but the only escape clause really available to large multinationals is the "worldwide equity ratio" clause. This allows the German company to keep its interest deductions if it can show that its ratio of equity to assets (i.e., 1 minus its debt-to-assets ratio) is not lower than that of the worldwide group (on a consolidated basis, i.e., all third-party debt and assets), with a 2% buffer.[31]

The rule applies to third-party debt as well as intra-group and guaranteed debt and to domestic debt as well as cross-border debt. So a German subsidiary which has borrowed only from a German bank, without a guarantee from a foreign parent, and who uses the loan to derive German income only, will still have its interest deductions disallowed if its leverage ratio is higher than that of the worldwide group and its net interest cost exceeds the 30% threshold.

The rule is based on actual interest outgoings in Germany. There is no capacity for a German subsidiary which is "fatly capitalized" with an equity ratio higher than that of the worldwide group to have a notional interest deduction as if its equity ratio equalled that of the worldwide group, even if the result would be under the 30% threshold.

Germany applies its transfer pricing rules, based on article 9 of the OECD Model, to the interest rate on related-party loans. However, using the ratio of interest cost to EBITDA rather than a debt-to-capital ratio as the basic threshold means that the interest barrier rule itself also does some work in disallowing excessive interest rates.

The German regime has been criticized in Germany as complex, likely to lead to insolvencies and loss of investment, and potentially invalid under national and supra-national law.[32] The empirical evidence about its effectiveness is as yet mixed.[33] It remains in force and anecdotal evidence suggests that corporate taxpayers and their advisers are adapting to it. Another criticism is levelled at the calculation methodology, specifically the compulsory reduction for book equity in subsidiaries which German (but not necessarily foreign) multinationals have to make. Any attempts to adapt the German worldwide ratio rule to other countries in order to achieve the recommendations of this article would have to address this calculation anomaly.

3.2.2. Other worldwide aspects of interest limitation rules

Australia and New Zealand each have a worldwide ratio alternative within their thin capitalization rules. In Australia it is an alternative test, but it is has a renewed significance given the 2013 reduction of the safe harbour from 75% to 60% and the 2014 policy review of the arm's length alternative test. In New Zealand the local leverage ratio permitted is 110%

30. Sec. 4h, German Income Tax Act.
31. The German company must also show that its interest payments to related parties outside its consolidated group (such as majority shareholders) do not exceed 10% of its net interest: sec. 8A, para. 3, Germany Corporation Tax Act. This aspect of the German rules can be arbitrarily harsh; arguably it is better dealt with through the definition of the boundaries of the corporate group.
32. *See* D. Dessler & U. Sheuering, *Empirical Evaluation of Interest Barrier Effects*, Centre for European Economic Research Discussion Paper No. 12-046 (2012), articles cited at p. 4.
33. Dessler & Sheuering, *supra* n. 32; H. Buslei & M. Simmler, *The Impact of Introducing an Interest Barrier: Evidence from the German Corporation Tax Reform 2008*, DIW Berlin Discussion Paper No. 1215 (2012).

of the worldwide leverage ratio, as an alternative to the 60% safe harbour leverage ratio.[34] The Netherlands also had a worldwide group leverage ratio alternative from 2004[35] until the abolition of the thin capitalization rules in 2013.

The alternative "arm's length" test in the Japanese system, described briefly above, involves a search for comparable companies with third-party debt and to that extent appears to be closer to the "stand-alone" paradigm. However, if the Japanese company could select as the comparable its own consolidated worldwide group, then this alternative would also manifest a worldwide approach similar to that of Germany.

The United States attempted to introduce a worldwide ratio earnings stripping rule in the early 2000s, although while third-party debt was included in calculating the ratio, the only deductions that would be disallowed were those on intra-group debt. This was referred to as the "disproportionately leveraged" test, designed to amend the earnings stripping rule in Internal Revenue Code section 163(j). The proposed reform was abandoned by the Bush administration, reportedly after pressure from lobby groups.[36] There has been a suggestion that the Unites States is again considering whether the earnings stripping rules should be "tightened" by adding a worldwide group leverage ratio comparison.[37]

3.2.3. US interest allocation rule and Canada's foreign affiliate rules

The United States has separate regimes for inbound and outbound thin capitalization. The former is dealt with under the earnings stripping rules. The latter is dealt with by the "water's edge" interest allocation rules, which limit US debt deductions to the extent of US-source income.[38] These prevent a US parent from benefiting from "parking" debt in the United States, that is, borrowing to "fatly capitalize" a foreign subsidiary with equity on which dividends can be deferred, and ultimately carry foreign tax credits. Countries with exemption systems face the same strategy, all the more so in fact, and some (such as Germany, Australia and others) deal with it by extending their thin capitalization rules to outbound taxpayers and third-party financing. Canada, also an exemption country, has introduced additional rules. These are discussed briefly below.

The US allocation rule takes an apportionment approach based on the comparison of US and worldwide assets, and to that extent is an example of the "worldwide" approach. It does not ask how much debt the US parent could have borrowed on an arm's length basis.

The apportionment is achieved by spreading the US parent's interest expense across all of its assets (US versus non-US) on a pro-rata basis. The calculation method fails to look through foreign subsidiaries which themselves have debt finance and to this extent can underestimate foreign tax credits; a fix for this flaw has been deferred until 2020,[39] presumably for revenue preservation reasons.

34. A. Judge & C. Plunket, *New Zealand Report: The Debt-Equity Conundrum*, 97B Cahiers de Droit Fiscal International (2012), p. 513.
35. G. de Keizer & M. Sunderman, *Netherlands Report: The Debt-Equity Conundrum*, 97b Cahiers de Droit Fiscal International (2012), p. 503; S. Webber, *Thin Capitalization and Interest Deduction Rules: A Worldwide Survey*, Tax Notes International (29 November 2010), p. 699.
36. Benshalom (2008), *supra* n. 7, pp. 185-186 and references cited therein.
37. C. Lowell & M. Martin, *Transfer Pricing Strategies*, (New York, Thomson Reuters, 2010) paras. 9-19 to 9-20.
38. Sec. 864(e), (f), US Internal Revenue Code and corresponding regulations.
39. *See* G. Yin, *Temporary-Effect Legislation, Political Accountability and Fiscal Restraint*, 84 New York University Law Review (2009).

Canada has recently introduced a "foreign affiliate dumping" rule which deems an outbound dividend in certain circumstances.[40] The rule is both an inbound and an outbound one as it applies to Canadian corporations with foreign owners and foreign assets. The dividend can be deemed if the Canadian corporation undertakes a leveraged acquisition of a company or companies ("dumping" subsidiaries under Canada). Because Canada has a participation exemption for foreign source non-portfolio dividends, the allowing of debt deductions, and the avoidance of Canadian dividend withholding tax, was seen to erode Canada's tax base. If the rule applied only to "created" intra-group debt (that is, not sourced from third-party debt) then it would be a form of worldwide ratio rule. However, it does not appear to be restricted to intra-group debt. A related rule ("upstream loans") deems a Canadian parent to derive income where it has borrowed from a non-portfolio subsidiary. The rules are complex and have been criticized as overreaching.[41] They appear to be directed at more than interest stripping, but one wonders whether they would have been necessary if Canada introduced a worldwide leverage ratio interest limitation rule.

3.3. Hybrid approach

The most common form of an interest limitation rule is a fixed ratio limit. The ratio is either a debt-to-capital ratio or an interest-to-profits ratio. In addition, the interest rate on any intra-group debt which is not disallowed by these rules must comply with the transfer pricing rules (usually based on article 9 of the OECD Model).

This is not a pure stand-alone model, but it is closer to the stand-alone approach than it is to the worldwide approach, given the "arm's length" exercise for the interest rate.

3.3.1. Fixed debt-to-capital ratio model

A fixed debt-to-capital (either debt-to-equity or debt-to-assets, noting their arithmetic relationship) ratio is the most common form of interest limitation rule. The ratio itself is largely arbitrary[42] other than being a round figure and, often, one that other countries use as well. Popular ratios of debt-to-equity are 4:1 (which equates to a debt-to-assets ratio of 4:5, i.e. 80% leverage),[43] 3:1 (75%),[44] 2:1 (66.67%)[45] and 1.5:1 (60%).[46] Some empirical studies suggest that 2:1 exceeds the majority of arm's length group leverage ratios, but there are still large numbers of groups with arm's length ratios in excess (even well in excess) of it.[47] In some countries the ratio applies only to intra-group debt, in others it applies to all debt.

40. P. Marley, *Canada Revises Proposed Foreign Affiliate Dumping Rules*, 67 Tax Notes International (2012) 805; S. Suarez, *New Foreign Affiliate 'Dumping' Rules Constitute Major Canadian Tax Policy Change*, 68 Tax Notes International (2012), p. 1145.
41. *See*, for example, Marley, Suarez, *supra* n. 40.
42. P. Hinny, *General Report: New tendencies in tax treatment of cross-border interest of corporations*, 93b Cahiers de Droit Fiscal International (2008), p. 38.
43. For example, Denmark.
44. For example, Japan.
45. For example, China.
46. For example, Australia, Canada, France and the United States.
47. T. Edgar, J. Farrar & A. Mawani, *Foreign Direct Investment, Thin Capitalization, and the Interest Expense Deduction: A Policy Analysis*, 56 Canadian Tax Journal 4 (2008), pp. 864-869 and studies cited therein; US Treasury, *Earnings Stripping, Transfer Pricing and US Income Tax Treaties* (Washington, US Government Printing Office, 2007).

Some countries refer to the fixed ratio as a "safe harbour". This is an apt description if the country also offers a way to prove a higher ratio (for example, as in Japan, China, Australia and Germany). Traditionally, a "safe harbour" in tax law is a modest threshold that spares the taxpayer the burden of proof. However, taxpayers can choose to undertake the more onerous task of proving the facts if they desire a better tax result; they won't have the protection of the safe harbour but if their proof passes muster they will obtain the desired result. In many countries the interest limitation fixed ratio is not a safe harbour in this sense. Taxpayers are either under the limit, in which case all their interest is deductible, or over the limit, in which case the interest that exceeds the limit is not deductible.

A fixed debt-to-capital ratio limit with no alternative can operate quite arbitrarily. Firms whose third-party debt-to-capital ratio exceeds the fixed limit because, say, their shareholders have a high risk appetite, or the business is in financial difficulty, will have interest deductions disallowed under this rule even though they are paying the interest out to third parties, a real and permanent cost to the firm. In some countries, the fixed ratio limit only operates to disallow deductions on intra-group debt. Even in those situations, though, it can operate unfairly on subsidiaries of a worldwide group whose third-party debt-to-capital ratio is higher than the fixed limit. In that case, the otherwise appropriate practice of using intra-group debt at the same leverage rate as third-party debt is penalized.

3.3.2. Fixed interest-to-profits ratio model

A fixed ratio of interest-to-profits (usually EBITDA or a variation thereon) is the interest limitation rule in some countries. Once again, in setting the ratio it seems important to choose a round figure. The ratios vary widely – from 25% in France, to 30% in Germany, Italy and Spain, to 50% in the United States and 80% in Denmark. The variance is partially explained by some differences in calculation formulae and by the fact that in some countries this limit stands alone whereas in others it is additional to a fixed leverage ratio limit. In some of the latter countries the taxpayer must be within both the leverage ratio limit and the interest-to-profits ratio limit;[48] in others it need only satisfy one.[49]

An interest-to-profits ratio might appear more targeted than a debt-to-capital ratio – after all, the target is profit erosion via interest deductions. However, a ratio of this type can operate even more arbitrarily than a fixed debt-to-capital ratio. This is because a company's profit tends to fluctuate more than its capital, both over time and as between jurisdictions. The fluctuations are also due, to a significant extent, to factors beyond the company's control or that of its group. Further, the link between debt (or equity) finance and profits is more remote than its link with capital. The link between debt (or equity) finance and assets could not be any more direct: debt plus equity equals assets.

On this basis, the interest limitation rules of Italy and Spain, being 30% interest-to-profits caps with no significant exceptions, are probably the harshest. However, each country's tax system is different and its interest limitation rule cannot be viewed in isolation. In Italy, for example, there is now a limited allowance for corporate equity (ACE), which presumably tempers some of the harshness of the interest limitation rule.

48. For example, France, Denmark and Japan, although in Japan there is also the "arm's length" alternative, discussed above.

49. For example, the United States.

3.3.3. Variability leading to double taxation and double non-taxation

In addition to the arbitrariness discussed above, another shortcoming of fixed ratio interest limitation rules is their variability across countries. There are wide variations in the ratios themselves, the type of ratios, how many cumulative or alternative tests apply and the methods of calculation, including whether third-party debt is included or not. Further variables include whether the disallowed interest is deemed to be a dividend, whether it can be carried forward if there is capacity in a later year and whether one of a myriad of special exceptions (either ameliorating or toughening) apply.

This inter-nation variability leads directly to double taxation[50] and double non-taxation, as well as significant compliance costs. There is little interaction between countries' various interest limitation rules, despite the fact that their primary target is tax-motivated cross-border financing.

A classic example of double taxation in this context is the disallowance of an interest deduction on a parent-to-subsidiary loan in the subsidiary jurisdiction because the subsidiary exceeds the relevant fixed ratio, but taxation of the interest received by the parent because the parent jurisdiction still sees the amount as taxable interest. There may also have been interest withholding tax.

Double non-taxation can be achieved by ensuring that the borrowing subsidiary is under the interest limitation threshold and the lending subsidiary is in a jurisdiction which, for whatever reason, does not tax the lender's receipt. Converting the intra-group debt into equity in this jurisdiction can ensure permanent double non-taxation if the parent is in an exemption country.

It is interesting to note that the United Kingdom applies its stand-alone arm's rate leverage concept to interest paid to – not just by – the UK subsidiary. But rather than requiring UK advisers and tax administrators to perform a full-fledged functional analysis of the foreign borrower, the United Kingdom may accept that outbound debt is performing an "equity function"[51] and not tax the interest income to the extent that the borrower's jurisdiction has disallowed interest deductions pursuant to its own interest limitation rules.[52]

3.3.4. Awkward interaction between fixed ratio debt amount and arm's length interest rate

A further difficulty is encountered when a country attempts to combine a fixed rate debt-to-capital ratio with an arm's length interest rate. In undertaking the transfer pricing analysis to determine the correct interest rate for intra-group debt, the question of whether the debt amount is an arm's length one necessarily has to be considered. If the subsidiary is within the fixed debt-to-capital ratio limit, but nonetheless its debt amount is so large relative to the subsidiary's debt servicing abilities it that it would not have been borrowed from a third party at all, regardless of the interest rate, then the rules face a dilemma.

50. R. Zielke, *Shareholder Debt Financing and Double Taxation in the OECD: An Empirical Survey with Recommendations for the Further Development of the OECD Model and International Tax Planning*, 38 Intertax 2 (2010).
51. Southern, *supra* n. 19, p. 765.
52. Id.

There are three different ways to resolve the dilemma. One, respect the debt amount and impose a very high interest rate, on the basis that some (possibly predatory) lender would provide an arm's length comparable – this approach leads to very large interest deductions. Two, use the transfer pricing rules to override the interest limitation rules and deem the debt to be a lower (arm's length) amount and impose a (low) arm's length interest rate – this approach cuts interest deductions but can be seen to contradict the "safe harbour" in the interest limitation rules. Three, a compromise approach: apply the interest rate calculated under the second approach (i.e., based on a hypothetical lower debt amount) to the actual debt amount. The latter approach has been adopted in Australia.[53]

An additional criticism is that the need to undertake a transfer pricing analysis for interest rates (which necessarily involves estimating the company's arm's length debt capacity) tends to defeat the compliance-easing purpose of having a fixed ratio at all.

3.3.5. Effectiveness in targeting interest stripping

Fixed ratio interest limitation rules are at best blunt tools. As discussed above, they can overreach when applied to groups with high third-party debt levels. On the flip side, the best they can do in countering avoidance is to slice the top off interest stripping. Within the fixed ratio, significant amounts of interest stripping can still take place.[54] Interest limitation rules can also be avoided by using hybrid instruments, hybrid entities and other arbitrages between jurisdictions.[55]

4. The Underlying Propositions

The three distinct approaches that have been adopted by countries are those described above: a pure stand-alone approach, a worldwide debt-to-capital ratio approach, and the most common approach of a fixed ratio limit with arm's length interest rates.

In the author's view, the first two approaches are more principled than the third, which as discussed above has inefficiencies and conceptual shortcomings (although it appears to be administrable in practice).

In the course of deciding which of the stand-alone and worldwide approaches to prefer, this article examines some of the economic propositions which seem to underlie the two very different approaches:

(1) Intra-group debt is a close or perfect substitute for equity, pre-tax.

(2) A subsidiary has an identifiable arm's length amount of debt and an intra-group loan has an identifiable arm's length price.

(3) A multinational group's choice of location for its third-party debt is influenced (or even dominated) by tax considerations.

(4) For tax purposes, a multinational group should have the same level of leverage and interest rates in each jurisdiction in which it operates.

53. Sec. 815-25, Income Tax Assessment Act 1997 Australia; *see also* Australian Tax Office Ruling TR 2010/7.
54. Webber, *supra* n. 35, p. 703; BEPS Report, *supra* n. 9, pp. 40, 44; *see also* studies cited in *supra* n. 9.
55. De Mooij, *supra* n. 8, p. 502.

Proposition 1 underpins the worldwide approach to the extent it applies to intra-group debt and Propositions 3 and 4 underpin it to the extent it applies to third-party debt as well. Proposition 2, on the other hand, underpins the stand-alone approach.

4.1. Proposition 1 – Intra-group debt is a close or perfect substitute for equity, pre-tax

This proposition is part of the justification for the worldwide approach. It also underpins most existing interest limitation rules to the extent that they apply to intra-group debt. If this proposition is correct, it suggests that the stand-alone approach – indeed, any attempt to apply a traditional arm's length transfer pricing process to intra-group debt – is futile. This is because what is sought to be priced under that process, intra-group debt, is a substitute for the very thing which must be ignored: the equity interest between the parties.

Proposition 1 appears to be accepted by many tax lawyers and economists. The following are some quotes in this respect:

– "No real distinction exists between debt and equity in a controlled corporation";[56]

– "Parent loans to foreign affiliates are often regarded as equivalent to equity investment both by host countries and the investing corporation".[57]

– "There seems to be only one serious problem with related party debt: by most standards of economics, "substance" or common sense, it is not debt … ostensible loans from one entity to another would probably be viewed as equity transfers".[58]

– "Where the provider of capital is a related party, there is little economic significance in the distinction between debt and equity".[59]

To further test the proposition, the author gathered the explanations traditionally used to explain why a business chooses to be financed with debt instead of equity or vice versa.[60] This topic has a venerable history and is dense with scholarship but the studies tend to compare third-party debt with either third-party equity or intra-group debt, rather than comparing intra-group debt and equity.

The following sections discuss whether the traditional explanations can also be applied to the choice between intra-group debt and intra-group equity. Corporate treasury and corporate law distinctions between intra-group debt and equity are also considered, as is the extent to

56. C. Hufbauer & A. Assa, *US Taxation of Foreign Income* (Washington, Peterson Institute for International Economics, 2007), p. 159.
57. A. Stonehill & T. Stitzel, *Financial Structure and Multinational Corporations*, 12 California Management Review 1 (1969), p. 93.
58. H.D. Rosenbloom, *Banes of an Income Tax: Legal Fictions, Elections, Hypothetical Determinations, Related Party Debt*, 26 Sydney Law Review (2004), p. 35.
59. Southern, *supra* n. 19, p. 764.
60. F. Modigliani & M. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 American Economic Review 3 (1958); Modigliani & Miller (1963), *supra* n. 3; M. Miller, *The Modigliani-Miller Propositions After Thirty Years*, 2 Journal of Economic Perspectives 4 (1988); S. Myers, *Determinants of Corporate Borrowing*, 5 Journal of Financial Economics (1977); H. DeAngelo & R. Masulis, *Optimal Capital Structure Under Corporate and Personal Taxation*, 8 Journal of Financial Economics 1 (1980); M. Jensen & W. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 Journal of Financial Economics (1976); R. Gertner, D. Scharfstein & J. Stein *Internal versus External Capital Markets*, 109 Quarterly Journal of Economics 4 (1994); B. Chowdhry & V. Nanda, *Financing of Multinational Subsidiaries: Parent Debt vs. External Debt*, 1 Journal of Corporate Finance 2 (1994).

which debt/equity and general anti-avoidance rules are used to recast intra-group debt as equity.

4.1.1. Tax differences between debt and equity

Finance literature often identifies the tax deductibility of debt as the most significant factor governing the choice between third-party debt and equity finance.[61] This factor applies equally, perhaps even more so, in the intra-group situation. However, Proposition 1 is about pre-tax differences between intra-group debt and equity, so this factor can be put to one side.

4.1.2. Bankruptcy risk

If a company leveraged with third-party debt becomes unable to service or repay any of that debt, the lender can take steps to bankrupt the company. This is costly to the company and can lead to the complete destruction of its value. Pre-bankruptcy enforcement action can also be damaging to the company's efficiency and reputation. Finance theory puts these costs forward as a reason for a company to prefer equity over third-party debt finance, at least beyond a certain level of leverage.

An intra-group lender, however, is in a different position from a third-party lender. Enforcement of the debt is not its only means of recovering its investment; it can rely on the equity relationship.[62] If it is not in the interests of the overall group that the subsidiary be bankrupted, and it usually will not be, then the intra-group lender will generally elect not to enforce its loan. The group is compensated by the preservation of the value of its equity, and by future dividends. The underperforming assets can also be redeployed in another part of the group, a further advantage which an intra-group lender has over an unrelated lender.[63]

The same reasoning applies to situations less extreme than potential bankruptcy. If the subsidiary has short-term cash flow difficulties, the intra-group lender will tend to waive or defer an impending payment on the loan, or cause an injection of equity, if repayment is not in the overall group's interests at that point in time.

Further, if the position is just that the subsidiary has identified a more profitable use for the funds which had been earmarked for repayment to the intra-group lender, it is also economically rational for the lender to permit this use to take priority over its loan, or to invest equity to enable both payments to be made.

Because intra-group loans do not involve the same bankruptcy risk as third-party loans, this explanation does not apply in the intra-group context.

4.1.3. Informational asymmetries

One theory posits "information asymmetries" as a reason to prefer either equity or debt finance, depending on which funding source is more concentrated (and ultimately to prefer internal sources of funding).[64] Widely dispersed shareholders or bondholders are assumed

61. Modigliani & Miller (1963), *supra* n. 3; Chowdhry & Nanda, *supra* n. 60.
62. Gertner, Scharfstein & Stein, *supra* n. 60, p. 1212.
63. Gertner, Scharfstein & Stein, *supra* n. 60, p. 1213.
64. S. Bharath, P. Pasquariello & G. Wu, *Does Asymmetric Information Drive Capital Structure Decisions?*, 22 Review of Financial Studies 8 (2009); D. Diamond, *Financial Intermediation and Delegated Monitoring*, 51 Review of Economic Studies 3 (1984); Gertner, Scharfstein & Stein, *supra* n. 60, p. 1212.

to have less information about the group's true prospects than management, a majority shareholder or a concentrated lender, such as a bank. However, even concentrated external financiers can suffer information disadvantages compared with internal financiers, as the recent financial crisis has shown. Information asymmetries can be reduced through monitoring, but this too is costly.

The crux of this theory is that costly informational asymmetries may arise where there is a distance between the financier and the corporate group. Therefore, this theory does not assist in distinguishing intra-group debt from intra-group equity. Indeed, as Miller has noted, the agency and incentive problems associated with external debt are moderated where the lender is also the shareholder.[65]

4.1.4. Management incentives – Overcoming agency costs

The management incentive theory favours third-party debt over equity. It posits that local management will perform better if their subsidiary is highly leveraged.[66] Two main reasons are given for this. One, the high interest costs will restrict the free cash flow of the company and prevent the managers from making complacent investments, or siphoning perquisites, out of an excess of cash. Two, it will keep the managers nimble, as they face the constant threat of bankruptcy.

In the intra-group context, however, these conclusions do not necessarily follow.

Free cash flow within the subsidiary can be moved to the parent level through dividends and reductions of capital; intra-group interest is not the only way to achieve this goal. And even if intra-group debt is used to keep the subsidiary's cash reserves low, if local management convince the group that it has identified a more profitable investment opportunity, this debt is liable to be overridden, because the lender has an interest in that profit.

The aim of keeping management nimble, too, is not achieved as effectively with intra-group debt as with third-party debt. Management knows that an intra-group lender is unlikely to bankrupt their subsidiary, as discussed above.[67] Replicating the incentivizing effects of high third-party leverage is probably more effectively achieved through synthetic methods such as a formula in the managers' compensation agreement which, for example, rewards profitability only after a certain threshold has been met.

4.1.5. Signalling costs

This explanation suggests that companies should take on less third-party debt than they could bear, as this sends positive signals to the marketplace. Having spare debt capacity makes management appear confident and the company appears a safe investment.[68] High leverage, on the other hand, can signal weakness or precariousness; it may suggest that the company has had to call in all of its lines of credit.

65. Miller (1988), *supra* n. 60.
66. Jensen & Meckling, *supra* n. 60.
67. *See also* B. Akbel & M. Schnitzer, *Creditor Rights and Debt Allocation within Multinationals*, Governance and the Efficiency of Economic Systems Discussion Paper No. 304 (2009).
68. Modigliani & Miller (1963), *supra* n. 3.

This factor is also unpersuasive in the intra-group context. Intra-group finance is often invisible to the market, as it disappears upon consolidation. Even when it is visible, however, it stands to reason that the market perceives intra-group debt as similar or equivalent to equity, for the other reasons discussed in this section and because the interest and principal paid on intra-group debt are retained by the group rather than being permanently lost to it. It would follow that there is no substantial signaling difference between intra-group debt and equity.

4.1.6. Stage in business maturity

One theory holds that equity is preferable for new and risky ventures, as it acts like a call option and prevents "debt overhang", and then third-party debt becomes relatively more attractive as the business matures and its growth rate flattens.[69]

However, intra-group debt is also a call option in the sense in which that term is used in this theory. An established corporate group can choose to fund a new, risky subsidiary with intra-group debt or equity, albeit that it must have at least a nominal amount of equity. Even if it chooses large amounts of debt, if the venture fails the group does not need to enforce the debt, and it will often make no economic sense to do so: the debt is sunk in the manner of an equity investment (or the purchase price of an unexercised call option). But if the investment is a success and generates super-profits, the group can still enjoy these through its equity link to the subsidiary, even a nominal equity link. The upside of the option is preserved, whether intra-group debt or equity is used.

4.1.7. Treasury and regulatory efficiencies and corporate law

There is said to be a corporate treasury advantage to using intra-group debt instead of intra-group equity. It is the administrative ease with which interest and principal payments can be made, as a way of repatriating funds to the parent, compared with the cumbersome legal process for declaring a dividend. Further, in jurisdictions with high regulations on foreign direct investment, intra-group loans can be more manageable than equity from the perspective of exchange, corporate capital and foreign investment controls. The size of this advantage will depend on the nature of the legal, administrative and regulatory hurdles (and the relative administrative costs of intra-group debt such as legal and transfer pricing compliance), although it is unlikely to exceed the tax advantage in most cases.

There is also a corporate law restriction on dividends in some jurisdictions which is put forward as a reason to prefer intra-group debt. In many countries, dividends can only be paid to the extent to which the company has profits, usually accounting profits.[70] In these countries, intra-group debt allows the repatriation of excess cash when cash flow exceeds accounting profits. However, this can also be done without intra-group debt by a return of capital, although in some jurisdictions this involves additional corporate law steps.

More fundamentally, these explanations do not provide an in-substance distinction between intra-group debt and equity. If debt is being used to repatriate in-substance profits to the parent, then it resembles equity, not debt. The practical reasons for its use may be sound, but it does not necessarily follow that the "interest" needs to be tax deductible.

69. *See* Myers (1977), *supra* n. 60
70. For example, most continental European countries, as well as the United Kingdom and Hong Kong; however, many other countries have a less stringent "solvency test": Australia, Canada and New Zealand.

4.1.8. Debt/equity characterization rules

The reasons put forward to distinguish third-party debt from equity generally do not hold in an intra-group situation, and the intra-group-specific reasons likewise fail to distinguish intra-group debt from equity in terms of economic substance.

This raises the question of whether tax rules in place in some countries which take an economic substance approach to distinguishing debt from equity should recast intra-group debt as equity for tax purposes.

The country with the most substance-bound debt/equity rule is the United States. Many of the cases under the debt/equity rule in section 385 of the Internal Revenue Code involve shareholder loans.[71] However, the section does not achieve a wholesale recharacterization of intra-group debt as equity – the group relationship is recognized in a handful of the many "factors" developed by the courts, but there are many factors which can point the other way even in an intra-group situation.[72]

The latest US debt/equity cases involving intra-group debt, *NA General Partnership (Scottish Power* case)[73] and *PepsiCo*[74] suggest that section 385 is not an effective or predictable method for recasting intra-group debt as equity based merely on the fact that it is intra-group.[75] Avi-Yonah, Ring and Brauner suggest that debt/equity rules could achieve the objective of interest limitation rules more effectively, but also conclude that this outcome is unlikely at present.[76]

Australia's debt/equity characterization rules are probably the next most substance-based, although they involve a statutory "bright line" test rather than a multifactorial judicial test. The test does involve a qualitative consideration, however, being whether the borrower has an "effectively non-contingent obligation"[77] to repay the amount advanced. If it does, and is not subject to a statutory exception, the instrument will be debt. The Parliamentary material relating to this rule suggests that "non-contingent" is a legal test but that the adjective "effectively" broadens the test.[78] This begs the question of whether an intra-group loan could satisfy the "in substance or effect" test. As Rosenbloom has put it, in the context of the US debt/equity test:

> an obligation owed by one piece of paper to another (both controlled by the same interests) is hard to satisfy as an 'unconditional promise' to pay a 'sum certain' at a 'fixed maturity date' (or on demand) within the 'reasonably foreseeable future'. It may have the appearance of touching each of these bases, but the reality of the situation belies satisfaction of any of these points. There is no 'unconditional promise' when the parties can, with a wave of the pen, waive their prior handiwork.[79]

71. For example, *Roth Steel Tube* (1986) 800 F2d 625; *Nestle Holdings Inc v. Commissioner for Internal Revenue* (1995) TC Memo 1995-441 and cases cited therein.
72. *See also* Rosenbloom, *supra* n. 58, p. 33.
73. *NA General Partnership v. Commissioner of Internal Revenue* (2012) TC Memo 2012-172.
74. *Pepsico Puerto Rico Inc v. Commissioner of Internal Revenue* (2012) TC Memo 2012-269.
75. But *see also Hewlett-Packard Company v. Commissioner of Internal Revenue* (2012) TC Memo 2012-135.
76. R. Avi-Yonah, D. Ring & Y. Brauner, *US International Taxation, Cases and Materials*, 3rd ed. (New York, Foundation Press, 2011), p. 186, footnote 2.
77. Sec. 974-20, Income Tax Assessment Act 1997 (Australia).
78. Explanatory Memorandum to *New Business Tax System (Debt and Equity) Bill 2001* (Australia), para. 2.181; *see also* the descriptions "in substance or effect" in section 974-135, Income Tax Assessment Act 1997 (Australia).
79. Rosenbloom, *supra* n. 58, p. 34.

However, given the investment of Australia's tax authority in the interest limitation and transfer pricing rules in the intra-group debt context,[80] it is unlikely that the debt/equity rules will be used systematically for this purpose in the near future.

4.1.9. Recharacterization under general anti-avoidance rule

The fact that the analysis supports the correctness of Proposition 1 also raises the question of whether a general anti-avoidance rule (GAAR) could operate to deny related party interest deductions. However, so far attempts by governments to apply a GAAR to the decision to use intra-group debt instead of equity have failed.[81] There is a perception that attempting to apply a GAAR to such a fundamental and simple business decision would be a crossing of the Rubicon, a risk not worth taking given the proliferation of specific regimes directed at intra-group debt.

4.2. Proposition 2 – A subsidiary has an identifiable arm's length amount of debt and an intra-group loan has an identifiable arm's length price

The stand-alone approach is premised on this proposition. This is so both for the strict (orphan assumption) stand-alone approach used in the United Kingdom as well as the traditional arm's length rule used in most countries to price intra-group interest rates.

4.2.1. Large range of "arm's length" outcomes and consequential electivity

While the traditional arm's length analysis starts with the pricing of a given transaction, in the debt context it is not possible to start and finish with the interest rate. Interest rate is influenced by debt amount and vice-versa; the two concepts cannot be separated. For that reason, this proposition considers both the supposed arm's length debt amount and the supposed arm's length interest rate which corresponds to it.

The UK rules, in their assumption of a single arm's length debt amount and interest rate, have been criticized as:

> wholly unsatisfactory… [as] most creditors, other than banks, could be said to be perfectly happy to lend to any debtor, irrespective of its credit rating and its debt:equity ratio.[82]

A similar point was made by private sector submissions on to the Australian tax ruling that raises the proposition of a debt level in excess of arm's length leverage.[83] As discussed above, the OECD PE Report also queries whether it is possible to determine the arm's length leverage ratio (under the thin capitalization approach to free capital) outside the financial sector.[84] A number of economics and law experts have also proposed that there is no one

80. Division 815 and section 815-25, Income Tax Assessment Act 1997 (Australia); Australian Tax Office Ruling TR 2010/7.
81. H. Fischer & A. Lohbeck, *Germany Report: The Debt-Equity Conundrum*, 97b Cahiers de Droit Fiscal International (2012), p. 319; *Bundesfinanzhof* (BFH – Federal Fiscal Court), I R 127/90, 5 May 1992, BStBl II 1992, 532. In Australia the tax authority has so far abandoned each of its attempts to apply the GAAR to the decision to use debt rather than equity, *see also Commissioner of Taxation v. Hart* (2004) 217 CLR 216, para. 3.
82. J. Ghosh, *UK Report: New tendencies in tax treatment of cross-border interest of corporations*, 93b Cahiers de Droit Fiscal International (2008), p. 743.
83. Compendium to Australian Taxation Office Taxation Ruling TR 2010/7.
84. OECD PE Report, *supra* n. 1.

arm's length leverage amount, and no one corresponding arm's length interest rate; rather there is a substantial range.[85]

Third-party debt amounts of multinational groups vary widely, even within industries or market capitalization brackets. Some lenders, particularly banks, have restrictions on borrowers based on credit rating. However, the market for credit is an entrepreneurial one like any other market, and gaps in that market tend to be filled by enterprising lenders. In the corporate context, the reality of the junk bond market and hedge fund private loans exemplifies this.

The counter-argument is that high debt amounts and correspondingly high interest rates, while attractive to a potential lender, would not be agreed to by the subsidiary borrower, acting rationally. This is so particularly when they have the alternative option of equity, financed through cheaper debt at the parent level. The arm's length standard requires a hypothetical arrangement which would be agreed to by both parties.

Even so, under the arm's length approach there will often be a large range of permissible debt amounts and corresponding interest rates. The significance of this range, and the positive relationship between debt amount and interest rate, is that it offers multinational groups an element of electivity in setting intra-group debt amounts and rates. Rosenbloom refers to intra-group debt as "a transactional election … which the tax planner may choose, or not choose, to put in place".[86]

Pursuant to this electivity, the group will often use intra-group debt to leverage subsidiaries at ratios significantly higher than the group's third-party leverage ratio. That is because the arm's length standard looks at how much "could" have been borrowed from third parties, not how much was in fact borrowed from third parties.[87] In relation to third-party debt, there is evidence that firms tend to borrow less than they could; Modigliani and Miller call this "a substantial reserve of untapped borrowing power".[88] This is consistent with the signalling theory referred to above in relation to Proposition 1. Under the arm's length standard, this spare capacity can be captured – by replicating the thin capitalization of the "lowest common denominator" in the comparables group – and turned into interest deductions. Due to the mobility and fungibility[89] of debt, these deductions can be taken where they result in significant tax savings.[90]

There is little support for Proposition 2. There is no one arm's length amount or price of debt, rather, there is a large range. The range can be used, at the company's election, to create intra-group debt and corresponding tax deductions.

85. Modigliani & Miller (1958) *supra* n. 60; and Modigliani & Miller (1963), *supra* n. 3; Benshalom (2008), *supra* n. 5, pp. 184 and 220; P. Blessing, *The Debt-Equity Conundrum – A Prequel*, 66 Bull. Intl. Taxn. 9, p. 208 (2012), Journals IBFD.
86. Rosenbloom, *supra* n. 58, p. 34.
87. The tension between a "could" and a "would" test has been noted by the Board of Taxation of Australia in its review of the thin capitalization arm's length debt test: Board of Taxation (Australia), *Review of the Thin Capitalization Arm's Length Debt Test: Discussion Paper* (Government of Australia, 2013), pp. 30 and 35.
88. Modigliani & Miller (1963), *supra* n. 3, p. 442; *See also* Allen, *supra* n. 3 and other studies cited therein; Myers (1984), *supra* n. 3; Leary & Roberts, *supra* n. 3.
89. Benshalom (2008), *supra* n. 7.
90. *See* studies at *supra* n. 9.

4.2.2. *Fungibility and no internal value-add*

Another way of showing that the traditional "stand-alone" arm's length standard makes little sense for intra-group debt is to attempt to trace a dollar of profit earned by a company back to either debt or equity finance. It cannot be done. Finance is fungible, and intra-group debt is equivalent to equity, as discussed under Proposition 1. Transfer pricing, however, is ultimately a quest to trace profits back to their sources in the various jurisdictions in which the multinational group operates.

The basic example of transfer pricing of a widget may illustrate this proposition. A firm sells widgets to its ultimate customers for USD 50 each. The firm has a basic manufacturing subsidiary in state A, then the partially finished widgets are shipped to state B for more complex finishing, then the finished widgets are shipped to state C for marketing and sale. The raw material, labour and transport costs are USD 30. Transfer pricing seeks to allocate the USD 20 profit between states A, B and C. Various transfer pricing methodologies exist, but the essential enquiry is: how much value was added in each state? The result of the methodologies may be that USD 5 of value was added in state A, USD 6 in state B and USD 9 in state C.

The allocation between all three countries will be the same regardless of whether debt or equity finance was used. Value is created by the firm's assets, which are purchased using debt or equity finance, it is not created directly by the debt or equity itself. It is these assets, particularly intangible and human capital assets, which allow the firm to extract economic rents in the marketplace. Whereas a dollar of debt finance is worth the same as a dollar of equity finance (although at the third-party finance level the respective costs of raising it may be different), and this worth remains the same as the dollar moves through the group in the form of either equity or intra-group loans. There is no transformation and no internal value-add with respect to the finance itself.[91] It is not possible to say that any part of the group's ultimate profit is attributable to debt finance as opposed to equity finance.[92]

For this reason, the task of applying transfer pricing rules to intra-group debt might be completely inappropriate, rather than just one which is difficult or bedevilled by a large range.

On the upside, this analysis suggests that the difficulties and intransigent positions involved in the transfer pricing of intangibles and other high value or unique sources of economic rents can be largely avoided in the intra-group debt context. If the BEPS initiative is looking for "low hanging fruit", a discrete regime for intra-group finance is a good candidate. As explored in the next two propositions, a worldwide debt-to-capital ratio limitation is a principled, neutral interest allocation rule, and it also prevents substantial base erosion and profit shifting.

91. The lack of value-add from intra-group debt, as compared with intra-group research and development or headquarters activities, is recognized in M.J. Graetz, *A Multilateral Solution for the Income Tax Treatment of Interest Expenses*, 62 Bull. Intl. Taxn. 11, p. 491 (2008), Journals IBFD.

92. The position may well be different for financial services businesses, however, where a loan *is* the proverbial widget, in the sense of being part of the business's stock-in-trade. For this reason and others, financial services groups are outside the scope of this article, *see supra* sec. 2.1.

4.3. *Proposition 3 – A multinational group's choice of location for its third-party debt is influenced (or even dominated) by tax considerations*

As discussed above, there is much support for Proposition 1: that intra-group debt is substitutable with equity, pre-tax. By contrast, Proposition 2, that intra-group debt has a given arm's length amount and price, lacks support. One natural tax policy response to these results is to treat intra-group debt as equity, for tax purposes. The primary consequence would be a disallowance of deductions for intra-group interest payments, as if they were dividends.

4.3.1. Shifting of third-party debt

However, this would not necessarily solve the problem of tax-motivated electivity in relation to the debt and equity financing of multinational groups. Empirical research suggests that intra-group debt and third-party debt are often substitutable.[93] Many high-tax countries have interest limitation rules, but as the majority of these involve a fixed ratio limit, with some ratios being quite generous, the group can allocate all or most of its third-party debt amongst these countries without exceeding the respective limits. Further, many interest limitation regimes do not apply to third-party debt at all.

Proposition 3 concerns the extent to which third-party debt is (and can be) shifted between a multinational's jurisdictions for tax reasons. Because intra-group and third-party debt are fungible – both result in a fixed amount of finance being available to the relevant subsidiary – it prima facie follows that the latter can be substituted for the former in response to the disallowance of deductions for intra-group interest.

4.3.2. Guarantees, implicit support and unsupported third-party debt

Third-party debt of a subsidiary which is guaranteed by a foreign parent is economically equivalent to debt of the parent which is then invested by the parent in the subsidiary. In this situation the lender is usually content to lend to either company, so long as it has recourse to the parent's assets. Therefore, guaranteed debt can be seen as mobile and able to be shifted depending on tax conditions (or other conditions, although usually tax reasons have the biggest cash impact). It is for this reason that many interest limitation regimes treat guaranteed third-party debt like intra-group debt.

A more difficult example is presented by third-party debt of a subsidiary which is not expressly guaranteed by the parent (or another asset-rich part of the group). A phenomenon referred to as "implicit support" is recognized by those experienced in estimating the credit profile of members of corporate groups.[94] According to this concept, a subsidiary's credit profile is enhanced by its group membership, even if the parent or other group company does not provide a guarantee. The assumption is that it will usually be in the parent's interests to help the subsidiary to service the loan, even without a legal obligation to do so, rather than see the subsidiary bankrupted or otherwise damaged by defaulting on the third-party loan.

93. Desai, Foley & Hines, *supra* n. 9; Dessler & Scheuering, *supra* n. 32, p. 4 and studies cited therein.
94. *See* the *GE Capital* decisions in Canada, *supra* n. 22; Tarassov & Tsiopoulos and Russo & Shirazi, both *supra* n. 23; N. Dewaelheyns & C. van Hulle, *Internal Capital Markets and Capital Structure: Bank Versus Internal Debt*, 16 European Financial Management 3 (2010).

Implicit support exists along a spectrum, from strong implicit support, akin to a legal guarantee, to weak or no implicit support. Because it has this gradation effect rather than being a yes/no proposition, implicit support makes it difficult to distinguish between the tax reasons and the non-tax reasons for locating third-party debt in a particular country.

For example, consider a multinational with a subsidiary in a country facing high political risk. The group can assume the risk and finance the subsidiary with equity or intra-group debt. Alternatively, it might prefer for the subsidiary to borrow from a third party. The third party, in such a situation, is likely to request a parent company guarantee. If the parent refuses to guarantee, a high interest rate will be charged, pricing-in the political risk. In that situation, it appears that non-tax factors determined that third-party debt should be located in this jurisdiction. It makes sense to allow a tax deduction in that jurisdiction for all of the interest. After all, it is a real cost of doing business in that high political risk country.

However, there is no easy way to distinguish that situation from one in which tax considerations have played a material role in the location of third-party debt. Because of implicit support, a third-party lender may be content to lend to a subsidiary rather than to the parent company, even without a parent guarantee. It may, through a choice of law clause, nominate the law of a country with high levels of creditor protection, but this will not impact on tax deductibility. In the face of relative indifference on the part of the lender, therefore, the group can select the location in which interest deductions are maximized.

The presence of an express limited recourse clause in the loan agreement (often found in project finance) may be the most robust objective sign that the location of the debt is not tax motivated. Some countries may decide to exclude limited recourse debt or other objectively "quarantined" debt from the interest limitation rule.[95] However, this is not a perfect distinction. The parent company can still effectively override a limited recourse clause if it is in the group's interests to do so.

Of course, third-party debt is not offered in every country on equally attractive terms. Some countries, particularly the United States, have very deep and liquid debt markets and the choice of locating third-party debt there will often be influenced by this (non-tax) factor. However, in most of the countries concerned about interest stripping, a subsidiary of a multinational can obtain credit directly from US or other large foreign markets, even without a parent guarantee. Further, there is the question of whether a country in which credit happens to be cheap and widely available should have to bear the lion's share of the third-party interest deductions of multinational groups. This is discussed below in relation to Proposition 4.

4.3.3. Evidence of tax-motivated shifting of third-party debt

Despite the existence of non-tax reasons for the location of third-party debt, there is significant empirical evidence that the location of third-party debt is shifted for tax reasons,[96] although the responsiveness of third-party debt levels to the local corporate tax rate is not as high as the responsiveness of intra-group debt.[97] Similarly, interest earning investments (both third-party and intra-group) tend to be located in low tax jurisdictions.[98]

95. Cf. sec. 820-39(3) of the Income Tax Assessment Act 1997 (Australia).
96. *See* studies *supra* n. 9.
97. Ibid.
98. Benshalom (2008), *supra* n. 7.

4.4. Proposition 4 – For tax purposes, a multinational group should have the same level of leverage and interest rate in each jurisdiction in which it operates

If it is accepted, in line with Proposition 3, that third-party debt is often located in a particular country for tax reasons and that it is not possible to easily observe the exceptions to this proposition, it follows that some other basis for allocating the third-party debt deductions of a multinational should be investigated.

4.4.1. Equalizing the debt-to-capital ratio across the multinational group

This is where the "worldwide ratio" approach of allocating third-party interest deductions in proportion to assets in each jurisdiction returns to the analysis.

Because debt and equity finance both consist of money and are therefore fungible, and because together (and inextricably) they finance all assets, it is logical for assets (or another proxy for value) to be the "key" by which third-party interest deductions are allocated.

The worldwide ratio of third-party debt to assets can be seen as the appropriate ratio to also impose at the subsidiary level because allowing any other ratio invites tax-motivated leveraging and debt shifting, as discussed above in relation to Propositions 2 and 3. Further, the group's third-party leverage ratio is economically significant. It is direct arm's length evidence. To quote Edgar:

> The rationale for the use of this identification tool is the fact that the consolidated leverage of the group reflects the level of risk acceptable to shareholders, who determine the level of acceptable leverage through the share-pricing process.[99]

Insisting on the same leverage ratio for every country in which a group operates may seem excessive. After all, the various subsidiaries of a multinational may have different business models and strategies, making different leverage ratios appropriate. However, as demonstrated under Proposition 1, the traditional business reasons for using debt or equity break down in most intra-group settings: the group will obtain third-party finance as cheaply as possible (this will often be on a centralized basis) and will distribute the finance through the group as equity or intra-group debt (with tax as the main distinguishing factor). Equalizing the leverage ratio may be seen as unfair, though, where the group has compelling non-tax reasons for the location of its third-party debt, such as those discussed under Proposition 3 above.

However, it bears noting that this is a consequence of the long-standing US outbound interest allocation rules, so it is not a novel or startling consequence. That is, even though the size of the US debt markets is a significant non-tax reason for locating third-party debt in the US, there is a tax penalty for having the US parent company act as "banker" for its subsidiaries (without earning commensurate intra-group interest from them).

A worldwide ratio rule does not force a multinational for whom, say, the United States is the cheapest source of third-party credit to instead obtain more expensive third-party loans in other countries. The US company can remain the "banker" for the whole group and intra-group debt can appropriately be used to pass this finance through the group so that the other subsidiaries have the same leverage level. The US company's intra-group loan assets will

99. Edgar, Farrar & Mawani, *supra* n. 47, p. 856.

increase as a result and it will no longer be disproportionately leveraged compared to the rest of the group. It will be taxed on the intra-group interest income, ensuring the United States does not bear a disproportionate deductions burden.

4.4.2. How to measure assets?

Using the consolidated debt-to-assets (or debt-to-equity) ratio of the worldwide group, and comparing it to the debt-to-assets ratio in each jurisdiction, puts significant pressure on the definitions of debt and assets – particularly assets. Accounting measures of assets are objective and easy to observe and for this reason are attractive as a definition. However, in many cases the market value of a company or group far exceeds its book value.

The market value of assets is probably the most appropriate definition of "assets" for the purposes of a worldwide debt-to-assets ratio rule, given the way that debt and equity together fund the firm (including its off-balance sheet assets and sources of value). While market capitalization can be used to measure the group's consolidated debt-to-market-value ratio if it is listed, the respective market values of subsidiaries are generally not easily observed.

The next best solution may be to define assets as book assets plus payroll, at least for corporate groups in the services industries or industries involving significant off-balance sheet value.[100]

The reliance on accounting assets in each jurisdiction (even if payroll is also included) raises the question of the mobility of certain assets – particularly the financial and intangible assets that the BEPS project is most concerned with. However, if a worldwide debt-to-assets ratio interest limitation rule creates incentives to shift accounting assets to high tax countries for tax purposes, those incentives run counter to the existing incentives to shift mobile assets to low tax jurisdictions. At least, this is so for non-financial groups for whom third-party interest expense significantly exceeds third-party interest income. For them, shifting accounting assets to tax havens will have the negative consequence of reducing the interest deductions that are available in higher tax jurisdictions. In this way, tackling intra-group debt as part of the BEPS project could have a knock-on positive effect for the other, larger BEPS topics of stripped supply chains and transfer pricing of intangibles.

4.4.3. Is this formulary apportionment?

In some ways, the worldwide ratio approach resembles formulary apportionment: it takes the total third-party debt of the group and "spreads" it amongst jurisdictions in proportion to assets, by inviting subsidiaries to equalize their debt-to-capital ratios in order to not suffer disallowance of interest deductions.[101]

However, a worldwide ratio interest limitation rule is fundamentally different from formulary apportionment in the traditional (and controversial) sense, which seeks to apportion a group's profits. This interest limitation rule undertakes the more modest task of allocating the group's interest cost. It does not interfere with profits, which are more complex and mul-

100. Benshalom (2008), *supra* n. 7, pp. 207-215.
101. For example, Edgar, Farrar & Mawani, *supra* n. 47, p. 856 consider the group's worldwide leverage ratio to be a defensible ratio to apply to each of the subsidiaries as well, but baulk at the resemblance to formulary apportionment and its attendant controversies.

tifaceted. It recognizes that it is not possible to trace a particular profit back to a particular source of finance, debt or equity, and does not attempt to do so.

Further, a multilateral regime, as necessary under most formulary apportionment proposals, is not needed. The existing tool of a worldwide ratio rule in countries' domestic interest limitation legislation can be used. This is convenient in countries where taxation by reference to notional transactions is not permitted.[102] In these countries, the subsidiary is required to acquire actual leverage (either third party or intra-group) up to the worldwide ratio if it wishes to obtain the maximum interest deduction to which it is entitled.

The rule works equally well if some countries instead allow notional deductions for interest on debt up to the worldwide leverage ratio limit, regardless of the subsidiary's actual balance sheet. This approach is likely to be preferred by taxpayers to the approach in the previous paragraph as it does not require subsidiaries' debt to be altered as and when the worldwide ratio changes, and it also allows deductions for fatly capitalized subsidiaries. However, not all countries are able or willing to allow notional interest deductions.

4.4.4. Conclusion on Proposition 4

As explored above, equalizing a multinational's leverage ratios across its various jurisdictions, for tax purposes, has the benefits of being a principled allocation rule and countering tax avoidance strategies. Although it is imperfect where there are strong non-tax reasons for locating higher leverage within a particular jurisdiction, this is a relatively minor imperfection as the rule would not disallow the extra interest deductions, but allocate them across the group, and harshness may be able to be further ameliorated with special rules for true non-recourse debt.

5. Consequence of Worldwide Ratio Approach – Elimination of a "Residual"

5.1. The concept of the "residual"

To illustrate the revenue preserving effect of a worldwide ratio rule, it is convenient to co-opt the familiar transfer pricing concept of the "residual" – the part of a corporate group's profit which cannot be allocated under the arm's length principle. It emanates from the parts of the group working together to earn the profit rather than working as stand-alone entities as assumed by the arm's length principle. Significant study has gone into the question of how to allocate the residual between the countries in which the multinational operates, whether under traditional arm's length rules or a formulary apportionment approach.[103]

The word "residual" is also sometimes used in a different way, to describe the cost "saving" when the group's actual costs are compared to the costs it would face if all of its entities had to transact on an arm's length basis. It is in this sense that one can speak of a "residual" with

102. For example, due to European Court of Justice requirements.

103. R. Vann, *Taxing International Business Income: Hard-Boiled Wonderland and the End of the World*, 2 World Tax J. 3 (2010), Journals IBFD; W. Schön, *Transfer Pricing – Business Incentives, International Taxation and Corporate Law* in W. Schön & K. Konrad (eds.) *Fundamentals of International Transfer Pricing in Law*, (Berlin, Heidelberg, Springer-Verlag, 2010) R. Avi-Yonah & K. Clausing, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment*, in J. Furman & J. Bordoff (eds.) *Path to Prosperity: Hamilton Project Ideas on Income Security, Education, and Taxes* (Washington, Brookings Institution Press, 2008), p. 319; S. Langbein, *The Unitary Method and the Myth of Arm's Length* 30 Tax Notes (1986), p. 625.

respect to the financing transactions of non-financial institutions, for whom interest is usually a substantial net cost.

5.2. *The large and unique residual for intra-group debt*

The author suggests that this residual is much larger for intra-group debt than for other transfers of goods and services in a transfer pricing context, and that most of it is different in kind from the traditional residual. Part of it is a traditional (cost savings) residual, in the form of the difference between the third-party interest rates actually paid by the group and the (higher) intra-group interest rates that can often be justified at the subsidiary level (with attendant debates about the level of implicit parental support).

However, most of the residual in this context comes from the electivity as to the amount of debt. The arm's length standard allows subsidiaries to be leveraged up to the maximum justifiable debt (a "could" standard). This potential leverage ratio will usually be higher than the group's actual third-party leverage ratio, noting the observed phenomenon of spare debt capacity and the large range discussed in relation to Proposition 2. In turn, this multiplies interest deductions because of the positive relationship between debt amount and interest rate.

This particular residual is unique to the intra-group debt context. It exists because debt and equity are fungible: the "could" analysis turns up many different potential outcomes because, under each, the balance of what is not funded by debt can be funded by equity. This residual has the potential to be large: not just a fraction of the interest cost but a major part of it. When it is added to the traditional residual based on different interest rates, the total residual can be very large indeed.

5.3. *Policy analysis*

In the author's view, there is no convincing policy reason for allowing this large residual to be used to reduce taxes in the jurisdictions in which the group operates. Both the size of the residual and the jurisdictions in which it is taken as a deduction are largely within the control of the multinational group, as discussed above. Intra-group debt is simple to create and, as shown in Proposition 1, is substitutable with equity, which inheres in every group relationship. Further, third-party debt is relatively simple to relocate, as shown in Proposition 3. Tax-motivated debt creation and shifting also cause deadweight losses from implementation costs, transfer pricing compliance costs, and pre-tax inefficient allocation of capital.[104]

The above "residual" analysis has considered interest cost only, not interest income. While all intra-group interest expenses will, in theory, be matched by intra-group interest receipts in other entities within the group, it is largely within the group's control to ensure that the deductions for the former exceed the taxable inclusion of the latter. This is achieved by the lending companies being in lower tax jurisdictions than the borrowing companies, or being in tax loss, and/or through the avoidance of CFC attribution and the use of hybrid instruments and entities and other arbitrages by which the interest income is taxed nowhere, or lightly. It can therefore be assumed that the multinational group will have net deductions from intra-group financing, not just from third-party loans. The tax-motivated shifting of

104. Huizinga, Laeven & Nicodeme, *supra* n. 9, p. 114.

interest-earning assets to low tax jurisdictions can be neutralized if the rule applies to spread the multinational's *net* interest deductions amongst the jurisdictions, but as discussed below this would represent a more ambitious reform which would also do some of the work of CFC rules.

6. Achievable Next Steps

6.1. Wider adoption of worldwide leverage ratio rule

The recommendation of this article is that the BEPS project endorse, and more countries adopt, a worldwide debt-to-capital ratio interest limitation rule: one which denies interest deductions on debt where its proportion to the company's assets exceeds the proportion that the group's worldwide third-party debt bears to its worldwide third-party assets. This rule is inherently suited to international harmonization. It makes sense to extend the rule to net interest deductions, thereby also spreading the group's interest income around the jurisdictions based on assets. This would represent a more fundamental reform, moving into territory currently occupied by CFC rules.

A worldwide leverage ratio limit is preferable to a worldwide interest-to-profits ratio limit because the latter is more prone to fluctuations caused by factors beyond the group's control.

Some countries have adopted such a rule already (albeit for gross, not net, debt): Australia, Germany and New Zealand, although they have accompanied it with alternative tests of varying permissiveness. But this shows that the worldwide ratio rule exists in the toolbox of current rules. It is also familiar to countries with an apportionment-based interest allocation rule for outbound investment, such as the United States.

All attempts should be made to harmonize the details of the worldwide leverage ratio rule. Present differences between methods of accounting for debt, equity and assets (particularly the differences between US GAAP (Generally Accepted Accounting Principles) and IFRS (International Financial Reporting Standards) will probably be the most significant barrier in the way of complete harmonization of the mechanics of the rule.

6.2. Consistency with international framework and EU law

The existing international tax framework of bilateral and multilateral treaties does not need to be changed in order to implement this recommendation. An extension of the worldwide ratio model is a multilateral apportionment system for the financing expenses (and income) of multinationals including those in the financial sector such as the models of Graetz and Benshalom.[105] However, the more modest proposal of convergence around a worldwide ratio rule achieves most of the same objectives, at least for non-financial institutions, and can be implemented more easily and progressively.

Further, the Multilateral Convention on Mutual Administrative Assistance in Tax Matters facilitates the effective operation of the worldwide ratio rule. As at December 2013 the convention has been signed by 64 countries.[106] Source countries could use this convention to

105. *See supra* ns. 5, 7 and 91.
106. OECD Press Release, "*Kazakhstan signs the Convention on Mutual Administrative Assistance in Tax Matters*", 23 December 2013, available online at http://www.oecd.org/ctp/exchange-of-tax-information/kazakhstansignstheconventiononmutualadministrativeassistanceintaxmatters.htm.

obtain or confirm information about the group's worldwide third-party leverage ratio, easing a "practical difficulty" that was identified by Graetz in 2008.[107]

Before recommending widespread adoption of worldwide ratio rules, their ability to survive European Court of Justice (ECJ) scrutiny should be considered. It might be argued that a worldwide ratio rule breaches the freedom of establishment[108] by discriminating between domestic companies and foreign-controlled (or foreign investing) companies. By the same reasoning, the rule might also be accused of breaching bilateral tax treaty non-discrimination articles.

To illustrate the argument, imagine that Poland introduced a worldwide ratio rule. The claimant before the ECJ is a Polish subsidiary with an Irish parent company and a low third-party leverage ratio. It compares itself to a more highly leveraged Polish domestic group and feels discriminated against because the Polish group has higher interest. It may even put forward evidence that, statistically, Irish third-party leverage ratios are lower than those in Poland. The Irish-controlled Polish company argues that, in preventing it from deducting interest at the same leverage ratios as its Polish peer, the worldwide debt test is discriminatory and inhibits free establishment of companies (or Irish-controlled companies, specifically) in Poland.

The argument would remain unchanged even if every EU Member State had a worldwide ratio rule in identical form.

To respond to this case, the author would argue that there is no "discrimination based on the place in which companies have their seat".[109] The difference in the tax treatment of the Irish-controlled Polish company and its Polish domestic peer is a disparity based on different third-party leverage ratios. This disparity exists domestically too; it is an observed variation among businesses. Two given all-Polish groups, for example, may have different leverage ratios even if their operations are similar.

There might be a general correlation between certain countries and higher or lower average leverage ratios, but there are statistically observable variations in many different business costs from one European country to another. In and of themselves, these variations do not violate the fundamental freedoms.

Further, the cause of the disparity, the group's third-party leverage ratio, is a matter which is wholly within the group's control. It is hard to argue that a member of a MNE is discriminated against because of a fact which the MNE can easily change. For example, the Irish-controlled group is free to borrow additional third-party debt in Poland (or Ireland), to mirror the third-party leverage ratio of the Polish company. Under the worldwide leverage rule the resulting interest deductions are not disallowed, although they are spread across Poland and Ireland proportionately to assets (whether through notional deductions, or the use of intra-group debt to equalize the leverage ratios).

Ultimately, the Irish-controlled group may still be dissatisfied with this result, because interest deductions are worth less in Ireland than in Poland due to a lower corporate tax rate. Indeed, different corporate tax rates are a factor in the statistical difference in aver-

107. *See* Graetz, *supra* n. 91, pp. 492-493.
108. Article 49 of the Treaty on the Functioning of the European Union; *see also* arts. 26, 54 and 63.
109. ECJ, 13 March 2007, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation*, para. 37.

age leverage ratios among countries.[110] However, the ECJ has said that disparities based on different tax rates (and other tax system features) amongst European countries are not a discrimination which violates the fundamental freedoms.[111] Setting tax rates remains a sovereign prerogative of a Member State. The Irish-controlled MNE will not obtain relief from the ECJ where its case boils down to the fact that the majority of its assets are in a country with lower tax rates.

It is probably necessary, from an ECJ perspective, for the worldwide leverage ratio rule to apply to domestic groups as well as to MNEs.[112] A de minimis rule (*see* below) should be applied so groups (domestic or international) with less than, for example, EUR 5 million of gross interest expense are excused from the rule. Even still, this might be criticized as overreaching, or perhaps the criticism can be levelled at the ECJ for requiring the overreach.[113] But it would immunize the worldwide leverage ratio rule from this attack in the ECJ.

As an aside, there is a possible rejoinder to the suggestion that it is just a burdensome formality to extend an interest limitation rule of this nature to purely domestic groups. It is easier to justify a worldwide leverage rule in a domestic setting than a fixed ratio interest limitation rule. The latter can arbitrarily disallow purely domestic, purely third-party interest deductions, if the domestic group happens to be leveraged more highly than the fixed ratio (or in case of a fixed interest-to-EBITDA ratio, if the domestic group happens to exceed that ratio). Whereas a domestic group will not offend its worldwide leverage ratio[114] unless it creates intra-group debt the tax consequences of which do not net out. They will usually net out, either under group relief rules or the general symmetry of deduction matching inclusion. If they do not, this might indicate that intra-group debt is being used to shift profits to a loss company or an otherwise lesser taxed group company, or that a hybrid is being used to obtain a tax advantage. In such a case, the policy behind the worldwide leverage ratio rule may also apply in a purely domestic context.

6.3. How to set the interest rate?

The interest rate on debt permitted under the proposed worldwide ratio interest limitation rule can be set at the average interest rate paid on the group's third-party debt. In the author's view, this is as reliable a source of relevant arm's length interest rate information as any other and is much simpler than the traditional transfer pricing exercise (*see* section 3.1.2.). However, if a country feels that this deviates too far from article 9, and a multilateral change in the rules cannot be achieved in the short term, the rate can be determined on the basis of traditional arm's length principles. Although this leaves open some room for profit shifting using interest rates, that is a marginal activity compared to profit shifting using debt amounts.

110. *See supra* n. 11.
111. FR: ECJ, 12 May 1998, Case C-336/96, *Gilly v. Directeur des services fiscaux du Bas-Rhin*, ECJ Case Law IBFD; DE: ECJ, 6 Dec. 2007, Case C-298/05, *Columbus Container Services B.V.B.A. & Co. v. Finanzamt Bielefeld-Innenstadt*, ECJ Case Law IBFD; NL: ECJ, 29 Nov. 2011, Case C-371/10, *National Grid Indus BV v. Inspecteur van de Belastingdienst Rijnmond/kantoor Rotterdam*, ECJ Case Law IBFD.
112. *Thin Cap* (Case C-524/04); DE: ECJ, 12 Dec. 2002, Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, ECJ Case Law IBFD; *Bosal* (Case C-168/01).
113. UK: Opinion of Advocate General Geelhoed, 29 June 2006, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*, ECJ Case Law IBFD, para. 68.
114. "Worldwide" is something of a misnomer in this context.

The multilateral change in the rules flagged in the previous paragraph may come out of the work on BEPS Action Item 4, which recognizes that interest barrier and transfer pricing rules are interrelated, as well as Action Item 15 on multilateral measures. In conjunction with a worldwide debt-to-capital interest limitation rule, the OECD could recommend that the deductible interest rate be limited to the group's average third-party interest rate. The transfer pricing analysis would be folded into the interest limitation rule: use the debt-to-capital ratio in each jurisdiction to allocate total third-party interest cost.

6.4. Transitional and softening measures

The previous section sought to illustrate that when a country adopts a worldwide ratio interest limitation rule, it eliminates a "residual", being the potential for large additional interest deductions that inheres in the traditional arm's length approach as it applies to financing transactions.

For this reason, governments may tend to favour adoption of a worldwide ratio rule and corporate taxpayers, particularly multinationals, may tend to oppose it. This opposition may make it politically difficult to undertake this reform in some countries. To the extent that the objection is that the corporate taxpayer has put particular financial structures into place in reliance on previous interest limitation rules (a legitimate complaint), this can be dealt with by having the worldwide ratio rule eased in transitionally.

Another compromise or transitional measure, albeit one which reduces the effectiveness of the system, is to accompany the worldwide ratio rule with a safe harbour of a fixed leverage ratio or interest amount. It should be a safe harbour in the traditional sense. As such, it should be set at a relatively low level, with companies able to exceed the threshold if their group has a higher leverage ratio. If a buffer is to be added around the worldwide ratio, it should be a small one closer to the 2% in place in Germany than the 10% in New Zealand. These ameliorating rules should be as consistent as possible between countries, to minimize double taxation.

A further alternative would be to treat intra-group loans as equity for tax purposes, and devise another allocation rule for third-party interest (other than based on the worldwide debt-to-capital ratio as applied to assets in the jurisdiction). The allocation rule would need to attract international consensus or else double taxation and double non-taxation would be rife. In the author's view, the worldwide ratio rule is the most logical allocation rule for third-party interest, but another allocation rule based on hard-to-manipulate factors would still achieve most of the aims discussed in the project, if it accompanies a recharacterization of intra-group debt as equity for tax purposes.

6.5. Anti-double tax measures

Ideally, interest deductions disallowed by the borrower's jurisdiction under this rule should not be taxed as interest via withholding taxes or in the lender's jurisdiction.

The withholding tax fix is relatively simple; when reforming their interest limitation rules as recommended in this article, countries should also provide that disallowed interest will be treated as equity for withholding tax purposes, or not charge withholding tax at all.

Where it is intra-group debt on which the deduction is disallowed in the borrower country, the lender country could use its transfer pricing rules to treat the income as a dividend, not interest. The United Kingdom does something similar under its transfer pricing rules at present.[115] A rule guaranteeing this outcome, in relation to intra-group debt, could be written into countries' legislation for the worldwide ratio interest limitation rule – this would also likely make that rule more attractive to corporate taxpayers. The interest limitation rule could specify that deductions in relation to intra-group debt are disallowed first, and only once they are reduced to zero are deductions in relation to third-party debt disallowed.

As for disallowed third-party interest cost, this is more difficult to recharacterize as a dividend as the third-party lender will often be unaware that the borrower has breached the interest limitation rule. However, in that situation there is no double taxation in the sense of the one economic (let alone legal) entity being taxed twice. At an aggregate worldwide economy level there could be said to be double taxation, but that is a remote complaint in this context, and can be overcome by the extension of the rule, discussed in the next section.

An alternative to treating disallowed interest as a dividend is allowing the interest deduction to be carried forward until the subsidiary has "capacity" relative to the group's worldwide leverage ratio. This would only be useful in countries not allowing notional deductions, but even in those countries fresh intra-group debt can be used to fill up spare capacity without the need for a carry-forward. Recharacterization as a dividend (in both jurisdictions) is probably the more principled treatment.

6.6. Extending the rule and complementary measures

In tandem with this reform, governments and the OECD should also address other tax arbitrage opportunities which involve intra-group debt, particularly those enabled by hybrid entities and hybrid financial instruments.

If a worldwide ratio rule becomes more widely implemented, the gradual reduction of safe harbour alternatives should follow. The rule could be extended to cover financial income and passive income, effectively being a CFC system as well, and to cover financial institutions as well as non-financial; both prospects are discussed in detail by Benshalom in the context of a formulary apportionment system.[116] It could become a system well-suited to multilateral enforcement, if tax authorities start systematic cooperation with the aim of providing a "one stop shop" service.[117]

6.7. OECD and G20 leadership

As a tangible immediate step to encourage countries to consider the worldwide ratio rule, the OECD should give the worldwide ratio approach greater prominence in its survey of thin capitalization regimes, currently published only in draft form.[118]

115. *See supra* sec. 3.3.3.
116. Benshalom (2008), *supra* n. 7; Benshalom (2009), *supra* n. 5; on proposals for a multilateral CFC regime and the possible extension of this into transfer pricing generally, *see*, respectively C. Burnett, *Swapping CFC Regimes for a Collective Attribution System*, 38 Tax Notes International 12 (2005); and Vann, *supra* n. 103.
117. P. Baker, *Alternative approaches in a world without the Government of India principle*, presentation to Oxford University Said Business School and Max Planck Institute for Tax Law and Public Finance Joint Conference, 18 March 2013, available online at http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Events/conferences/2013/taxing_multinationals/philip-baker.pdf.
118. OECD, *Thin Capitalisation Legislation – A Background Paper For Country Tax Administrations (Pilot version for comments)*, August 2012, available online at http://www.oecd.org/ctp/tax-global/5.%20Thin_Capitalization_Background.pdf.

More substantially, the BEPS Action Item 4 “best practice” survey should consider whether the traditional transfer pricing approach to intra-group debt – both the interest rate and debt amount components – makes sense from a practical perspective, let alone a policy perspective. It should also query whether fixed ratio interest limitation rules really offer an attractive alternative.

The recommendation of this article is that the OECD and G20 work on BEPS Action 4 involve an endorsement of the worldwide leverage ratio approach over stand-alone or fixed ratio approaches. As discussed above, the worldwide approach is more flexible than a fixed ratio rule, is multilateral in concept and also eliminates a sizeable capacity for tax-motivated debt creation and debt shifting. This exemplifies the desired outcomes of the BEPS project.

Arm’s length interest - close to hand

BEPS Conference, University of Sydney Law School
17 November 2014

SYDNEY LAW SCHOOL

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BEPS Action Item 4

“***Limit base erosion via interest deductions and other financial payments***”

- 2015 deliverable
- Part of protecting the coherence of the international tax system
- Preventing double non-taxation
- Comparing and attempting to harmonise the heterogeneous approaches

2

Worldwide ratio rule

- Explanation of rule
  - Only for debt amount?
  - For interest rate too?
- Example
- Extend rule to *net* interest deductions (if any)
- Not (unmodified) appropriate for financial institutions
- Structural rule, not just anti-avoidance

3

Existing interest barrier rules

- Worldwide ratio rule - some experience in Germany, the US, Australia, New Zealand
- Fixed ratio interest barrier (% of assets, % of EBITDA)
  - Over-reaches
  - Under-reaches
  - Heterogeneous
- “Arm’s length” debt amount and interest rate (eg UK)
  - Inherent gap between actual and “could” invites income stripping

4

Practicalities and principles

- Practical advantages of worldwide ratio rule:
  - Dearth of actual CUPs
  - Saves fact-intensive TP-type analysis of every loan
  - Less subjective / contestable
  - Could come within CbC reporting templates
- Advantages at the level of principle:
  - No internal value-add or transformation of debt finance
  - Fungibility
  - Intragroup debt substitutable with equity

5

Articles on this topic

Masui, “Interest Deduction, Corporate Groups and Tax Jurisdictions – A Hitchhiker’s Guide to an Aspect of the BEPS Project” 20 (2) *Asia-Pacific Tax Bulletin* (2014)

Burnett, “Intragroup Debt at the Crossroads: Stand-alone versus Worldwide Approach” 6(1) *World Tax Journal* 40 (2014)

Arnold, “Reforming Canada’s International Tax System, Toward Coherence and Simplicity” *Canadian Tax Research Foundation* (2009)

Benshalom, “The Quest to Tax Interest Income in a Global Economy: Stages in the Development of International Income Taxation [I & II]” 27, 28 *Virginia Tax Review* 631-708, 165-221 (2008)

Graetz, “A Multilateral Solution for the Income Tax Treatment of Interest Expense” 62 *Bulletin for International Taxation* 11 (2008)

Rosenbloom, “Banes of an Income Tax: Legal Fictions, Elections, Hypothetical Determinations, Related Party Debt” 26 *Sydney Law Review* 17 (2004)

6

Base Erosion Action 4: Interest and Base-Eroding Payments
Insights from Canadian Experience

Conference on Finalizing and Implementing the BEPS Agenda
University of Sydney Faculty of Law, 17-18 November 2014

David G. Duff
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1. Introduction

Among the various action items identified in the OECD's *Action Plan on Base Erosion and Profit Shifting*, one of the most challenging is Action Item 4, which aims to limit base erosion via interest deductions and other financial payments. In the context of inbound investments, the deduction of interest expenses on related-party and third-party debt has long been recognized is a way to reduce source country taxes. In the context of outbound investments, the deduction of interest expenses can be used to reduce residence country taxes, to the extent that borrowed funds are used to earn tax-exempt or tax-deferred income from foreign affiliates. Where investments are structured to obtain interest deductions in more than one jurisdiction, the deduction of interest expenses can simultaneously erode the tax bases of the residence country and the source country.

In order to limit opportunities for base erosion through the deduction of interest expenses, countries have over the course of the past several decades devised various anti-avoidance and interest allocation rules, including thin capitalization rules, earnings stripping rules, asset apportionment rules, and selected anti-arbitrage rules. Under BEPS Action 4, the OECD proposes to develop recommendations "regarding best practices in the design of rules to prevent base erosion through the use of interest expense".

Given the variety of existing and conceivable rules governing the deduction of interest expenses on inbound and outbound investments, this will be a monumental project – warranting a later target date than many of the other action items. For this reason as well, this short paper does not attempt to summarize or evaluate all these rules, but rather provide some insights from Canadian experience that may be relevant to Action 4. In particular, Canadian experience suggests that countries acting on a unilateral basis are apt to be more concerned about base erosion by non-residents than residents, so that "recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense" may be insufficient to limit base erosion associated with outbound investments absent a strategy for implementation through bilateral or multilateral agreement. Indeed, it is difficult to imagine how the most ambitious (and perhaps most ideal) proposals involving worldwide leverage ratios could possibly be implemented without an agreement among at least a few OECD countries.[1]

2. Canadian Experience

As with many developed countries, Canadian experience with rules to prevent base erosion through the deduction of interest expense begins with thin capitalization rules aimed at related-party debt. As Canada's system of taxing outbound foreign investment morphed from a credit system to an exemption system, policymakers turned their attention to limits on the deduction of interest expenses to earn exempt income from foreign affiliates. Most recently, the Canadian government acted to limit debt dumping or pushdown arrangements, through a somewhat broader anti-avoidance rule aimed at foreign affiliate dumping more generally.

(1) Thin Capitalization Rules

Canada was among the first countries in the world to introduce a thin capitalization rule for inbound investments, which came into effect in 1972.[2] Although this rule originally applied only to resident corporations, it was recently broadened to include resident trusts, partnerships in which resident corporations and trusts are partners, and branches of non-resident corporations and trusts operating in Canada.[3]

Unlike thin capitalization rules in some countries, which apply only where the resident borrower is controlled by a non-resident lender, the Canadian rules apply at a lower threshold, where the non-resident lender alone or together with other non-arm's length persons, owns at least 25 percent of a resident corporation's shares by votes or value or at least 25 percent of the fair market value of all beneficial interests in the trust.[4] In these circumstances, the effect of the rule is to disallow the deduction of interest expenses on "outstanding debts to specified non-residents" to the extent that these debts exceed a multiple of the "equity amount" of the corporation or trust,[5] and to treat this disallowed interest as a dividend.[6] While the allowable debt/equity ratio was 3:1 when the rule was first enacted in 1972, this

[1] See, e.g. Graetz (2008) and Burnett (2014).
[2] Mintz Report (1998), p. 6.26.
[3] ITA, subsection 18(4).
[4] ITA, subsection 18(5) "specified shareholder" and "specified beneficiary".
[5] ITA, subsection 18(4) and 18(5) "outstanding debts to specified non-residents" and "equity amount". In general, the equity amount of a corporation is the total of all retained earnings and contributed surplus and paid-up capital contributed by the specified non-resident shareholder, while the equity amount of a trust is the sum of its tax-paid earnings and contributions to the trust from specified non-resident beneficiaries, less capital distributions to specified non-resident beneficiaries.
[6] ITA, subsection 214(16).

ratio was reduced to 2:1 in 2000 and 1.5:1 in 2013 – in each case following recommendations from advisory committees that the ratio should be reduced.[7]

Although the thin capitalization rule applies to back-to-back loans,[8] it does not otherwise apply to arm's length debt, even if this debt is guaranteed by a specified non-resident shareholder or beneficiary of the corporation or trust.[9] To the extent that guaranteed debt is easily substituted for non-arm's length debt, this would seem to be a serious deficiency with the Canadian rule.[10] Nonetheless, both the Mintz Report in 1998 and the more recent Advisory Panel Report in 2008, questioned the merits of such a rule on the grounds that it could "disrupt normal commercial financing arrangements" and "increase the complexity of the current system and the compliance burden of businesses."[11]

Another possible deficiency with Canada's thin capitalization rule is its failure to consider all debt and equity of the relevant trust or corporation in determining its debt-equity ratio, rather than debt owed only to specified non-resident shareholders or beneficiaries, and equity (other than retained earnings) contributed only by specified non-resident shareholders or beneficiaries.[12] More generally, one might question the suitability of a fixed debt-to-equity ratio, when data consistently demonstrates that debt-to-equity ratios vary widely among different industries.[13] From this perspective, a ratio based on the multinational group's worldwide assets and arm's length liabilities is a theoretically attractive alternative, though administratively challenging given inevitable differences in the definition multinational firm and the computation of its equity.

(2) Interest Expenses to Earn Foreign Source Income

Until 1972, Canadian corporations could not deduct interest on borrowed funds that were used to invest in Canadian and foreign subsidiaries.[14] Since then, interest has been deductible if borrowed funds are used to earn dividends, even if these dividends are effectively exempt from tax as inter-corporate dividends from taxable Canadian corporations or exempt dividends from foreign affiliates.

Canada's rules for taxing income from foreign affiliates combine an exemption system for dividends paid out of a foreign affiliate's "exempt surplus" and

[7] Mintz Report (1998), p. 6.30; Advisory Panel Report (2008), para. 5.38.
[8] ITA, subsection 18(6).
[9] The federal government proposed to extend the thin capitalization rules to include guaranteed debt in the 2000 Federal Budget, but withdrew the proposal after it faced considerable criticism.
[10] Arnold (2009) at 308.
[11] Mintz Report (1998), p. 6.29; Advisory Panel Report (2008), para. 5.25.
[12] Arnold (2009) at 313 ("For purposes of calculating the amount of a corporation's debt and equity, all of its debt and equity should be taken into account").
[13] Advisory Panel Report (2008), Table 5.2 (reporting average debt-to-equity ratios from 2000 to 2005 ranging from 0.17 for insurance carriers and related activities to 3.76 for utilities).
[14] Mintz Report (1998), p. 6.11.

a credit system for dividends paid out of a foreign affiliate's "taxable surplus".[15] For the purpose of these rules, the exempt surplus of a foreign affiliate is generally defined as the after-tax income from active businesses carried on by it in a country with which Canada has entered into a tax treaty or (since 2007) a tax information exchange agreement (TIEA). A foreign affiliate's taxable surplus, on the other hand, is generally comprised of the after tax amount of passive "foreign accrual property income" received by the affiliate as well as income from active businesses carried on in non-treaty and non-TIEA countries.

When these rules were first adopted in 1972, Canada had 16 treaties, all with relatively high-tax jurisdictions, such that the exemption system for dividends from a foreign affiliate's exempt surplus could reasonably be regarded as an Over the subsequent decades, however, Canada's tax treaty network increased significantly, such that Canada now has 92 tax treaties (and 21 TIEAs). As a result, what once may have been characterized as a predominantly credit system was transformed into what is best described as an exemption system.

As this phenomenon became apparent in the 1990s, academics and policymakers began to consider whether Canada should limit the deduction of interest expenses incurred to earn exempt income from foreign affiliates. In 1992, the Auditor General suggested that the deduction of interest expenses by Canadian corporations on debt used to acquire shares of foreign affiliates was eroding the Canadian corporate tax base.[16] Six years later, the Mintz Report considered the issue in detail, reporting that Canadian multinationals had "significantly increased" their borrowings of in Canada over the previous years.[17] After considering various formulary methods for allocating a company's interest expense to its exempt income,[18] the Report recommended a tracing rule as the simplest and most familiar way to restrict the deduction interest expenses used to obtain exempt dividends, proposing a "broadly drafted" rule that would disallow the deduction of interest on "borrowings that can reasonably be considered, having regard to all of the circumstances, to have been used to assist, directly or indirectly, another person to make the foreign direct investment."[19]

Since the Mintz Report itself acknowledged that "under tracing, it will be difficult – even with elaborate anti-avoidance rules – to overturn arrangements whereby a Canadian taxpayer borrows to invest in Canadian domestic operations and, in separate transactions, uses existing equity to finance foreign direct

[15] ITA, subsection 113(1).
[16] Report of the Auditor General (1992) 46-51.
[17] Mintz Report (1998), p. 6.12.
[18] Mintz Report (1998), pp. 6.14-16 (considering a domestic allocation formula based on the ratio of foreign assets to total assets, a modified domestic allocation formula incorporating a fixed debt-equity ratio safe harbour, and a worldwide allocation formula based on the ratio of the corporate group's worldwide foreign assets to its worldwide assets).
[19] Mintz Report (1998), p. 6.14.

investment,"[20] it is perhaps not surprising that the federal government at the time decided not to act on this recommendation. More surprising still, is that the Conservative Government which had been elected in January 2006 decided to propose a tracing rule to limit the deduction of interest expense on indebtedness incurred to acquire shares of a foreign affiliate when it tabled its 2007 budget on March 19, 2007.

As Brian Arnold relates, "[t]he outrage of corporate Canada was predictable, swift, and effective."[21] A few weeks later, the government quietly withdrew its original proposal, replacing it with a more targeted anti-avoidance rule that would disallow the deduction of interest on borrowed funds used in "double dip" financing arrangements whereby an interest deduction is also available in another jurisdiction.[22] It also announced that it would establish an expert advisory panel to "undertake further study and consultations, with a view to building on the measures in the March 2007 budget, and identifying additional measures to improve the fairness and competitiveness of Canada's system of international taxation."[23] Membership of the Advisory Panel was announced on December 11, 2007,[24] and the Panel reported a year later. By then, the anti-double-dip provision had been enacted into law,[25] but with a delayed commencement date until after 2011.

Among the Advisory Panel's many recommendations when it issued its report in December 2008, the most pointed was that the federal government should repeal the anti-double-dip provision in section 18.2,[26] which the government immediately did before the provision came into force.[27] The Advisory Panel also rejected the idea of "any restrictions on the deductibility of interest expense incurred by Canadian companies to invest in foreign affiliates."[28] According to the Panel:

> Our research shows that many businesses based in other countries can deduct interest on borrowed money to invest in a foreign company even though dividends from the foreign company, when repatriated, will be either exempt or mostly free from home country tax. While some countries have introduced targeted rules aimed at restricting outbound financing arrangements, many such arrangements are widely available. The Panel

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[20] Mintz Report (1998), p. 6.14.
[21] Arnold (2009) at 188.
[22] Canada, Department of Finance. "Canada's New Government Improves Tax Fairness with Anti-Tax-Haven Initiative," News Release 2007-041, May 14, 2007. See also the accompanying Backgrounder, "International Tax Avoidance and 'Tax Havens'".
[23] Backgrounder.
[24] Canada. Department of Finance. "Government Establishes Advisory Panel on Canada's System of International Taxation," News Release 2007-09, November 30, 2007.
[25] ITA, section 18.2.
[26] Advisory Panel (2008) p. 53.
[27] 2009, c. 2, s. 6.
[28] Advisory Panel (2008) para. 4.155.

believes that Canada's tax system should not create disadvantages for Canadian businesses when they compete abroad.

> Canadian businesses need flexibility in raising capital and structuring the financing of their foreign acquisitions and expansions to be competitive with businesses based in other countries. In the Panel's view, this pragmatic concern is of greater weight than the theoretical basis for denying interest deductions on money borrowed to invest in foreign companies or in respect of outbound financing arrangements.[29]

As a result, it seems, the prospect of Canadian measures to prevent base erosion through the deduction of interest expenses on borrowed funds used to earn exempt income will depend on prior progress by other countries or coordinated initiatives among many.

(3) Foreign Affiliate Dumping

Despite rejecting any limitation on the deduction of interest expenses on borrowed funds used to finance outbound investments by Canadian multinationals, the Advisory Panel expressed "significant tax policy concerns" about "debt dumping" or debt pushdown transactions in which a foreign-controlled Canadian corporation (CanSub) uses borrowed funds to acquire shares of another related foreign corporation (ForSub).[30] According to the Panel:

> Where there is no other connection between the businesses conducted by CanSub and ForSub and especially where CanSub does not take part in the management of ForSub or share or benefit from an increase in the value of ForSub's operations subsequent to CanSub's investment, such a transaction has the effect of inappropriately reducing CanSub's Canadian tax liability It permits Parent to leverage its existing Canadian operations by simply reorganizing the group's ownership structure. The reorganization may not have had any purpose other than to shift deductible expenses into Canada. As a result, the reorganization reduces the Canadian tax base, generates no new economic activity in Canada, and provides little or no benefit to Canadians.[31]

For these reasons, the Panel recommended a specific anti-avoidance rule that would either: (1) disallow the deduction of interest expenses paid by the foreign-controlled Canadian corporation on borrowed funds "used to purchase, directly or indirectly, an equity interest in a related foreign corporation", or (2) "apply an appropriate level of Canadian tax to the purchase price paid by the foreign-controlled Canadian corporation in respect of the direct or indirect acquisition of the equity interest in the related foreign corporation" such as by deeming the

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[29] Advisory Panel (2008) p. 53 (paras. 4.165 and 4.166).
[30] Advisory Panel (2008) pp. 67-68 (paras. 5.51 and 5.52).
[31] Advisory Panel (2008) p. 69 (para. 5.53).

purchase price to be a dividend subject to withholding tax in Canada.[32] Presumably regarding the tracing approach in the first of these options to be complicated and relatively easy for taxpayers to circumvent, the government settled on the second option, introducing a more general "foreign-affiliate-dumping" rule in the 2012 Federal Budget.

Enacted as section 212.3 of the *Income Tax Act* and applicable to transactions after March 28, 2012, this rule generally applies (subject to specific exceptions[33]) whenever a corporation resident in Canada (a "CRIC") acquires shares or debt of or contributes capital to a corporation that either is a foreign affiliate of the CRIC or becomes a foreign affiliate after this investment – regardless of whether the investment is financed by debt or internal funds of the CRIC. In this circumstance, the rule generally deems the CRIC to have paid and its foreign parent to have received a dividend equal to the amount by which the amount invested in the foreign affiliate exceeds the paid-up capital of the parent's shares of the CRIC. In this respect, the foreign affiliate dumping rule operates as a surplus stripping provision rather than an interest expense limitation, discouraging debt dumping as well as other transactions that can be construed as substitutes for the distribution of dividends by the CRIC to its foreign parent. The rules have been criticized as complicated and potentially overbroad,[34] but they seem likely to curtail debt dumping or pushdown transactions … as well as other transactions involving foreign affiliates.

3. Conclusion

As Canadian experience suggests and Brian Arnold and James Wilson conclude in a recent paper, "historically, Canada has been vigilant about protecting the Canadian tax base from aggressive tax planning by non-residents" but "has not been particularly concerned about the erosion of the domestic tax base by Canadian multinationals."[35] Perhaps this is sound public policy, reflecting economic assessments regarding the positive externalities that Canadian-based multinationals confer on the Canadian economy and the public at large. Perhaps too, however, this is a predictable consequence of the fact that resident multinationals and their tax advisors are apt to have greater influence on Canadian pubic policy than non-residents who have every incentive to press their own governments for tax advantages as favourable as those granted to Canadian-based multinationals.

[32] Advisory Panel (2008) p. 70 (para. 5.57).

[33] The most important of these exceptions, anticipated in the Report of the Advisory Panel is where an investment in a foreign affiliate can be regarded as part of a strategic or more closely connected expansion of the business of the CRIC.

[34] See, e.g., Suarez (2012).

[35] Arnold and Wilson (2014) at p. 56.

For BEPS action 4, the lesson from Canadian experience should be clear. While many countries will gladly act on OECD recommendations on best practices to prevent base erosion through the deduction of interest expenses by foreign-controlled enterprises, they are unlikely to act unilaterally to prevent base erosion by domestic-based multinationals through the deduction of interest expenses to earn exempt income from foreign affiliates. For this reason, recommendations on best practices will have to move beyond the design of domestic rules to limit base erosion through the deduction of interest expenses, to strategies for coordinated action to promote bilateral and multilateral solutions.

Coordinating Inconsistent Choices – the Problem of Hybrids

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1. BEPS and Action Item 2: proposals in search of a principle

The 15 Action Items announced by the OECD in July 2013 are an interesting collection of measures.[1] They read as a seriatim list of discrete projects with only modest connections between them which begs the obvious question: is BEPS just that? Is it one project or many, and if it is one project what is the theme or concept which binds it together?

BEPS, it was said, would to contribute to the broader goal of establishing, 'a fundamentally new set of standards designed to establish international coherence in corporate income taxation.'[2] Although the BEPS shopping list is rather diverse, if one were to try to assemble underlying concepts from the 15 Items, there are many possible themes one might discern. It has Items which seem directed to the problem of companies behaving badly (items 2, 4, 6 , 7, 12), governments behaving badly (item 5, 11), measures to improve current national rules (items 3, 4, 12, 13), measures to improve the current supra-national rules to enhance their effectiveness (items 6, 7, 8, 9, 10, 14, 15), substituting new supra-national rules as way of dealing with emerging problems (items 1, 7), getting better co-ordination between national systems (item 2 , 14) or generating new and more informative data sets to assist tax administration (items 11, 12, 13).

No doubt, one can challenge the characterisations being attached to the various Action Items, and there are undoubtedly other ways to assemble the ideas in the Action Plan, but the point of this dissection is that it suggests BEPS is not one project but many. On the other hand, the proponents of the Action Plan claim there is a single idea which gives the BEPS Action Plan structural coherence – the notion that 'profits are taxed where the economic activities generating the profits are performed and where value is created.'[3] Just what that means is left vague because, like all slogans, the complexity of the real world diminishes the attractiveness of any simple dictum.

Action Item 2 – neutralising the effect of hybrid mismatch arrangements – is no different. Just like the larger BEPS project, Action Item 2 could be no broader a project than is captured by the proposed set of discrete rules (a rule for hybrid financial instruments, another for differing views about the transactions being undertaken, another rule for transactions between or involving transparent/opaque entities and so on). Indeed, it could be even narrower and limited to just the

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1 OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013).

2 OECD, above n. 1, at p. 15.

3 OECD, *Neutralising the Effect of Hybrid Mismatch Arrangements: Action 2 – 2014 Deliverable* (Paris: OECD, 2014) p. 3. See also *G 20 Leaders' Declaration*, St Petersburg (September 2013) para 50 https://www.g20.org/sites/default/files/g20_resources/library/Saint_Petersburg_Declaration_ENG_0.pdf ('profits should be taxed where economic activities deriving the profits are performed and where value is created. In order to minimize BEPS, we call on member countries to examine how our own domestic laws contribute to BEPS and to ensure that international and our own tax rules do not allow or encourage multinational enterprises to reduce overall taxes paid by artificially shifting profits to low-tax jurisdictions').

seven particular examples now described in the September 2014 *Recommendations Paper*.[4] Or it could be much broader – a project that is bound together by a single underlying theme that mismatches which lead to hybrid outcomes must be reversed. So the question that arises for BEPS *in toto* also arises for Action Item 2: is Action Item 2 one project or many, and if it is one project what is the theme or concept which binds the individual recommendations together?

There is no direct answer to this question in the *Recommendations Paper*but I think it is fair to say the various documents released as part of this project[5] imply that Action Item 2 is one project held together by a single theme, rather than another collection of discrete measures. But nailing down that coordinating theme is not simple: one strand in the OECD documents describes the ***problems*** of hybrids in the language of avoidance – corporations taking advantage of inconsistent treatment offered in the rules enacted by national governments,[6] another strand describes the ***solutions*** as structural, automatic and universal, with the implication that it is not dependent upon findings about the culpability of corporate actors.[7]

There is a tension here: is Action Item 2 a single project that is constructed around controlling the abusive behaviour of corporations, or is the project one that is agnostic about motives and indifferent to causes and is meant to lead to structural changes to the international tax lexicon which will apply automatically and universally. In other words, is the problem to be solved simply another manifestation of avoidance or is there something more profound to hybrids that requires a broader solution?[8]

One way of grappling with that question would to ask, what is to be made of the Examples in the *Discussion Draft* and the (rather fewer) Examples in the *Recommendations Paper*? Are they representative and meant to extend to every aspect of the international tax world, or are they just about the few identified instances? Action Item 2 could be a highly ambitious project which will generate automatic and universal rules that will apply regardless of needing to find indicators of corporate malfeasance; or a narrow and constrained project confined simply to the identified

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4 OECD, *Neutralising the Effect of Hybrid Mismatch Arrangements: Action 2 – 2014 Deliverable* (Paris: OECD, 2014) (‘***Recommendations Paper***’).

5 OECD, *Public Discussion Draft - BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Law)* (Paris: OECD, 2014) (‘***Discussion Draft***’), OECD, *Public Discussion Draft - BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues)* (Paris: OECD, 2014) and OECD, *Recommendations Paper*, above n. 4.

6 OECD, *Recommendations Paper*, above n. 4, pp. 67-68 (a ‘structured arrangement is any arrangement where the hybrid mismatch is priced into the terms of the arrangement or the facts and circumstances (including the terms) of the arrangement indicate that it has been designed to produce a hybrid mismatch’).

7 OECD, *Recommendations Paper*, above n. 4, p. 64 (‘the hybrid mismatch rules have been designed to maximise the following outcomes: (a) neutralise the mismatch rather than reverse the tax benefit that arises under the laws of the jurisdiction; (b) be comprehensive; (c) apply automatically; (d) avoid double taxation through rule co-ordination …’).

8 Interestingly, Australia’s tax authorities have apparently already concluded that any remedy to the hybrids issue will be limited to situations regarded as abusive: ‘both the ATO and Treasury support the approach that the rules should only apply to deliberate mismatches (for example, related party and structured arrangements) and exclude unintended mismatches.’ M Konza, Base Erosion and Profit Shifting - a Progress Report on G20/OECD action, unpublished speech (24-25 September 2014) available at https://www.ato.gov.au/Media-centre/Speeches/Other/BEPS---a-progress-report-on-G20/OECD-action/

examples and dependent upon (or perhaps based on the assumption that they are instances of) evidence of corporations behaving badly.

And then one could try to put together the greater and the lesser (i) whether there is a coherent underlying policy to the BEPS project, (ii) whether there is a coherent policy underlying Action Item 2 and (iii) if the answer to both is yes, whether the two sets of policies coincide or conflict.

The object of this paper is to explore Action Item 2 on its own terms, and then to add this issue of the relationship between Action Item 2 and the larger BEPS project. I want to test these ideas: if the entire BEPS project is about broader themes such as, 'taxing income where it is earned' then Action Item 2 framed around narrow notions of abuse and limited to the listed examples is a rather lame attempt at solving BEPS; but – and it is a very big 'but' – an Action 2 that is more ambitious, structural, automatic and universal will (i) be breathtaking in its scope and in the extent of the changes it would require, leading to changes that the authors are, it seems, trying to side-step and which nations may be unwilling to visit and (ii) is currently being constructed in a way that potentially undermines the policy of the broader BEPS project; and the changes that Action Item 2 could require would be so significant and the policy issues raised so fundamental that they cannot be done in the agnostic, value-free manner that the authors propose. Instead, some underlying tax policy position has to be articulated which would justify the outcomes that the proposed measures would require.

2. Hybrids – not a new issue; but a new BEPS approach?

The issue of hybrids is not new. David Rosenbloom wrote eloquently about it in 2000.[9] It may be just co-incidence, but it seems his paper generated a modest amount of interest with papers by Diane Ring,[10] Mitchell Kane,[11] Dan Shaviro[12] and others being published in the next few years, though I think it is fair to say that interest in the problem waned by the mid-2000s.[13]

The issue of hybrids, however, did not disappear entirely. In particular, the OECD kept alluding to the issue of loss duplication through hybrid entities in its reports on losses.[14] It was mentioned as a key issue in the joint report prepared for G 20 meeting in Cannes, November 2011,[15] was more fully

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9 HD Rosenbloom, International Tax Arbitrage and the International Tax System (2000) 53 *Tax Law Review* 137.

10 D Ring, One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage (2002) 47 *Boston College Law Review* 79.

11 M Kane, Strategy and Co-operation in National Responses to International Tax Arbitrage (2004) 53 *Emory Law Journal* 89.

12 D Shaviro, Exploring the Need for International Harmonisation. Money on the Table? Responding to Cross-border Tax Arbitrage (2002) 3 *Chicago Journal of International Law* 317.

13 T Greenaway, International Tax Arbitrage: A Frozen Debate Thaws (2010) 57 *Tax Notes International* 1

14 OECD, *Addressing Tax Risks Involving Bank Losses* (Paris: OECD, 2010) p. ____ ('those [situations] where the same tax loss is relieved in more than one country as a result of differences in tax treatment between jurisdictions'); OECD, *Corporate Loss Utilisation through Aggressive Tax Planning* (Paris: OECD, 2011) p. 3 ('the issue of multiple deductions of the same loss, typically through hybrid mismatch arrangements').

15 IMF, OECD, UN and World Bank, *Supporting the Development of More Effective Tax Systems – A Report to the G 20 Development Working Group by the IMF, OECD, UN and World Bank* (2011) p. 33 ('MNEs may use aggressive financial structures including the use of hybrid entities, instruments and transfers to create multiple deductions or credits, to create deductions without inclusions, and/or to

elaborated by the OECD with a dedicated paper on hybrids released in March 2012[16] and finally achieved prominence in the OECD's February 2013 paper, *Addressing Base Erosion and Profit Shifting*.[17] The basic approach to, and analysis of, hybrids in the February 2013 document was retained when addressing hybrids became Action Item 2 in the July 2013 Action Plan.[18] The two *Discussion Drafts* released in March 2014 elicited more than 450 pages of responses from about 70 respondents.[19] The *Recommendations Paper* released in September 2014, did not change the descriptions of the basic problem which had been isolated in the *Discussion Drafts*, although it did reduce the number and narrow the scope of the Examples quite substantially,[20] and there were significant changes to some of the recommended solutions, particularly those dealing with hybrid entities.[21]

The early work by Rosenbloom and other identified some themes and problems which survive into the current discussion, but to my mind, the OECD's approach to the issue has been distinctive in several ways. First, the authors have clearly taken the view that the class of situations to be addressed can and should be very limited: just to those situations which (i) arise from certain types of instruments and entities and (ii) arise in situations which are almost certainly deliberate and therefore likely to be abusive. As will be seen, the pre-conditions and exceptions to the recommended rules, significantly narrow the potential scope of Action Item 2. Secondly, the authors have taken the view that this issue can be addressed in an agnostic, value-free way – that it is not necessary to decide which country loses revenue from various type of hybrid arrangements and so whose revenue should be restored.[22] This agnosticism really amounts to a declaration that the ultimate goal is rule co-ordination rather than conceptual soundness.[23] Thirdly, the authors have

reduce or avoid withholding taxes sometimes relying on treaty shopping') http://www.oecd.org/g20/meetings/cannes/48993634.pdf. The specific reference to hybrids was not repeated in the communiques from the Leaders Meetings in Los Cabos in June 2012 or St Petersburg in September 2013.

16 OECD, *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (OECD: Paris, 2012).

17 OECD, *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013).

18 OECD, above n. 1, pp 15-16.

19 Interestingly, almost all of the commentators took the approach of focusing on what was in the 2 Discussion Drafts and responding to them according to their terms. None of the respondents seriously tried to look behind the document to discern any underlying policy or theory, and challenge it. The commentators did not seem to attach any broader significance to what was being suggested beyond what was apparent on the face of the documents. Maybe that is because the commentators view Action Item 2 as just another list and so they respond to the items on the list.

20 No discussion of issues involving use of PEs; less specific attention paid to FTC duplication transactions.

21 It is instructive to compare the Table in the *Public Discussion Draft* with the similar Table in the *Recommendations Paper*. Compare OECD, *Discussion Draft*, above n. 5, p. 18 with OECD, *Recommendations Paper*, above n. 4, p. 17.

22 OECD, *Recommendations Paper*, above n. 4, pp. 12-13 ('the rules recommended in this Report take into account a number of design principles including the need for comprehensive rules that operate automatically without requiring to establish which jurisdiction has lost tax revenue under the arrangement').

23 OECD, *Recommendations Paper*, above n. 4, pp. 32-33 ('because of the wide variety of financial instruments and the different ways jurisdictions tax them, it has proven impossible, in practice, for this Report to comprehensively identify and accurately define all those situations where cross-border conflicts in the characterisation of a payment under a financing instrument may lead to a mismatch in

concluded that the problems can be addressed and are best addressed through domestic laws alone; it is not necessary to have treaty to co-ordinate national responses.[24] These aspects of Action Item 2 give it rather different focus from the debate of the early 2000s.

3. The problem behind 'hybrid mismatch arrangements'

The fundamental precondition to the problem of hybrids is simple: it is the fact of inconsistent policy choices made by national governments. That circumstance is almost ubiquitous; inconsistency between national income tax systems is the rule, not the exception. Hybrid outcomes in this sense are everywhere, so solving all hybrids would be a mammoth task. This may seem exaggerated, but differences between governments arise almost any time one moves past examining all but the most basic transactions. Governments routinely differ about the fundamental building blocks of the income tax: what is this transaction, what is this instrument and what are the returns it generates, when did the transaction occur, how much income or expense is to be recognised from the transaction, where did the transaction occur, to what year (or years) are the consequences to be allocated for tax purposes, and who is the taxpayer to whom the tax consequences are ascribed?

Because of Australia's pronounced tendency to go our own way on tax law design, Australian tax law is fuller than most with instances of significant misalignment with other countries' approaches to the same issue: our debt / equity rules are highly idiosyncratic, our tax consolidation system has many features that are unique, even among countries with consolidation systems, our formal conduit foreign income rules are uncommon (although other countries may achieve similar outcomes through a combination of rules), our views about the circumstances when a partnership or a trust is, and can remain, transparent and when it is to be taxed as a company (Divisions 5A, 6B, 6C and foreign hybrids) are not likely to match the classifications that other countries apply to these entities, our notion of the border between a lease and a sale with vendor finance will not always correspond with the border drawn by other countries, our treatment of fringe benefits formally taxes the wrong person, our approach to taxing personal services income that is diverted to entities or family members is not universally followed, our retirement income system adopts income tax treatment (taxed-taxed-exempt) while other countries more commonly employ a consumption tax model (exempt-exempt-taxed), other countries may view a payment for the use of intellectual property simply as a royalty while we treat it as including a payment for services or as involving such a significant limitation of owner rights that it amounts to a sale, and we do not use the notion of a 'permanent establishment' in domestic law in describing the jurisdictional nexus required before we seek to impose tax on non-residents, and so on. A moment's reflection suggests the potential for cross-border mismatches is enormous.

The Examples presented in the *Recommendations Paper* all serve to demonstrate manifestations of disagreement. The nomenclature used is not especially illuminating but all the Examples depend

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tax treatment. Rather than targeting these technical differences, the focus of this Report is on aligning the treatment of cross-border payments under a financial instrument').

24 This paper focusses just on the parts of Action Item 2 that are meant to lead to changes in domestic law. Action Item 2 also involves proposals to adjust the provisions of the OECD Model treaty but those changes are not especially significant as a mechanism for solving the problem of hybrids. Rather, the focus of the treaty work is principally about the confirming the ability of the domestic law changes being recommended to survive scrutiny under existing treaty provisions, rather than devising a new treaty or new treaty provisions to address hybrids. See OECD, *Public Discussion Draft: BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues)* (Paris: OECD, 2014). The OECD recognised early that treaties were unlikely to play a significant role in any solution because, 'most hybrid mismatch arrangements exploit differences in domestic laws. Therefore, the impact of treaty-based provisions in these respects may be limited.' OECD, above n. 16, at p. 13.

upon disagreements between States. Some Examples demonstrate disagreements about the classification of instruments and the returns they produce: the discussion of 'hybrid financial instruments'[25] and 'imported mismatch'[26] transactions are both driven by disagreement about the classification of an instrument and the returns it pays – the State where the payer resides sees interest paid on borrowed money; the State where the recipient resides sees a dividend received on an equity investment.

The Example of 'hybrid transfers' demonstrates disagreements about the nature of transactions: the discussion of 'hybrid transfers'[27] is driven by a disagreement about the nature of a stock lending or REPO transaction – the State where the recipient resides treats a 'stock lending' arrangement as the purchase of the underlying stock with the dividends received on the stock being tax exempt; the State where the payer resides sees the transaction as a borrowing (secured by the stock) with the dividend payments made likened to deductible interest.

The remaining Examples all depend upon disagreements about the identity and number of taxpaying entities involved in a transaction – is there one entity or two; if there are two entities, can their positions be combined to create one:

- the discussion of receipts coming from a 'hybrid payer'[28] is driven by a disagreement about the existence of an intermediary and as a consequence disagreement about whether or not a transaction has occurred – one State says the payer is not an entity and therefore no transaction occurred between the payer and the recipient and therefore no tax needs to be paid on the receipt; the other State says the payer is an entity and a transaction occurred and the payment is one that gives rise to a deduction;

- the discussion of amounts received by a 'reverse hybrid'[29] is simply a variant on the same disagreement: disagreement about the existence of an intermediary and as a consequence disagreement about the identity of the recipient – cash is received by an entity established in the State but the authorities of that State says the recipient is not a taxpayer and instead the relevant taxpayer is a foreign entity; the tax authorities of the other State disagree and treat the recipient as the proper taxpayer;

- the discussion of payments by a 'hybrid payer'[30] is another manifestation of the same disagreement: disagreement about the existence of an intermediary and as a consequence disagreement about the identity of the payer – a payment is made by an entity established in the State and the authorities of that State say the payer is entitled to the deduction; the tax authorities of another State disagree and treat an entity established in their jurisdiction as the payer and the taxpayer entitled to the deduction;

- the discussion of payments by a 'dual consolidated'[31] entities is driven by disagreement about aggregating the tax position of discrete taxpayers: one State aggregates the position

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25 OECD, *Recommendations Paper*, above n. 4, p. 33.

26 OECD, *Recommendations Paper*, above n. 4, p. 59.

27 OECD, *Recommendations Paper*, above n. 4, p. 35.

28 OECD, *Recommendations Paper*, above n. 4, p. 42.

29 OECD, *Recommendations Paper*, above n. 4, p. 45.

30 OECD, *Recommendations Paper*, above n. 4, p. 51.

31 OECD, *Recommendations Paper*, above n. 4, p. 54.

of the payer with another entity resident in its jurisdiction; another State aggregates the position of the same payer with an entity resident in its jurisdiction.

The Examples also combine multiple disagreements. But there are myriad other manifestations of disagreements about instruments, transactions and entities, and if one were to think more widely, there are possible disagreements about almost any other tax-relevant circumstance: ownership: one country might treat the user of equipment as the owner; the other country might treat the entity with legal title as the owner; residence: the country where an entity was formed might treat the place where it is managed as the place of residence; the country where an entity was managed might treat the place where it was formed as the place of residence; source: the country where the contract for sale of an intangible was made might treat the profit as arising where the property passed; the country where the property passed might treat the profit as arising where the contract was made; timing: the country where the payer resides might treat the amount as deductible in the current year; the country where the recipient resides might treat the amount as assessable in a future year; capital v. revenue outlays: the country where the asset is located and used might treat the amount spent as a repair and immediately deductible; the country where the owner resides might treat the amount spent as an improvement and added to the asset's cost.

4. Action Item 2: A small target

Given how prevalent hybrid outcomes (that is to say, inconsistent national choices) are, it is not surprising that the OECD document focuses on a small target.[32] It does not purport to address all mismatches; instead, it is clearly preoccupied with just a few key issues in the current international tax order, principally disagreements about drawing the debt / equity distinction ['hybrid financial instruments' and 'imported mismatch' transactions], disagreements about borrowing done in different forms ['hybrid transfers'] and disagreements about entity recognition arising principally from the US check-the-box rules and corporate consolidation systems [payments from a 'hybrid payer', 'reverse hybrids', payments by a 'hybrid payer' and payments from a 'dual resident'].

The six rules proposed in the *Recommendations Paper* are constructed by reference to the outcome that the disagreement produces. So, rules are proposed for arrangements that result in:

- a deduction in one country not offset by the inclusion of an amount of income in another country (including where that outcome has involved three countries not two) [D/NI outcome], and
- a deduction being claimed for the same amount in two countries [DD outcome].

Interestingly, the paper does not consider the other possibility – a NI/NI outcome. For example, the sale of all the shares in a non-land-rich company by a taxpayer resident in a country with a participation exemption is not captured by the discussion in the Paper. While this particular example produces a NI/NI outcome without needing to rely on a hybrid instrument or entity, instances can be imagined where a hybrid element is the mechanism for producing that outcome. For example, the sale of redeemable preference shares in a land-rich company by a non-resident: the source country treats redeemable preference as debt and does not claim tax from a non-resident who sells debt owed by a resident company; the vendor resides in a country which extends its participation exemption to sales of redeemable preference shares.

[32] It is interesting to observe the narrowing of the scope of the project from its first public airing in the 2012 Hybrid Mismatch paper, through the *Discussion Draft* in March 2014 and the *Recommendations Paper* in September 2014.

Nor does the paper address as much attention to transactions and structures involving the duplication of claims for foreign tax credits through hybrid entities [a FTC/FTC outcome]. Are scattered references to changes to domestic law. The discussion of hybrid instruments and transfers does allude to this issue[33] but the discussion about the use of hybrid entities is almost entirely focused on duplicated deductions.

It might have been possible to approach the matter in another way. It would have been possible to construct the rules around the circumstance which has led to the disagreement: a rule that is invoked when countries disagree about the nature of an instrument and the returns it generates, the nature of the transaction being undertaken, the identity and number of parties involved in the transaction or structure, and so on. However, the detail of the rules proposed in the document probably comes to the same outcome: for example, the rule for 'arrangements that produce D/NI outcomes' is triggered only for a 'financial instrument' that leads to a 'hybrid mismatch.'[34] A 'financial instrument' is defined to include 'any arrangement that is taxed under the rules for taxing debt, equity or derivatives under the laws of the payee and payer jurisdictions ...' In other words, the rule being proposed is driven by the fact of disagreement about the nature of debt and equity, as well as the D/NI outcome that the disagreement produces.

4.1 The six rules

The Table below, which is taken from the *Recommendations Paper* gives a good sense of the permutations and combinations contained in the proposed rules, but much technical complexity lies behind the cryptic entries in the Table, and many defined terms have to be unravelled in order to make sense of the scope and limitations of each rule. It is important to note that six separate rules with their own discrete preconditions and exceptions are recommended for the seven hybrid situations identified.[35] It also is interesting to observe that for some of the seven hybrid situations, the report recommends changes to the general domestic law and then, in addition, dedicated 'hybrid mismatch' rules. For example, the *Recommendations Paper* proposes that domestic law should be changed so that no dividend exemption is available for a payment that was deducted offshore. That recommendation is in addition to the two subsequent elements to the 'hybrid mismatch' rule for 'hybrid financial instruments.' And it is also worth noting that the 'hybrid mismatch' rules often come in two parts – an initial Response rule and a further Defensive Rule.

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33 OECD, *Recommendations Paper*, above n. ____, p. _____.

> In order to prevent duplication of tax credits under a hybrid transfer, any jurisdiction that grants relief for tax withheld at source on a payment made under a hybrid transfer should restrict the benefit of such relief in proportion to the net taxable income of the taxpayer under the arrangement.

34 OECD, above n. _____, pp. 37-38.

35 The rule proposed for 'hybrid financial instruments' is to apply to the problem described as 'hybrid transfers.'

Mismatch	Arrangement	Specific recommendations on improvements to domestic law	Recommended hybrid mismatch rule		
			Response	**Defensive rule**	**Scope**
D/NI	Hybrid financial instrument (including hybrid transfer)	Deny dividend exemption for deductible payments Proportionate limitation of withholding tax credits	Deny payer deduction. (Exception if payer is CIV and entity tax is eliminated by deduction)	Include as ordinary income	Between related parties, or involving a structured arrangement
	Disregarded payment made by a hybrid (to foreign owner)		Deny payer deduction (unless double income inclusion also occurs). Surplus deduction may be carried forward	Include as ordinary income	Parties are members of same controlled group, or involving structured arrangement
	Payment made to a reverse hybrid	Improve CFC or offshore investment fund regimes. Treat (domestic) tax transparent intermediaries as taxable resident entities where non-resident investors treat the entity as opaque. Increase reporting of hybrid's income and allocation	Deny payer deduction (in its jurisdiction)		Parties are members of same controlled group, or involving structured arrangement
DD	Deductible payment made by a hybrid		Deny parent entity a deduction in its jurisdiction (unless dual inclusion of income also occurs). Surplus deduction can be carried forward (or may be allowed in full)	Deny payer a deduction (unless dual inclusion of income also occurs)	No limitation on Response. Defensive rule applies if parties are members of same controlled group, or involving structured arrangement
	Deductible payment made by dual resident		Deny deduction in both jurisdictions (unless dual inclusion of income also occurs). Surplus deduction can be carried forward (or may be allowed in full)		
Indirect D/NI	Imported mismatch arrangements	Improve CFC or offshore investment fund regimes. Treat (domestic) tax transparent intermediaries as taxable resident entities where non-resident investors treat the entity as opaque. Increase reporting of hybrid's income and allocation [see recommendation 5]	Deny payer deduction in its jurisdiction		Payer is member of same controlled group as parties to the hybrid, or involving structured arrangement

Based on: OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements. Action 2: 2014 Deliverable* (Paris: OECD, 2014) p. 17.

4.2 Preconditions

There are many important qualifications, exceptions and concessions that are not captured by the Table, some of which are alluded to below. It is not my intention in this paper to disentangle the various combinations and permutations nor to dissect the defined terms which lie behind the Table. It is sufficient, for present purposes, to note in general terms what the *Recommendations Paper* proposes.

First, there are important preconditions to triggering most of the six rules, and exceptions to their operation, which combine to narrow the target of Action Item 2 significantly.

Dependent upon hybrid. The relevant outcome must be triggered by the cross-border disagreement, rather than being the natural outworking of the same rule being applied in two jurisdictions:

> the only types of mismatches targeted by this Report are those that rely on a hybrid element to produce D/NI and DD outcomes[36]

There will be many circumstances where D/NI outcomes will occur but this outcome is not meant to be sufficient to invoke any of the hybrid mismatch rules. At one level, the operation this precondition will be obvious – interest paid to a foreign tax exempt entity does not produce the D/NI outcome because the D/NI outcome is not a function of the nature of the payment. At another level, however, just what amounts to a 'hybrid element' may prove to be quite problematic. For example, assume a company resident in State A pays $110 to redeem a bond with a face value of $100. In State A, the $10 is treated as interest, but in State B, where the holder resides, the transaction is constructed as triggering a capital gain of $10. Is this discrepancy a 'hybrid element' and does the answer change if State B does not tax capital gains?

Between related parties, members of a 'controlled group' or the parties to pay 'structured arrangement'. Perhaps the most telling qualification is limiting the operation of the proposed rules just to transactions between related parties set at the level of 25% common ownership,[37] the members of a 'controlled group,'[38] or the parties to a 'structured arrangement.'[39]

These terms implicitly constrain the application of the rules just to transactions that might be thought abusive. Presumably, transactions between related parties or within a controlled group are undertaken with a degree of care, planning and forethought so that the benefits arising from the hybrid outcomes are unlikely to be unintentional. Similarly, the notion of a 'structured arrangement' is meant to capture transactions which are structured or marketed based on the hybrid outcomes, or which depend upon the hybrid outcome in order to produce a commercial profit. And just to be clear, a taxpayer will not be a party to a 'structured arrangement' unless it shares in the value of the tax benefits. Clearly there will be practical difficulties in applying these rules to widely-held

36 OECD, *Recommendations Paper*, above n. 4, p. 30. In fact, each of the six rules has its own specific notion of what makes the arrangement an example of a hybrid mismatch.

37 OECD, *Recommendations Paper*, above n. 4, p. 69.

38 OECD, *Recommendations Paper*, above n. 4, p. 69.

39 OECD, *Recommendations Paper*, above n. 4, pp. 67-68.

instruments where the treatment of the payer might be contingent on the treatment of holders in many different countries. This notion of a structured arrangement may exclude some widely-held retail investment products, but not those which are marketed in particular ways.

In addition, scattered throughout the *Recommendations Paper* are other less visible caveats and limitations on the operations of the various rules.

Limitation to payments (and only between the parties?). One interesting limitation is the notion that the rules in question are only to be invoked with respect to the tax treatment of 'payments':

> All the mismatch arrangements described above involve payments… The hybrid mismatch rules do not extend to payments that are only deemed to be made for tax purposes and that do not involve the creation of economic rights between the parties.[40]

Presumably, this has the effect of taking out of Action Item 2 amounts which have tax consequences that arise otherwise than from a payment. For example, the *Recommendations Paper* insists that the proposed rules do not apply to purely fictional deductions:

> The hybrid mismatch rules do not extend to payments that are only deemed to be made for tax purposes and that do not involve the creation of economic rights between the parties. Rules, for example, that entitle taxpayers to a unilateral tax deduction for invested equity without requiring the taxpayer to accrue any expenditure (such as regimes that grant "deemed" interest deductions for equity capital) are economically closer to a tax exemption or similar taxpayer specific concessions and do not produce a mismatch in tax outcomes in the sense contemplated by Action Item 2.[41]

The example given, an allowance for corporate equity, is apparently meant to be immune from these rules even though it 'treats equity like debt' and in one country only.

But it is not clear whether this limitation would serve to exclude 'double dip' leases where two taxpayers each claim entitlements to depreciation deductions. There certainly are 'payments' – the price paid by the financier and the rent paid by the user – but they are not the same payment and the tax-relevant item for the financier is not itself a 'payment' but the depreciation deduction created by law and, while no doubt derived from a payment, is not itself a payment. What does seem clearer is that both parties could claim any additional investment allowance or tax credit that might be given to 'owners' without being affected.

Nor is it clear how this might affect foreign tax credit duplication arrangements where the same credit is enjoyed by two parties if that can happen without a 'payment' and without the creation of rights between the two claimants. The reference to payments which 'involve the creation of economic rights between the parties' suggests that foreign tax credit duplication arrangements are not within the scope of the rule.

Timing matters. The discussion in the *Recommendations Paper* about the relevance of timing discrepancies is not especially definitive. The text does suggest that timing discrepancies will not trigger the application of these rules, provided that the discrepancies are not too large:

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40 OECD, *Recommendations Paper*, above n. 4, p. 29.

41 OECD, *Recommendations Paper*, above n. 4, p. 30.

> the hybrid mismatch rule limiting D/NI outcomes should not ***generally*** address differences in the timing of payments and receipts under the laws of different jurisdictions and the rules limiting DD outcomes for hybrid entity payments should ***generally*** preserve both deductions to the extent they are offset against income that is taxable under the laws of both jurisdictions or to the extent the DD outcome simply results in shifting the net income of the taxpayer from one taxable period to another[42] (emphasis added)

Overall revenue loss. While the discussion suggests that the rules are to be self-executing and are designed to exclude any consideration which requires identifying the country that has lost revenue from the hybrid mismatch, other passages suggest the rules will only be triggered if revenue has been lost to both countries considered together:

> [the] mismatch in tax outcomes lowers the aggregate tax paid by the parties to the arrangement[43]

This qualification would likely prove problematic. Consider for example the receipt by an Australian company of interest on non-share equity (for example, interest on a participating loan). Is the aggregate revenue loss to be analysed just by comparing the two companies or does it take into account the position of Australian shareholders? Is the overall revenue loss determined just by looking at the corporate tax or does it include withholding taxes? If it includes corporate tax, does it take into account the refund of corporate tax to resident shareholders?

In fact, this problem is much more general. If a payment was deducted in the source country, not taxed in the recipient country in the hands of the immediate recipient, but was applied in a non-deductible manner, to pay an amount that was assessable in the hands of the ultimate recipient, the fact that the income was not taxed in the hands of the immediate recipient could be neither here nor there. Whether there is a problem or not depends upon where one stops the analysis. It is evident throughout the *Recommendations Paper* that the authors regard companies as independent beings having their own taxable capacity, rather than as conduits for organising the affairs of ultimate investors.

Not included in income; include in income. As noted above, the rules are structured around a D/NI (or DD) outcome. This raises the obvious question, what happens if the amount is included in income but is afforded special treatment. The obvious example would be an amount that was included as a capital gain. In fact, this issue turns up in two ways: is the amount insufficiently included in income so that anti-hybrid rule is to be invoked; does the anti-hybrid rule, once triggered, operate to include an amount in the tax base but within a particular class or type of income.

There is no specific discussion of these issues in the *Recommendations Paper* or its predecessors but the text is replete with references to amounts being included in 'ordinary income.'[44] This suggests that including amounts in a class of income that is notionally taxed but enjoys a concessional rate is intended to be within the operation of the relevant rules.

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42 OECD, *Recommendations Paper*, above n. 4, p. 31.

43 OECD, *Recommendations Paper*, above n. 4, p. 31.

44 OECD, *Recommendations Paper*, above n 4, p. 74 ('ordinary income means income that is subject to tax at the taxpayer's full marginal rate and does not benefit from any exemption, exclusion, credit or other tax relief applicable to particular categories of payments (such as indirect credits for underlying tax on income of the payer).'

And the same is probably true of income which is notionally taxed and at full rates, but carries the benefit of a tax credit. The *Recommendations Paper* does not specifically address situations where deductible payments are in formal terms assessable and as ordinary income, but are effectively untaxed because of the operation of a tax credit of some kind which reduces the tax payable on that class of income – that is, a NI effect is achieved even though the amount is included in 'ordinary income,' but it would be expected that such arrangements are an intended target of the regime.

The scope question. Ultimately, the net result of these qualifications and limitations is that, perhaps not surprisingly, the OECD takes on a target which is a function of 3 elements:

- a **hybrid feature** of the listed kind (debt, equity or derivative). Disagreements about ownership, residence, source, character and so on are not within scope,
- a relationship between the parties which likely indicates **avoidance**: transactions have to be structured financial products, or occur between related entities or members of a controlled group presumably because transactions occurring in those circumstances will be deliberate and the hybrid outcomes apparently intended, and
- a D/NI or DD **outcome**.

This raises the obvious question: if these rules are to be constrained just to situations that are intentional and thus likely to be abusive, don't we have rules against that already? The OECD appears to have concluded early on that specific or general anti-avoidance were not a sufficiently robust mechanism to solve the problem for the obvious problem that it is not always clear just which country's tax is being avoided when neither taxes.[45]

5. The implications for some structures and instruments

This section explains how these rules might be applied to some instruments and structures, and what the adjustments to Australian law might be if Australia were to implement Action Item 2.

5.1 Hybrid financial instrument rule – inbound investment

Assume A Co, a resident of Country A, holds redeemable preference shares in Aus Co which qualify as debt interests for Australian tax purposes. Aus Co claims a deduction for the dividends it pays. A Co is potentially entitled to the benefit of the participation exemption in Country A and does not pay tax on the dividends it receives.

The starting point is whether Country A has also signed up to the Action Item and has unilaterally revoked its participation exemption. If so, apparently Australia need do nothing further and it would presumably allow the interest deduction.

However, under the proposed hybrid financial instruments rule, Australia would deny the deduction to Aus Co. If Australia failed to implement that rule, Country A would (again) deny A Co the benefit of the dividend exemption, but this time under a dedicated anti-hybrid rule. It is worth noting, however, that s. 974-80 ITAA 1997 in Australia's debt / equity rules may already unilaterally deny a deduction to a resident entity for interest payments made to non-residents where the instrument is

45 OECD, above n. 16, pp. 13-14 (the 'need to show a direct link between the transactions and the avoidance of that particular jurisdiction's tax tend to make the application of general anti-avoidance rules difficult in many cases involving hybrid mismatch arrangements').

akin to an equity interest (at least as far as Australian law defines it). The role of s. 974-80 ITAA 19997 as an implicit, but unilateral and non-contingent, anti-hybrid rule is not often appreciated.[46]

However, the relevant rule (presumably in both countries) might not be applicable if the companies were not related or part of a structured arrangement, perhaps if the instrument was widely held, or one of the other exceptions applied.

5.2 Hybrid financial instrument rule – outbound investment

Aus Co subscribes for a class of shares in B Co, which is resident in Country B. The shares represent a 10% interest in B Co. Under the law of Country B, the returns on these particular shares are deductible in Country B. Under the former Australian law, even though the instrument was regarded as a debt interest under Australia's debt / equity rules, the dividends on these shares were treated as exempt income of Aus Co.

Under the proposed hybrid financial instruments rule, Aus Co's entitlement to the dividend exemption would depend upon whether Country B retained or removed the tax deduction for B Co. If Country B retained the deduction, Australia would 'turn off' the exemption; if not, Australia would permit the exemption to remain.

Under the recently enacted rules in Div 768-A ITAA 1997, a different set of outcomes would occur. Aus Co would no longer be entitled to a dividend exemption, which would mean that Country B should reinstate the tax deduction for B Co.[47]

5.3 Hybrid entity payments rule

Aus Co is a company incorporated and resident in Australia, and the head entity of the Aus Co consolidated group (comprising Aus Co and its wholly-owned subsidiary, Aus Sub). Aus Co is a wholly-owned subsidiary of US Co and under the US check-the-box rules, Aus Co (but not Aus Sub) is a disregarded entity for US tax purposes. Aus Co borrows funds from Bank and pays interest on the borrowed funds. Aus Co (as head entity of the consolidated group) deducts the interest in Australia, in effect reducing the tax payable on the income of Aus Sub. In the US, US Co is regarded as the borrower and is entitled to deduct the same interest payment.

Under the proposed hybrid entity payment rule, the US would deny US Co a deduction for the interest to the extent it shelters Aus Sub's income from Australian tax. If, however, the US did not act to deny US Co the deduction, Australia would deny the Aus Co group a deduction for the interest payment.

Other elements of the proposed rule try to adjust the outcomes if, for example, some of the income of Aus Co was being included in both countries simultaneously, and to allow the carry forward of losses if US Co could demonstrate to the IRS that the deduction it is being denied cannot be set-off against the income of any entity in Australia.

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[46] See example in EM.

[47] Notice that Div 768-A ITAA 1997 is not a solution to the hybrid issue. What matters is how Country B treats the payment, not how Australia classifies it. Making our domestic classification of inbound and outbound dividends internally consistent may or may not solve the mismatch issue because that is ultimately driven by the classifications applied offshore.

5.4 Reverse hybrid

Aus Co is one of a number of investors in a corporate limited partnership (LP) in Country C. LP manufactures and sells products to an entity in Country D which then pays the price to LP. Under the laws of Country C, the income of LP is treated as taxable in the hands of the partners, being Aus Co and the other investors. Under Australian law, the entity in Country C, rather than the partners, is viewed as properly taxable on the income it receives (assuming LP is not a CFC and Aus Co has not made an election to treat LP as a foreign hybrid).

This is one situation where the September *Recommendations Paper* differs significantly from the March *Discussion Draft*. Under the series of rules proposed in the *Discussion Draft* for reverse hybrids some or all of the following should then occur: Australia should ensure its FAF rules would include in the assessable income of the Aus Co a share of the income of LP; if necessary, Country C should impose tax on the LP if the amounts it derives will not be taxed in the hands of Aus Co and the other partners; if necessary, Country D should deny a deduction for the price paid to LP, and Country C should gather substantial information from LP and make it available to Aus Co and the tax authorities in Australia.

By the time of the *Recommendations Paper*, the solution has changed quite significantly: the only rule is that Country D should deny a deduction for the price paid to LP.

6. Some thoughts on the outcomes, explicit and implicit

The combination of an initial Response rule and (sometimes) a Defensive Rule seems designed to ensure two outcomes: namely that income arising from hybrid instruments is taxed in at least one country and deductions incurred by companies are deducted in only one country. To put this another way, the implicit conclusion to which Action Item 2 leads is that the various rules are trying to give effect to two propositions: all income must be taxed at least once; and it does not matter where – whether the tax is collected under the Response rule or the Defensive rule is immaterial.

The positions expressed in the six rules are not reached on the basis of any overarching principle. The paper deliberately disavows any attempt to determine which country lost revenue and which country should benefit by a greater revenue collection. Hence, which country ends up collecting revenue from implementing the recommended rule could be arbitrary or driven by strategic behaviour.

It is not obvious to me that the first proposition should be pursued; the second proposition potentially runs counter to the policy said to be underlying the BEPS Agenda.

6.1 Domestic, unharmonised and agnostic v. international, harmonised and policy-based

The authors of the *Recommendations Paper* and earlier documents have taken a particular approach to addressing the problem of hybrid entities and instruments:

- they have decided that any solution is to be executed in domestic law – it is not necessary to try to address this through amendments to existing international instruments or creating a new instrument;
- the domestic law requires two elements – one part of the law must lay a claim to tax on amounts that are currently not being taxed in that state, and another part of the law must

be prepared to abandon that claim under a priority rule which is meant to coordinate conflicting claims;

- the proposed domestic rules do not need to be harmonised around any substantive doctrine or concept; it will be sufficient to coordinate outcomes -- for example, the domestic rules do not need to enact the same definitions of 'debt,' 'equity,' 'dividend,' or 'interest'; it will be sufficient if the countries' substantive rules do not allow lacunae; and

- the co-ordination does not need to be principled – any rule which reverses the effect of the mismatch is acceptable and the recommended solutions are entirely agnostic about which country should collect the revenue.

Does this approach makes sense? It might have been possible to address the problem of hybrids through a project which attempted to remove disagreements (that is, through greater rule harmonisation). Instead, the project accepts the existence of disagreements but tries to cure its effects.

Domestic law v. treaty. The OECD report deliberately avoids any attempt to address the problem of hybrids through a supra-national instrument. Instead, a series of domestic rules is proposed. It is not obvious that this is a suitable way to approach the topic.

We have seen the problem of inconsistent national rules before: it is the same problem we felt it necessary to negotiate over 3,000 bilateral tax treaties to resolve. We have needed tax treaties to resolve the problem of overlapping and inconsistent national claims – two countries laying claim to tax on the same pot of money.[48] In the case of hybrids, the problem is 'underlapping' and inconsistent national claims – two countries each of which might but hasn't yet laid claim to tax on the same pot of money – and yet apparently this can be solved entirely in domestic law. The contrast between the approach taken for Action Item 2 and the vast project that is bilateral tax treaties is striking. Can we really reconcile inconsistent choices without a tax treaty?

The first step – enacting domestic rules to make a claim to tax – is likely to be easy. The more difficult part is the second step – abandoning that claim under a rule about priority or coordination between nations.

One can be optimistic or pessimistic about the ability of nations to coordinate. Where two countries fight over a pot of money, we have been pessimistic, and assumed that mere requests for coordination would not prove adequate: two governments could agree in domestic law that the taxpayer will resident in only one of their states, two governments could agree in domestic law that income taxed at source will not also be taxed on a residence basis, two governments could agree in domestic law that income arises in just of the states, or two governments could agree in domestic law are way to share tax collected on the same income from different taxpayers.

Hybrids also present this challenge: two countries about to fight over a pot of money. It is undoubtedly curious that this pot of money has not been pursued by either country, but the remedy proposed by the hybrids project encourages both countries to enact domestic laws to pursue it. If

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48 Typically overlapping claims occur because two governments claim that the taxpayer is resident in their state, two governments claim tax on the same income (one on a source basis and the other on a residence basis), two governments claim tax on the same income (both claiming the income arises in their state), or two governments claim tax on the same income (one claiming tax from one taxpayer and the other claiming tax from a different taxpayer).

the two countries respond and decide they will each lay claim to this pot of untaxed money, are we optimistic or pessimistic whether they will then have second thoughts: 'after you;' 'no, after you.'

If the two countries do not in their domestic law work out a way to prioritise the conflicting claims, will tax treaties resolve those conflicts? That may turn out to be correct, but the work being done for Action Item 6 encourages countries not to let treaties stand in the way when tax avoidance is observed. Given that Action Item 2 defines the class of hybrids to be affected in terms which raise the spectre of avoidance, it seems plausible to believe that treaties will not come to the aid of taxpayers affected by anti-hybrid rules invoked in two countries.

Harmonisation v. sequencing. It is perhaps not surprising that the authors of the report came to the conclusion early on that any attempt to harmonise national law around common principles would be doomed to failure. Indeed, the 2102 report dismissed it without qualm:

> One theoretical approach to deal with hybrid mismatch arrangements is the elimination of commonly exploited differences in the tax treatment of entities, instruments and transfers. As it does not seem possible to have a harmonised treatment even for the most commonly exploited differences which would eliminate the possibility for mismatches among different countries, this option is simply mentioned for the sake of completeness.[49]

It is hard to argue with that view. One would have to be very optimistic to believe that States could agree on what makes something 'interest' or a 'dividend,' which entities should be transparent and which should be opaque, or when it is appropriate to aggregate entities and treat them as a single taxpaying unit. An approach which can side-step this problem is obviously very attractive. Instead, the solution is a two-step: a recommendation for rules that are (i) contingent and (ii) sequenced.

Principled v arbitrary outcomes. I will come back to this point below, but it is important to note here the report's agnosticism. It does seem more than a little odd to say that nations should agree to a rule for no reason other than it will impose tax on someone.

Moreover, is the proposition, 'if they haven't taxed it, then I must / might as well,' a defensible principle of tax policy? No other justification is offered for the rules; they exist to tax untaxed income (albeit, brought about in a particular way) and for no other reason.

It is interesting to compare the absence of a discussion about principle and tax policy in the *Recommendations Paper* with earlier work. When the US enacted its dual resident company rules, the debate was framed deliberately around notions of competitiveness – that US bidders for a US enterprise were at a disadvantage when compared to foreign bidders because the foreign bidders could use their losses twice.[50] Similarly, the 2012 Hybrids report tried to position the issue not just as a revenue measure, but also as involving issues of competitiveness, economic efficiency, transparency and fairness.[51] Stripping away considerations other than revenue, and framing the analysis almost entirely in the language of avoidance, may in fact diminish the case that these measures or at least dedicated measures. Countries with ambitious general anti-avoidance rules may feel that no further action is necessary if the only matter at stake is another manifestation of avoidance.

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[49] OECD, above n. 14, p. 13.

[50] [cite]

[51] OECD, above n. 16, pp. 11-12.

6.2 Must all income be taxed somewhere?

I argued above that the effect of the recommendations made in the *Recommendations Paper* is to change the BEPS mantra from, 'income should be taxed where rent rises' to, 'all income should be taxed somewhere.' The obvious questions are whether a country would always agree with the proposition that all income must be taxed somewhere, and that if the income has not been taxed offshore already, it is appropriate for that country to tax that income. Countries have national policies which they regard as being in their own interests and which would be challenged by this change of policy.

Consider for example Australia's conduit foreign income rules.[52] The theory behind these rules is that income earned offshore which is passing through Australia to non-resident owners should not be liable to Australian corporate tax or withholding tax. If the income being earned offshore was paid to Australia in a form that was deducted in the source country, should Australia's view change? It is not obvious that Australia should invoke a rule which would have the effect of taxing the income in the hands of the intermediate company just because the income was not taxed in the source country and displays some hybrid feature.

It might be argued that Australia would not be obliged to invoke its anti-hybrid rules because it is the conduit foreign income rules which cause the non-taxation, rather than some disagreement between countries about the returns on financing instruments. However, a hybrid instrument might be used as the mechanism to extract income untaxed from the source country with the result that the income would enjoy two exemptions in Australia – one under the rules which exempt foreign dividend is and a second exemption under the conduit foreign income rules. One of these is clearly unnecessary; but would Australia be obliged to negate its conduit foreign income treatment nevertheless?

There are other reasons why a country might consider that it is not in its own interests to start denying deductions for payments being made under hybrid instruments. Like many countries, Australia has taken the view that (provided the resident payer is not thinly capitalised) the appropriate rate of tax to claim on interest paid to unrelated nonresidents is 10%. If that interest is made non-deductible because of an anti-hybrid rule, Australia's claim to tax increases to 30%, collected from the payer. (It is not clear what happens to the withholding tax.) If the payment is to an unrelated party, one might expect that there would be a gross-up clause in the financing agreement such that Australian borrowers now suffer an increased cost of funding. If the burden of the tax increase is passed back to the Australian borrower, it is hard to see the benefit to Australia.

6.3 Becoming dependent upon the practices of other countries

It is clear that if these recommendations are pursued, a state's tax law would become much more contingent, and structurally dependent on the policies and practices of other governments. Surrendering sovereignty over tax matters to other countries is not something governments are used to, or are likely to enjoy.[53]

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[52] Div 802 ITAA 1997.

[53] It was amusing, therefore to observe Australia's claims we were enacting new rules defining which inbound payments will be regarded as dividends and thus exempt from Australian tax to rid the world of opportunities for hybrid mismatches. J Hockey, Ministerial Statement on G 20 OECD Tax and Transparency, 4 September 2014, http://jbh.ministers.treasury.gov.au/speech/014-2014/ ('the Government is … making sure that repayments of interest to companies in Australia from overseas subsidiaries are subject to tax even when they are dressed up as dividends'). The relevant rules are

The proposals in the *Recommendations Paper* render domestic law subservient to the policy decisions of other governments. If the solution to mismatches lies in sequenced and inter-dependent changes to the domestic law of a country, obvious questions include, which country is to change its treatment, will it agree to do so if the change would adversely affect its revenue, but if the change will increase its revenue, will the other country accept that outcome? Will there be a rush to 'get-in-first' and what action will this provoke in response? The incentive for opportunistic and strategic behaviour is obvious.[54]

It is here that the absence of a compelling theory becomes obvious. Countries will presumably want to act in their own interests when they see their own tax bases put in jeopardy. They may be willing to act in the interests of other countries with which they have a degree of affinity brought about by geography, cultural affinity or the ties of treaties.[55] But in the absence of a view about the soundness of the policy, the likelihood that countries will defer to decisions made in foreign unfriendly capitals seems unlikely.

There are many instances one could point to of situations where domestic law takes into account the legislation enacted in other countries. But I think the nature of the dance proposed in the *Recommendations Paper* is rather different. In cases like foreign tax credits or recognising foreign hybrids, domestic law is framed unilaterally but in light of what occurs offshore. The legislation is not expressly made dependent upon each movement to foreign legislation.

6.4 Stopping at the company

It is clear to an Australian audience that the authors of the *Recommendations Paper* come from classical system countries – all the analysis in the *Recommendations Paper* stops at the level of the company. There is an implicit assumption that a company is an independent taxpayer with its own taxable capacity and ought to be considered in isolation from that of its owners.

Since 1987, Australia has stopped viewing a company as an ultimate taxpayer. Instead, a company is nothing more than a convenient place at which to calculate (and collect a withholding tax) on

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Div 768-A ITAA 1997, enacted by *Tax and Superannuation Laws Amendment (2014 Measures No. 4) Act 2014.* The best that can be said of the measure is that it achieves internal consistency so far as Australian domestic law is concerned for inbound and outbound payments and thin capitalisation rules. But, to say the measure curtails opportunities for hybrid mismatches is mistaken.

54 This kind of co-operative v. non-co-operative behaviour in international tax is explored in S Whittington & J Prebble, Cross-border Tax Arbitrage and Convergence of Tax Systems: A Law and Economics Approach, unpublished paper presented to the ATTA Conference, Sydney University, January 2012 http://sydney.edu.au/law/parsons/ATTA/docs_pdfs/conference_papers/Cross_Border_Tax_Arbitrage_and_convergence_of_tax_systems_a_law_and_economics_approach.pdf. Prebble's work differs from the hybrids problem in that he analyses situations where, 'cross-border tax arbitrage increases the tax payable in one jurisdiction and decreases the tax payable in the other jurisdiction.' Id, at p. 5.

55 The obvious example is the recent change to article 4 in the Parent-Subsidiary Directive – Council Directive 2011/96/EU of 30 November 2011, as amended. It now reads,

1. Where a parent company or its permanent establishment, by virtue of the association of the parent company with its subsidiary, receives distributed profits, the Member State of the parent company and the Member State of its permanent establishment shall, except when the subsidiary is liquidated, either (a) refrain from taxing such profits to the extent that such profits are not deductible by the subsidiary, and tax such profits to the extent that such profits are deductible by the subsidiary

income that belongs to the owners of the company, and will or should be taxed in their hands either immediately or when shares are sold.

Once one relaxes the assumption that the company is the end of the line, complaint against hybrids losers some force. Untaxed foreign income received by an Australian company is likely to manifest itself in a higher tax bill for resident shareholders. While the income might be retained by the company, rather than distributed, in order to negate this effect, one would expect to see higher capital gains tax being paid by the resident on the sale of the shares. In either case the failures tax at the level of the company is not an incurable failing.

And if the income is passing through Australia to foreign shareholders, Australian tax policy settings are designed to ensure that no tax should be collected from either the company or the shareholders. And again, if the income is retained by the company rather than distributed, non-resident shareholders will be unlikely to suffer Australian capital gains tax on the sale of their shares, unless the company happens to be land-rich at the time the shares are sold.

In addition, treating the company as the termination of the analysis makes little sense for income that is applied to pay other Australian residents. Consider for example an Australian company which has borrowed from a resident bank and funds its foreign subsidiary using equity. Under current settings, the interest expense incurred to the Australian bank is deductible even though the dividends received from the foreign subsidiary are exempt from tax.

In this instance, the income will be taxed in the hands of an Australian resident, but it will be the bank rather than the company which becomes the taxpayer. It makes little sense in such a structure to insist that the company be taxed first and as well.

6.5 Solving all hybrids through deduction

One of the more curious features of the six rules proposed in the *Recommendations Paper* is the focus on solving each problem through denying deductions. The Table shows that the solution to problems, whether they are driven by differing views about instruments or transactions, or whether they are driven by differing views about the existence and number of entities, is the same. In all cases, the remedy is to deny a deduction. Sometimes the deduction will be denied to the parent company [hybrid transfers], sometimes to the operating company [hybrid financial instruments] and sometimes to the customer of the operating company [imported mismatches], but in all cases the primary remedy is deny deduction. The anti-hybrid project is interesting not least because it reflects a serious incursion into national law in ways that the OECD has not previously undertaken, but it seems the OECD's focus has not extended beyond deduction denial rules.

Denying deductions has a certain simplicity but it seems more than a little odd for problems that are either driven by something other than a deduction or are depend upon defects, limitations or other qualifications that must exist in domestic law.

Hybrid transfers. For example, in the hybrid transfer example, two questions arise. Why is the transferor being allowed a deduction for a payment being made by the company in which it holds shares, or used to? The transferor of the shares may well be regarded as 'borrowing' the purchase price, but the target company is the one paying the cost of that borrowing, and appears not to be reimbursed for that outlay. Why is its payment being regarded as paid by the borrower? And secondly, why is the dividend received regarded as still possessing the character of a dividend in the hands of a financier? The payment received by the financier ought more sensibly to be assimilated to interest, albeit satisfied by the receipt of a dividend.

A more direct and logical approach to the hybrid transfer problem lies in the proper classification of the dividend. The payment received by the financier ought to be assimilated to interest – that is presumably, taxable as ordinary income with no exemption or attached tax credit. It should then be a matter between the companies whether the financing cost is borne by the payer or by the borrower. Requiring the borrower to bear the cost of the financing is clearly more sensible but only if the payer has been compensated for bearing the borrower's cost.

Denying deductions seems even more odd as the means to counter problems arising from disagreements about the existence and number of entities.

Dual resident companies. Australia anticipated and addressed the problem of dual residents duplicating a deduction for the same loss through the consolidation system and proposed sensible and obvious mechanism based on the problem of dual residents: in effect, a resident company cannot be a member of a consolidated group if it is also resident in another country. [56] Two rules exclude the company from being eligible to be a member of a group: in the case of companies in treaty countries, a company that is a resident of Australia will be excluded if a provision in a tax treaty 'has the effect that the company is, for the purposes of the agreement, a resident solely of the foreign country …' and for companies that are resident in non-treaty countries, the definition operates to exclude companies that are incorporated offshore and are managed and controlled in another country. [57]

This provision has the distinct advantage that it identifies and addresses the problem directly. If the problem is dual residence; the neatest solution lies in changing the rule about residence.

Reverse hybrids. Similarly, for payments to reverse hybrids, the obvious remedy is in amending the CFC rules in the jurisdiction where the parent is resident. If that jurisdiction treats the foreign hybrid as an entity, and it is deriving passive income or base company income, then the CFC rules are a well understood and perfectly acceptable mechanism that should define the scope of tax on the foreign hybrid. The *Recommendations Paper* acknowledges that this is a better remedy.[58]

But for reasons which are not obvious to me, the recommendation for payments to a reverse hybrid is to deny a deduction to the entity making the payment to the hybrid. That seems to me a very oblique solution. It is also unlikely to be workable since the position of the payer depends upon its knowledge of the tax laws of both the jurisdiction to which it is making the payment (the jurisdiction in which the foreign hybrid is established) and the tax laws of the jurisdiction of the owner of the foreign hybrid. It might be plausible to expect the payer to know this if the payer is in the same control group as the other parties, but this becomes less likely the payer is implicated by these rules simply because the arrangement amounts to a structured arrangement.

Another remedy might be in proposing contingent entity recognition rules. That is a much more direct way of approaching the problem: if the problem is that two countries cannot agree on who is the proper taxpayer, the most direct remedy is surely one which tries to coordinate the entity recognition rules. Australia has tried to do this in its rules concerning 'foreign hybrids.'[59] Australian

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[56] Section 703-15(2) ITAA 1997 ('the entity must be an Australian resident (but not a *prescribed dual resident)').

[57] Section 6(1) ITAA 1936, definition of 'prescribed dual resident.'

[58] OECD, above n. 4, at pp. 47-49.

[59] Div 830 ITAA 1997.

domestic law begins from the presumption that corporate limited partnerships are the proper taxpayer rather than the partners in the partnership, and that all 'companies' are taxpayers in their own right .[60] However, aware that the UK treats the partners in limited partnerships as the taxpayer, Australia defers to the UK classification. Similarly, aware that the US treats a company created as a LLC as a partnership rather than as a company, Australia defers to the US classification. In each case, Australian law addresses the disagreement about the proper taxpayer by directly addressing that question, not indirectly by denying deductions to people who deal with it.

6.6 What happened to withholding taxes?

One can see in the paper a preoccupation with corporate tax and an almost complete disregard of withholding tax. The discussion in the *Recommendations Paper* contains only a handful of references to withholding taxes, and those references are mostly about limiting credits for withholding taxes that might otherwise be enjoyed. No doubt, withholding taxes are a matter of rather minimal concern in Europe because of the Interest and Royalties Directive and the Parent-Subsidiary Directive, but Australia still insists upon withholding taxes on unfranked dividends, interest, royalties and some trust distributions paid to non-residents, and these taxes counter, to varying extents, the effects that might at first glance appear to follow from hybrid instruments.

For example, the D/NI and DD outcomes are all expressed by referring only to the corporate tax base. But if deductible payments leaving a country trigger a withholding tax, is there still an evil that needs to be remedied by the recipient country? For example, a dividend on a non-equity share paid by an Australian company will likely be liable to interest withholding tax, and the fact that the payment was deductible against the profits of the Australian company is offset to some extent by the withholding tax at the border.

A similar observation can be made about inbound income. Assume an Australian company receives interest on a loan that is equity for Australian tax purposes. The fact that the payment is not assessable to the Australian company is likely to be negated to some extent by the foreign withholding tax levied at the border. That tax is a real cost because no credit for the withholding tax will arise in Australia.

And if one combines this discussion about withholding taxes with the discussion above about the precondition that there be an aggregate revenue loss, another question arises: what role does revenue loss play if one adds the fact of withholding taxes? Does the fact of revenue loss operate simply as a precondition to invoke the rule, or does the size of the revenue loss play a part in how the remedy works? For example, assume a payment is deductible against a corporate tax that is levied at 25%, but it triggers a withholding tax of 10% at the border. Is the recipient country meant to (i) not invoke its anti-hybrid rule, (ii) invoke it is rule but give credit for the withholding tax or (iii) invoke it is rule and tax the receipt in full with no credit?

6.7 Consistent with the BEPS paradigm

Finally, I can't help noting the inconsistency that emerges from the decision of the authors to deliberately eschew any attempt to position the discussions within a broader conceptual aspirations of BEPS. The *Recommendations Paper* makes a virtue of being agnostic about who should be collecting tax from situations involving inconsistent government choices, but how can this be so? What happened to the paradigm of taxing income where it is earned? The six proposed rules are a

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60 Div 5A ITAA 1936.

significant departure from the BEPS mantra that ‘profits are taxed where the economic activities generating the profits are performed and where value is created.’[61]

Just where the underlying income being depleted by the hybrid instrument or entity income ends up being taxed is more than a little arbitrary. This can come about in two ways.

First, and most obviously, the architecture of having primary and secondary rules will inevitably lead to tax collections in different countries depending on which country moved first.

Secondly, and focusing just on the primary rules, they too turn out to lead to different places:

- in the ‘imported mismatch’ example under the primary rule, the income is taxed in the jurisdiction where the intermediary’s customer (the borrower) resides – in this case it seems the economic activity which is generating the profits is the activity conducted by the borrower / customer. The same applies for payments made to a ‘reverse hybrid;’

- in the ‘hybrid transfer’ example, under the primary rule, the income is taxed in the state where the parent of the payer resides – presumably the economic activity is considered to be the holding of shares by the parent, rather than the place where the profits being appropriated to pay the financing cost arose; and

- in the case of payments made by hybrid entity to its owner, the primary rule will deny a deduction to the foreign hybrid – presumably on the basis that the economic activity is conducted by the hybrid and its connected entities.

The focus on implementing the anti-hybrid proposals through deduction denial rules leads to these odd outcomes. In some cases, the relevant economic activity apparently occurs where the parent operates; in other cases the relevant economic activity apparently occurs where the customer operates; and in other cases the relevant economic activity occurs where the operating company operates. This sits more than a little uneasily with the entire BEPS project.

Which leads to the final point: it would more than a little ironic if the anti-hybrid rules themselves became a mechanism for achieving base erosion and profit shifting. Assume B Co was receiving income and relying on a hybrid instrument to repatriate that income to its Parent, claiming a deduction in Country B. If the Country B enacts an anti-hybrid rule and denies B Co a deduction, one solution might be to relocate the deduction using the anti-hybrid rule and have the deduction denied in another country. The ‘imported mismatch’ rule is an available instrument to shift the country where the denial of the deduction occurs, and this could be attractive.

61 Indeed, the mantra that ‘profits are taxed economic activities generating the profits are performed and where value is created’ was never entirely accurate. A more accurate version of the underlying theme would be to say that, ‘it should not be possible to relocate profits and tax so that the income is taxed in a country other than the one where economic activities generating the profits are performed and where value is created.’

Co-ordinating inconsistent choices

Graeme S Cooper

1, 2. BEPS and Action Item 2

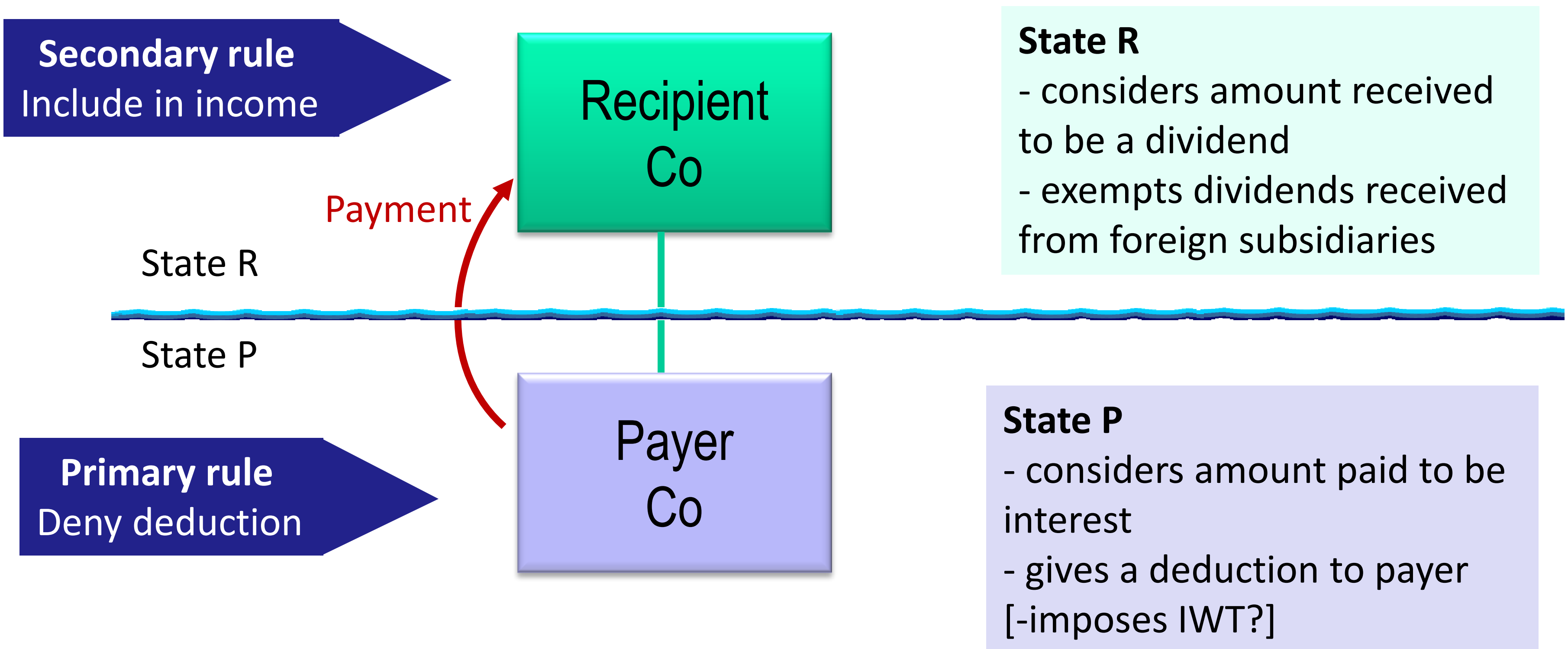
- BEPS and Action Item 2
  - A single coherent project
  - A series of discrete but related projects
  - Seven representative Examples
  - Six rules

- Not a new issue, but maybe a new approach
  - Rosenbloom and others
  - The resurgence

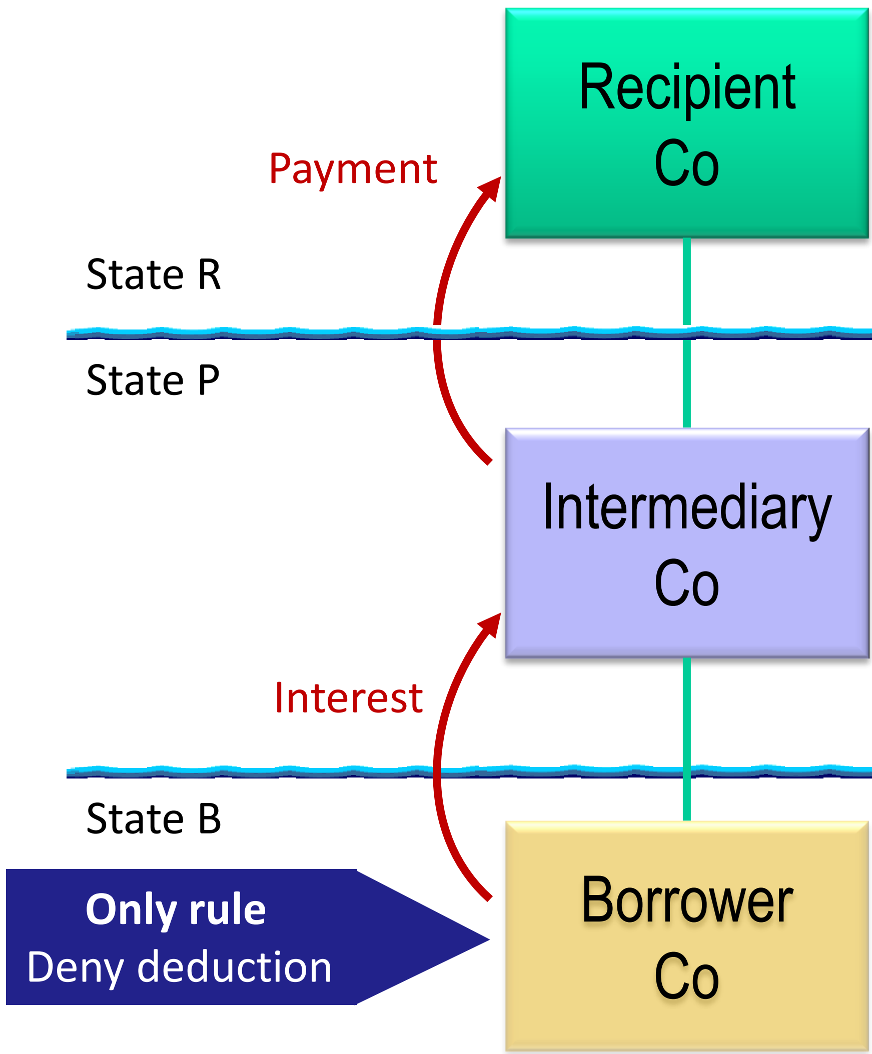
3. The underlying problem

- Disagreements can be everywhere
- With us, tax idiosyncrasy is the norm (Australian exceptionalism)
- The 7 Examples reflect disagreements about
  - debt v. equity
    - hybrid financial instruments
    - imported hybrids
  - Transactions – sale v. secured borrowing
    - hybrid transfers
  - existence / number of entities
    - receipts by owner from ‘hybrid payer’
    - receipts by ‘reverse hybrid’
    - payment by ‘hybrid payer’
    - ‘dual consolidated’ entities

Hybrid financial instrument



'Imported mismatch'

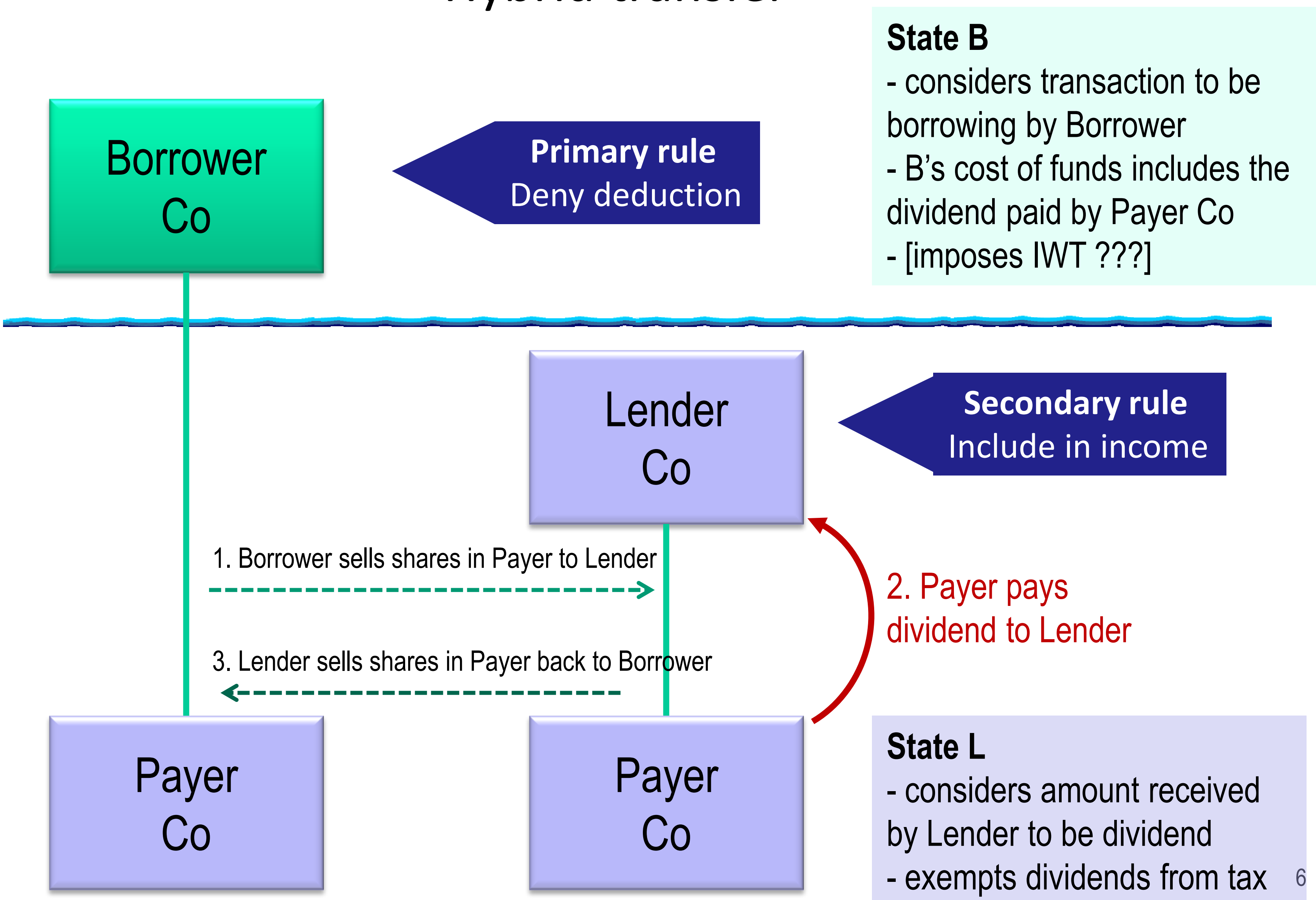


State R
- considers amount received to be a dividend
- exempts dividends received from foreign subsidiaries

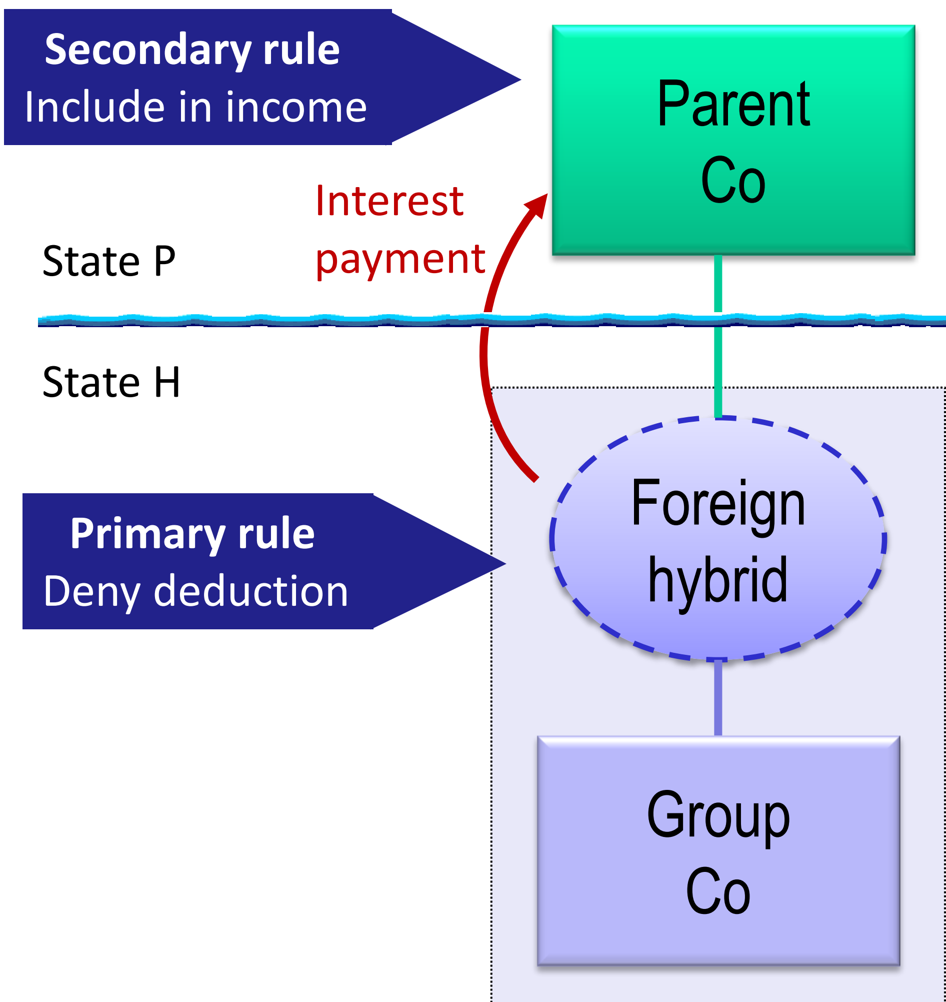
State P
- includes interest received in income
- considers amount paid to be interest
- gives a deduction to Intermediary
[-imposes IWT?]

State B
- gives a deduction to Borrower for Interest
[-imposes IWT?]

‘Hybrid transfer’



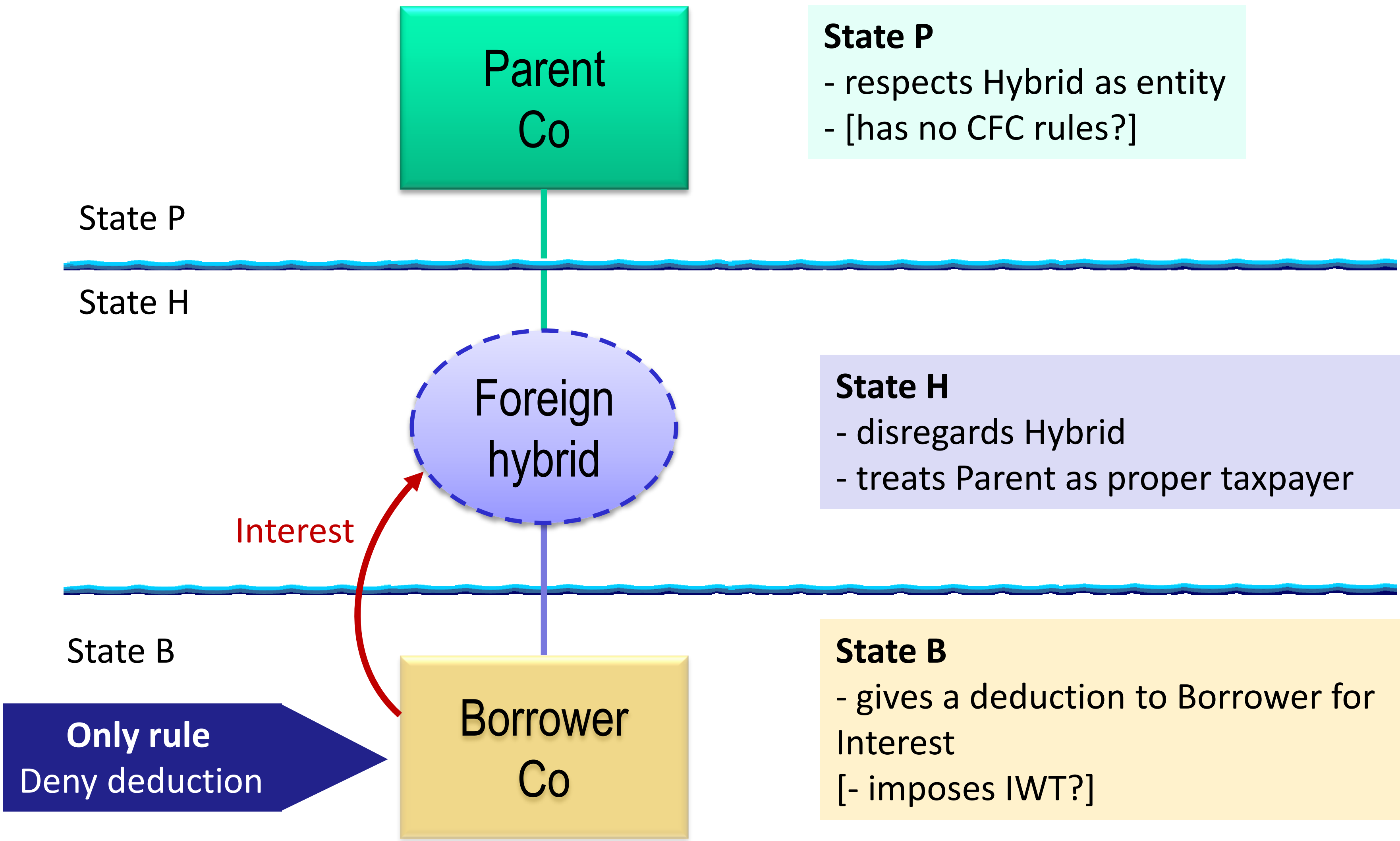
Payment made **by** hybrid entity (to Parent)



State P
- disregards Hybrid
- sees no loan
- sees no interest income

State H
- treats Hybrid as entity
- respects borrowing
- allows interest deduction
- [imposes IWT?]
- allows loss to offset income of Group Co

Payment **to** reverse hybrid

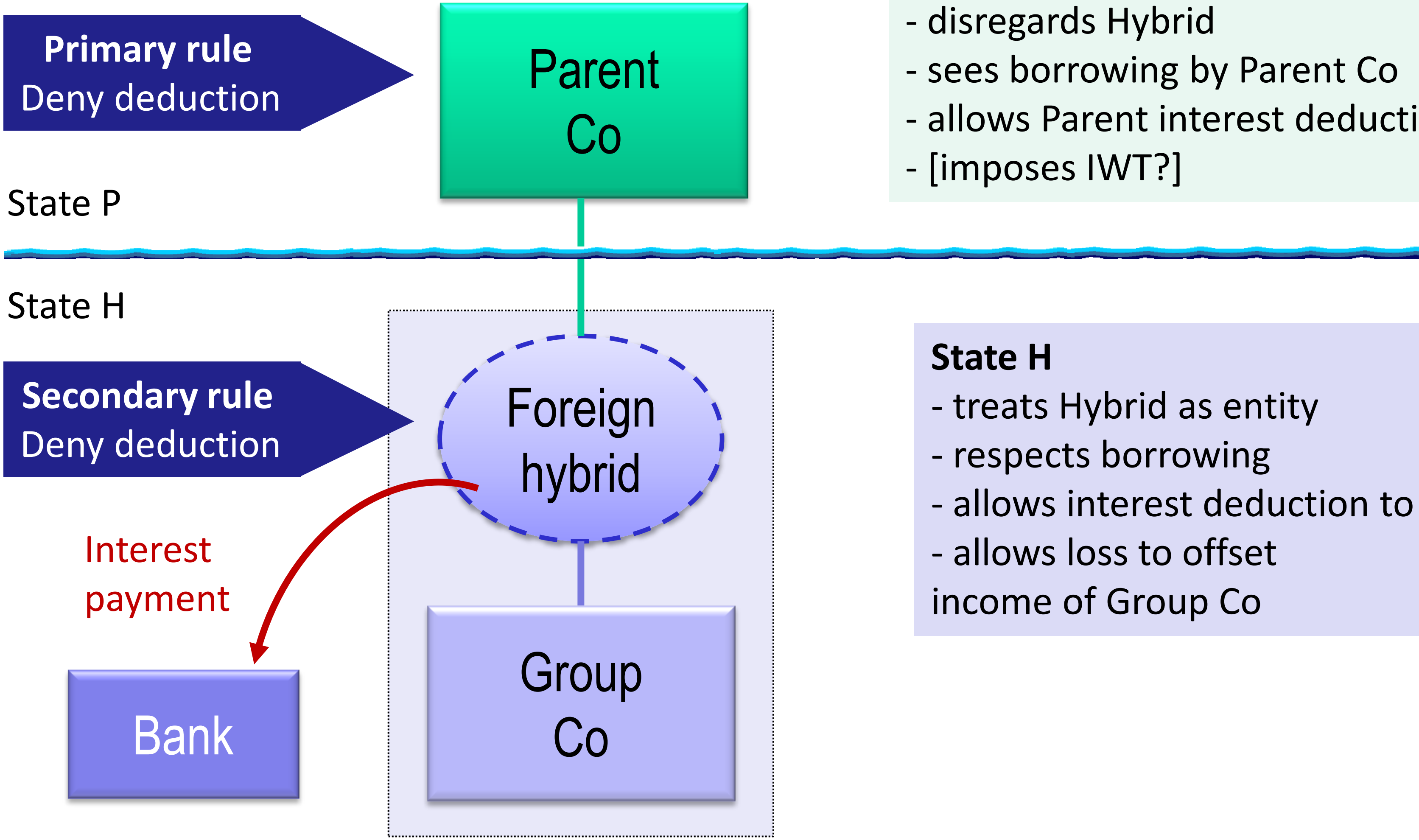


State P
- respects Hybrid as entity
- [has no CFC rules?]

State H
- disregards Hybrid
- treats Parent as proper taxpayer

State B
- gives a deduction to Borrower for Interest
[- imposes IWT?]

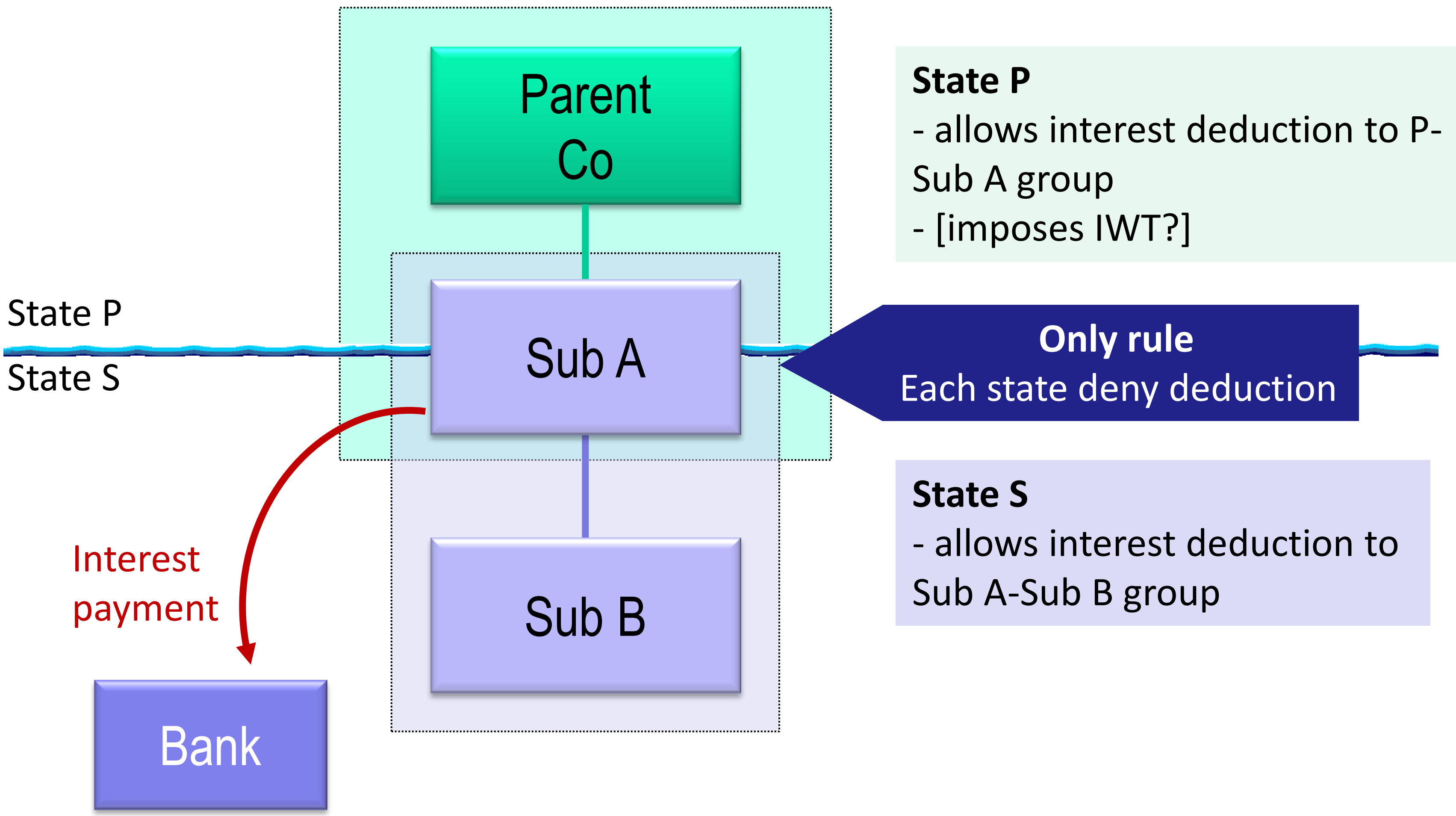
Payment made **by** hybrid entity (to third party)



State P
- disregards Hybrid
- sees borrowing by Parent Co
- allows Parent interest deduction
- [imposes IWT?]

State H
- treats Hybrid as entity
- respects borrowing
- allows interest deduction to H
- allows loss to offset income of Group Co

Payment made **by** dual resident entity (to third party)



- Both State P and State S allow consolidation of resident companies only
- Sub A is incorporated in State P; managed in State S

4. A small target

- Hybrid outcome
  - affecting instrument that is debt / equity / derivative
- Between related or controlled entities; part of a structured arrangement
  - presumably a marker for avoidance
- involving physical payments
  - between the parties to the arrangement?
- but not timing
- which generates an overall (not individual) revenue loss
  - compared to …?
- resulting a D / NI outcome or a DD outcome
  - but not NI / NI
  - nor FTC / FTC

6. Comments

- The remedy is deliberately
  - domestic
    - improve domestic law
    - an anti-hybrid rule that gets turned on
    - and adjusts to get turned off
  - unharmonised
  - agnostic
- So the BEPS policy gets shifted closer to, ‘all income must be taxed somewhere’
  - and either country is sufficient
- Becoming dependent upon actions of other countries

- Treating companies as real and final
- Solving every problem by denying deductions
  - what about CFCs / IWT / entity recognition rules
- What happened to withholding taxes
- Consistent with the BEPS paradigm
  - or rules that will be BEPS engines?

BEPS and Hybrids

Comment on a paper by
Professor Graeme Cooper

John Prebble

1

Lack of intellectual foundation and coherence

- Criticism of BEPS deliverables
- a. No fundamental intellectual basis
- b. Principles seem to lack coherence
- Graeme Cooper uses the metaphor of a shopping list

2

Some justification in this criticism

- Particularly apparent in our topic, Action 2: “Neutralising the Effects of Hybrid Mismatch Arrangements”
- Miscellany of rules, varying operation

3

This absence of intellectual basis

- Always bound to attract criticism
- Many examples in Graeme Cooper's paper
- One of the most dramatic:

4

BEPS starts with Leaders' Declaration

- A heavily substantive approach:
- "[P]rofits should be taxed where economic activities deriving the profits are performed and where value is created".

5

But Action 2 finishes with, in effect:

- "All income should be taxed somewhere".
- With recommendations that "are entirely agnostic about which country should collect the revenue".

6

Problems for BEPS

- a. Will people respect a project
- That labours under such contradictions?
- b. How can BEPS test itself
- Without articulating coherent principles?

7

The BEPS project sells itself short

- Convincing responses to criticisms like those we have just heard are available
- But BEPS overlooks them.

8

Prebble criticism

- Not that there can be no coherent intellectual foundation of the BEPS project in general
- Or of the "Neutralising Hybrids" document in particular
- But that the OECD fails to explain this intellectual foundation
- Failure seems to be a failure of conceptual reasoning

9

Prebble explanation today

- Skates over the surface
- Full arguments in papers cited in footnotes

The OECD response could be:

- Criticisms are misconceived
- The problem is fundamental
- It arises from the nature of tax law itself
- In that tax law is based on incoherent principles

Source of the intellectual foundation for BEPS?

- Work of the late Professor Ross Parsons
- Of Sydney University
- "The analytical fabric of the income tax … had congenital and … incurable defects, born as it was of a union of institutions which had no common policies."

Incoherence of tax laws becomes more pronounced

- As countries increasingly refine law
- In response to new challenges
- Problem is particularly acute
- In cross border trade and investment

13

Later scholars elaborated Parsons's insight

- Hybrids and other BEPS documents refer to this work
- Without realising that they are doing so

14

Several examples from single page of OECD Action Plan 2013.

- References to:
- "… practices that artificially segregate taxable income from the activities that generate it".
- "BEPS issues may arise … from … gaps, frictions [fictions?] or mismatches in the interaction of countries' domestic tax laws".

15

And later

- "[M]ultinationals have been able to use and/or misapply [transfer pricing] rules to separate income from the economic activities that produce that income …."
- These concerns lead to, for example:

16

Action no 8(ii), "Develop rules:

- "ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation"

17

The report fails to conceptualise

- The kind of problem that Action 8(ii) and the other examples identify.
- It just says, in effect:
- "To divorce value creation from taxable profits is bad;
- "Let's do something about it".
- What is the nature of the problem in these examples?

18

All are examples of ectopia

- That is, gap between the target of tax law
- And the law itself
- Here, target is "profits associated with value creation"
- Taxpayers "divorce" or shift the profit
- Creating an ectopia between tax law and economic profits.

19

Ectopia is endemic to tax law

- Makes tax law different in kind from other law
- Other law does not suffer from ectopia
- Sovereigns ensure that laws hew closely to facts that they govern.

20

For example, the law of assault

- Is about hitting people
- Not about the geographical source of the emotion that led to the blow

21

Not so with tax law

- Tax law taxes not true economic income
- But a legally defined simulacrum of income
- A dramatic simulacrum in the case of hybrids.
- Law fails to tax relevant economic profit at all.

22

Some consequences of ectopia:

- Tax law has increasingly granulated rules
- Contradictory qualifications
- Eg, in context of a hybrid repo
- Eg, treating a sale as a loan
- Or ignoring the corporate veil

23

Answer to Graeme Cooper's criticism?

- Of conflict between apparent economic logic of *Leaders' Declaration*
- And arbitrary recommendations of BEPS deliverables

24

Answer: Leaders' Declaration a pipe dream

- Notoriously
- In context of international transactions
- Impossible to define
- The *fact* of the location of value creation
- By legal *norms*, which are essentially ought statements

25

Solution

- Use specific rules as much as you can
- Reinforce them by broad GAARs
- Applying equally domestically and internationally
- Including treaties

26

BEPS project understands this solution

- But does not explain it on the grounds of principle

27

Other matters for further work

- Elaborate the substantive interpretation of treaties
- More study of avoidance: irrational to limit hybrids rules to abuse and structured transactions
- Bring same principles to bear on international shelters as domestic shelters
- Professional privilege: has become distorted from original litigation privilege
- Widespread misunderstanding of the function and role of companies
- Erroneous reach of European Community rules
- Address agency capture in creation of tax rules, especially GAARS

28

Action Plan on Base Erosion and Profit Shifting

An Indian Perspective

Working Paper No. 2014-133

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Action Plan on Base Erosion and Profit Shifting

An Indian Perspective

R. Kavita Rao

D. P. Sengupta

Abstract

The discussion in this paper highlights some evidence to support the notion that there is base erosion in India. On the specific action points listed in the OECD's Action Plan, a perspective from India's stand point has been presented along with a brief discussion on the steps needed to prepare for complying with likely proposed measures.

Action Plan on Base Erosion and Profit Shifting

An Indian Perspective

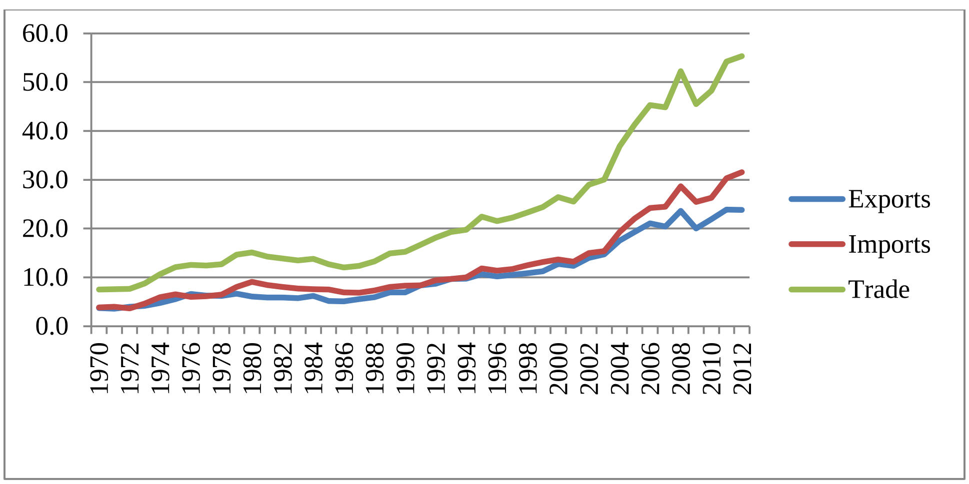
R. Kavita Rao*

D. P. Sengupta*

Section 1: Introduction

India has traditionally been a net capital importing country, with relatively low dependence on international trade, with trade to GDP at less than 20 percent till the end of the last century. However since the turn of the century there has been a sharp increase this ratio with the current levels being over 45 percent. Imports contributed more to this increase than exports – of the 25 percentage point increase, imports contributed 17 percentage points while exports contributed 7 percentage points. This increase in the ratio of trade to GDP indicates both a closer interaction with the global economy and an increased dependence on the same too, in order to finance the gap which has increased from less than 2 percent in 2002-03 to over 10 percent during 2010-12.

Figure 1: Trade in Goods and Services as percentage of GDP



Source: World Development Indicators, World Bank.

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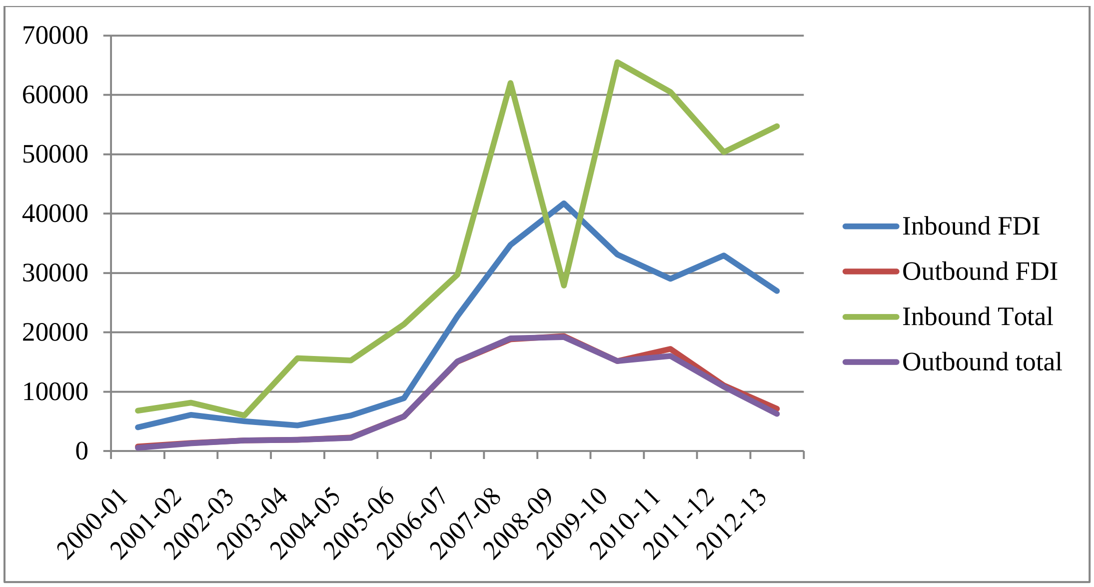
In order to finance this gap, the country has been dependent on capital inflows with a stated preference for Foreign Direct Investment (FDI). During the same period when there was a sharp increase in the trade to GDP ratio, India saw an increase in FDI flows from less than US$ 10 billion to over US$ 25billion. This would necessarily have helped in restoring some balance to the Balance Of Payments position of the country. However, in the same period, there was an increase in the outbound investment from India as well. These indicators too suggest a greater engagement with the international economy.

A significant feature of the FDI coming into India is that over 53 percent comes from low tax jurisdictions an indicator of possible aggressive tax planning leading to tax base erosion.

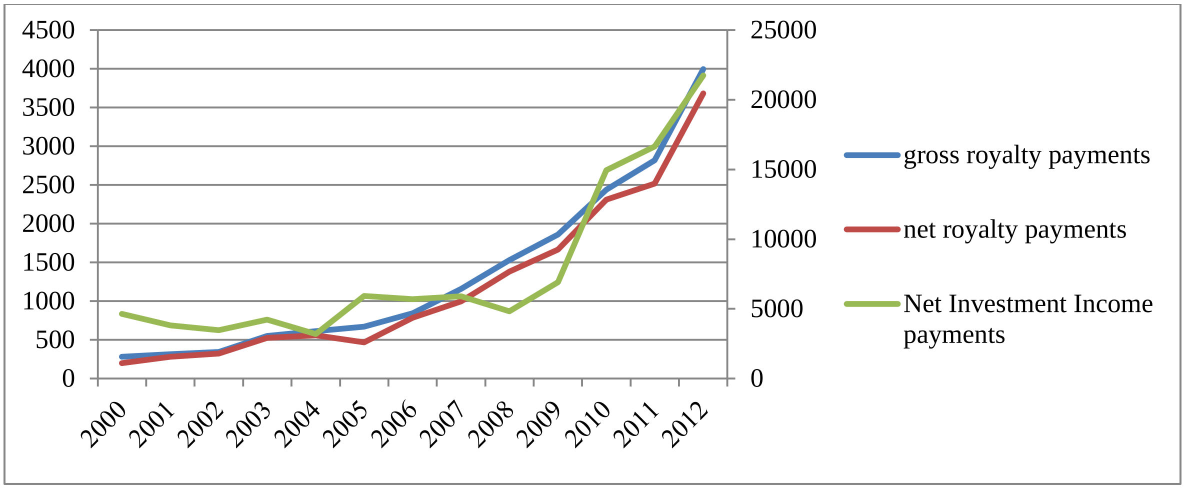
Figure 2: Trends in Foreign Investment: India, US$ million



Source: Handbook of Statistics on Indian Economy, RBI

In terms of passive incomes, royalty payments and payments on investment income by India show a sharp increase in the same period. (Figure 3) These trends suggest that of the incomes sourced in India, there is an increasing component moving out of the country.

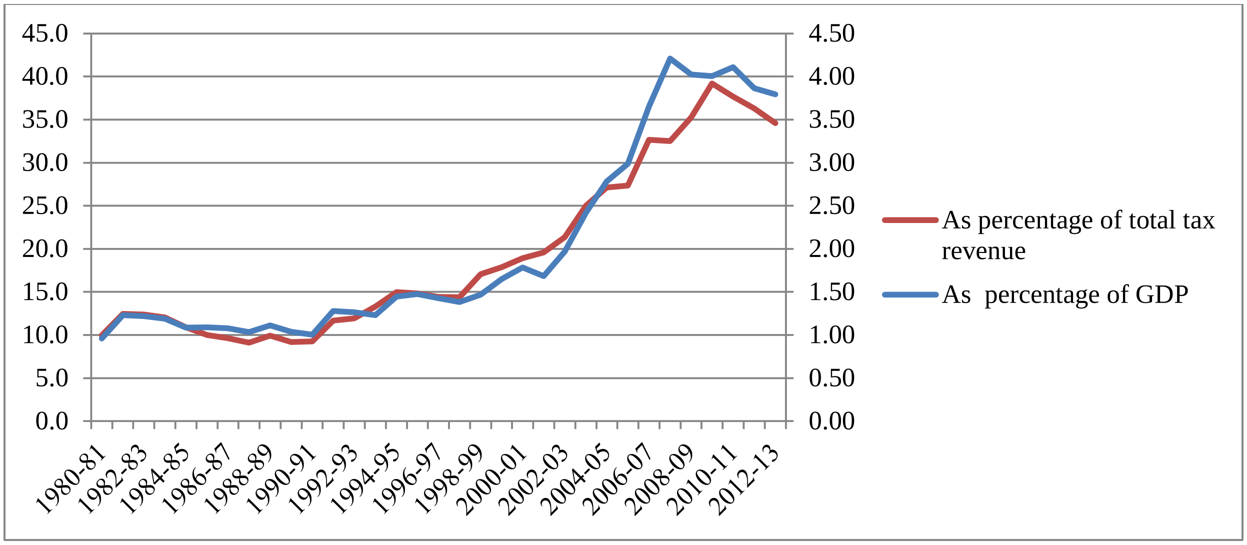
Figure 3: Passive Incomes: Net Payments by India (US$ Million)



Source: Balance of Payments, IMF

With greater integration of the domestic economy with the world economy, issues of international taxation acquire a lot of importance. This is even more so the case since these heads would affect corporate income tax collections in India, which is one of the major heads of revenue for the government. (Figure 4) While the reported figures for corporate tax include payments of Dividend Distribution Tax, which should be reported as a part of personal income tax, the over trends do suggest that corporate tax rose very sharply in the period since 2000 and has settled at a high of over 3.5 percent of GDP. Changes in the structure of the economy, could potentially affect the revenues on this count and therefore both the changes and the emerging discussion on base erosion and profit shifting globally are of interest to India.

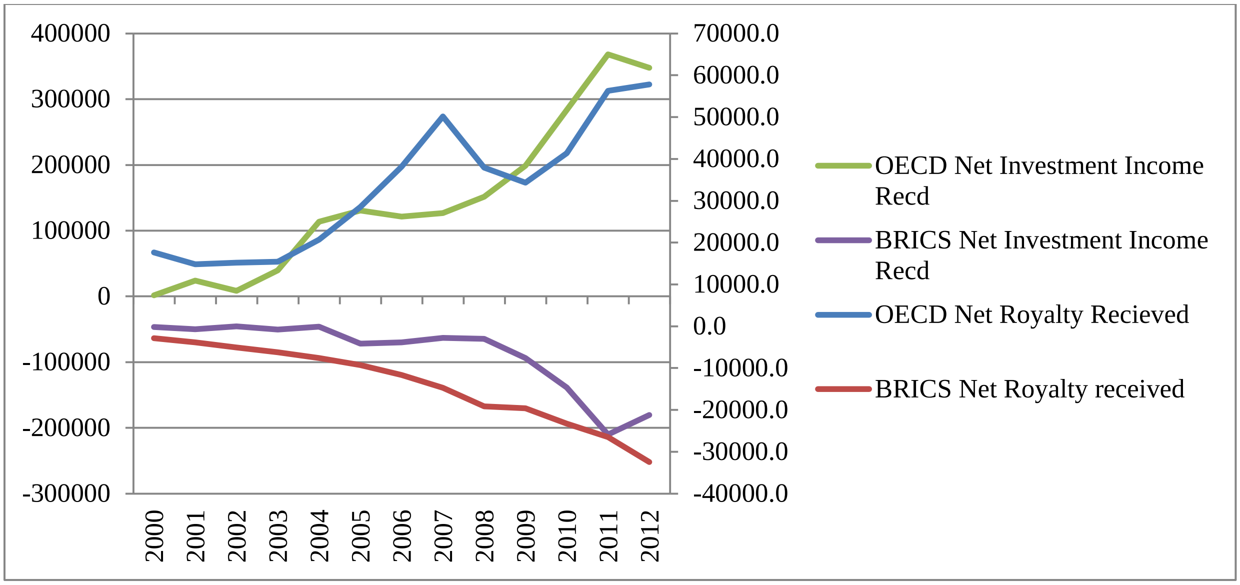
Figure 4: Trends in Corporate Tax



Source: Receipts Budget, Government of India.

Here it may be pointed out that some of the trends observed in India are observable for other developing countries as well. For instance, if we look at royalty payments, during the period since 2000, there is a consistent increase in the payments made out of BRICS. It is also interesting to note that while for the BRICS, there is a net outflow on this count, for the OECD there is a net inflow, even if there is a dip in the flows since 2007. If one considers net flows on account of investment income too, a similar trend is evident. These trends suggest that the interests of the developing countries in protecting their tax bases from erosion may not be exactly aligned with those of the developed countries. However, given the limitations to structuring an independent tax policy for any individual country, more so for developing countries, it is important for India to assess any proposed changes in the existing regimes and to the extent possible, protect its interests from being further diluted. The present note is an attempt to assess the recent initiative of the G20 and OECD on Base Erosion and Profit Shifting as summarized in the Action Plan on Base Erosion and Profit Shifting.

Figure 5: Net Royalty Receipts: US$ million



Source: Balance of Payments, IMF

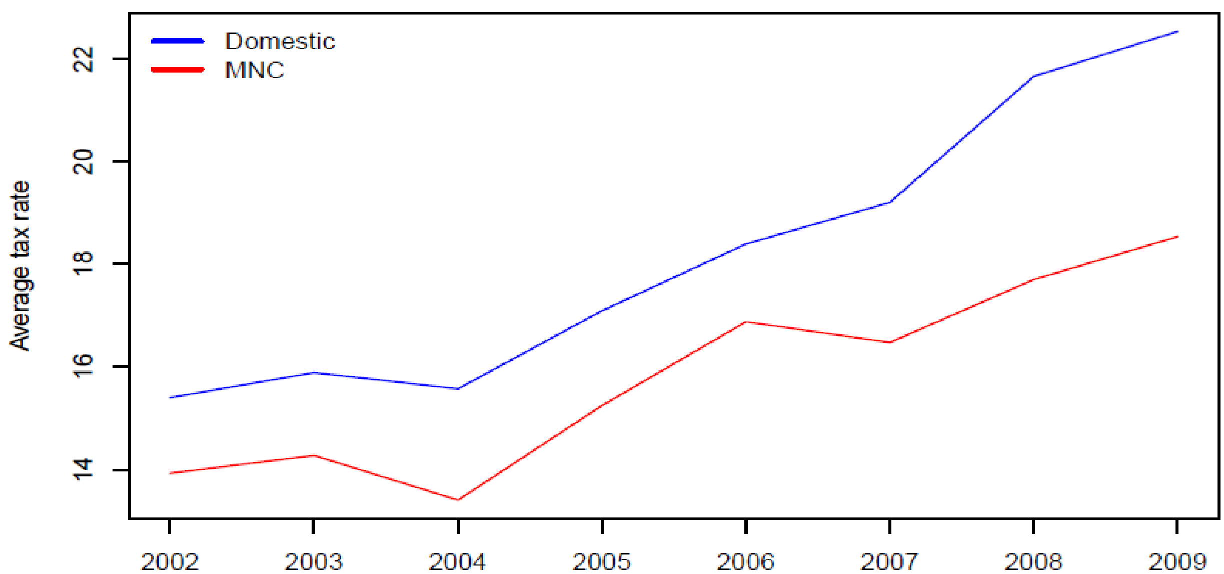
While all of these trends suggest that issues of international taxation are of growing importance for the Indian economy, it is equally important to ask whether there is any evidence of base erosion on account of closer links with the international economy. In the following sections, therefore, we seek to identify any evidence for India, which could answer the question on whether there is base erosion in India (Sections 2 and 3). This would be followed by a discussion on the assessment of the Action Points of the OECD Action Plan and India's preparedness on the same.(Section 4) Taxes are often argued to be an important factor in influencing the investment decisions of companies, especially of Multinational Corporations. In the context of discussion on the need for changes in the international tax regime, it is important to ask ourselves whether such changes would adversely affect the economic environment and therefore reduce the attractiveness of the domestic economy to both domestic and international investors. An attempt would be made to summarise the literature on the determinants of investment location decisions to seek an answer to this question. (Section 5) Section 6 presents some concluding observations.

Section 2: Tax Base Erosion in India: Empirical Evidence

Before exploring the utility of the BEPS project for India, it is useful to first ask whether there is any evidence of base erosion and profit shifting in the context of India. International studies have used broadly two approaches: one approach undertakes a comparison of the effective tax rates for multinational firms and firms which operate only in one country. Many of these studies use evidence either from company accounts or from the returns filed by these companies to examine for differences in effective tax rates. In the Indian context, one such study, Patnaik and Shah (2010) reports results to support the hypothesis that the effective tax rate for Indian MNCs is lower than the effective tax rate for domestic companies. (See Figure 6) Another study by Jansky and Prats (2013) titled 'Multinationals Corporations and the Profit Shifting Lure of the Tax Havens'[1] works with India specific data from a financial and ownership database, Orbis and demonstrates that MNCs operating in India with tax haven connections:

- report 1.5 per cent less profits
- pay 17.4 per cent less in taxes per unit of asset
- pay 30.3 per cent less in taxes per unit of profit
- have 11.4 per cent higher debt ratios than MNCs with no connection to tax havens.

Figure 6: Average Effective Tax Rate of MNCs and Non-MNCs



Source: Reproduced from Patnaik and Shah, 2010.

[1] http://www.christianaid.org.uk/images/ca-op-9-multinational-corporations-tax-havens-march-2013.pdf

This strand of literature works on the hypothesis that differences in tax rates would allow the firm to optimize and choose both their location of business as well the form of reporting of income so as to minimize the total tax liability of the company across all jurisdictions. Since the tax due in any given jurisdiction then can be at variance from the level of economic activity in that economy, this is considered evidence of profit shifting, or even base erosion. However, differences in the tax liability could be the result of differences in access to or utilization of various incentive measures provided by various governments and by looking at overall effective rates of tax, it would not be possible to segregate the effect of profit shifting from availing tax exemptions available in the tax regimes.[2] OECD proposes the use of hypothetical cases which incorporate the effects not only of tax exemptions and concessions but also the effects of the different tax regimes in different countries.

A second strand of literature focuses on the mechanisms used by the firms to shift profits to low tax jurisdictions and provides evidence on the use of such mechanisms. (See Heckemeyer and Overesch (2012), Dischinger and Riedel (2008) and Cristea and Nguyen (2013) for instance). The main mechanisms through which profit shifting or base erosion happens can be classified in 3 categories: financing mechanisms and the use of interest payment, intangibles and the related payment of royalty and transfer pricing mechanisms on sales and purchases from related parties. Increase in these forms of payments would reduce the reported profit or income that would be subject to tax in the hands of the corporation in the country where the economic activity takes place.

In order to find answers to the question on whether there is evidence of base erosion along the lines described above, we focus on two of these mechanisms – interest payments and royalty payments. For the purposes of this exercise, we work with company accounts data from PROWESS, for the period 2006-11. The question being posed is – are the interest payments/ royalty reported by companies different for "domestic" and "non-domestic" firms. For answering this question, firms need to be classified into two categories, "domestic" and "non-domestic".

[2] OECD (2013) calls this the "backward" looking ETRs and against an exercise which works out the potential tax liability on an economic activity based on the policy regime after incorporating the effects of all tax exemptions and the tax regimes in competing countries. The latter is referred to as a "Forward" looking ETR. See OECD (2013) for a more detailed discussion on the existing studies using this approach.

This classification is done on the basis of information provided in the PROWESS database on "Related Party Transactions". As per the documentation of the database, "Related party transaction is a business deal or arrangement between two parties (entities) that are joined by a special relationship prior to the deal. This data field describes the relationship of the related party with the company. The related party could be a key personnel of the company, relatives of key personnel or subsidiaries."

> "Accounting Standard 18 (AS-18) of the Institute of Chartered Accountants of India (ICAI) provides the guidelines regarding disclosures of related party transactions. Disclosure of such information became mandatory from 2004. Disclosures are mandatory for listed companies, banks, financial institutions, companies with sales of over Rs.500 million, or with a borrowing of over Rs.100 million, or the holding or subsidiary companies of any of these. Prowess classifies the related parties and the transactions into standardised types of related parties and transactions. These standardisations make it possible to access the information with some predictability. It overcomes the problem of a high degree of variability in the nomenclature used by companies in describing related parties and their transactions."

The database classifies the transactions under six categories, "holding company", "subsidiary", "Parties where control exists", "Key Personnel" and "Relatives of key personnel" and "others". Any company which reports transactions under any one of these categories is considered a "non-domestic" company with some opportunity to undertake actions which could result in base erosion. All other companies were considered "domestic" companies. It may be noted that by this classification, the status of a company could change over the years, if it reported some related party transactions in some years and did not in other years.

Since the database covers a wide variation in companies both in the kinds of activities they undertake and in their size, for comparability a subset of the firms in the database is considered for analysis. For the purposes of the present exercise, we exclude financial firms since the income flows for such firms would be quite different from those for other firms. For instance, interest receipt and interest payment may be much larger for these firms than for non-financial firms. Second, since the reporting requirements on related party transactions are mandatory only for large firms, as mentioned above, we excluded all firms which have total revenue below Rs 1 billion[3]. It may be mentioned here that prior to this exclusion, the size of non-domestic firms on average is much larger than the average size of domestic firms. By limiting the firms to those with revenue above Rs 1 billion, the firms in both categories are of comparable dimensions, making the analysis more meaningful.

Interest Payments:

To begin with we focus on interest payments as reported by the companies. The question being asked is whether there is any difference in the quantum of interest paid by domestic and non-domestic firms. A simple test of averages suggests that non-domestic firms pay more interest per firm than domestic firms, but domestic firms seem to pay more interest per unit of borrowing than non-domestic firms. To check for the possibility of a non-linear relation between interest and borrowing and for differences in the relation between domestic and non-domestic firms, we postulate a log-linear relation of the following form:

$$\log(interestpaid) = \alpha + \beta * \log(borrowing) + \gamma * dummy + \delta * dummy * \log(borrowing)$$

where $dummy$ = 0, for domestic firms and 1 otherwise.

In this relation, if the underlying relation between interest paid and borrowing is linear with differences in interest rate paid by domestic and non-domestic firms, then while 'γ' will be non-zero and 'δ' would not be significantly different from zero, while 'β' should be equal to 1. On the other hand, if the relation is non-linear, in the sense the interest rates themselves could be varying with changes in the level of borrowing, then 'β' or '$\beta + \delta$' would be different from 1.[4] Using this formulation, we find that for all the years being analysed, the data suggests that a one percentage point increase in borrowing results in a less than one percentage point increase in interest payment. (See Table 1) This suggests that with an increase in the level of borrowing, the interest payment per unit of borrowing would be lower. The other feature evident from the table is that for four out of the six years, non-domestic firms show a larger level of interest payment for any given level of borrowing when compared to domestic firms. This result appears to

[3] Revenue here refers to the sum of sales and other incomes reported in PROWESS. In the database, this category is referred to as Income. However, since the word "income" has different connotations in taxation as well as in economics, we use a more neutral term for clarity.

[4] Wald test was performed to check whether either of these coefficients are equal to 1. The results indicate that the hypothesis is rejected – the coefficients are not equal to one, in any of the years.

suggest that non-domestic firms either face higher costs of borrowing or alternatively, they could be using interest payment as a mechanism for transferring resources from one company to another whether domestically or internationally.

A second route to explore the difference between domestic and non-domestic firms is to explain the performance of these firms, in terms of the revenue generated. Revenue of a firm is postulated to be a function of the level of gross fixed assets of the firm and the level of borrowing of the firm. Dummies are incorporated to isolate the differences between domestic and non-domestic firms.

The second panel in Table 1 presents the results for Revenue. Higher levels of borrowing are associated with higher levels of revenue, and higher levels of Gross Fixed Assets (GFA) too are associated with higher levels of revenue. Further, these results too suggest that there are some differences between the performance of the domestic and the non-domestic firms. In five out of the six years considered, for given levels of GFA, the non-domestic firms report a higher level of revenue for given levels of borrowing. On the other hand, for given level of borrowing, the non-domestic firms report a lower level of revenue. Since we are examining the impact of borrowing on the firm, we focus on that component of the result. The result suggests that given the level of GFA, for a given level of borrowing, the non-domestic firms have a lower level of revenue when compared to domestic firms.

Given that both revenue received and interest paid of domestic and non-domestic firms respond differently to borrowing, it is useful to ask whether the amount of corporate tax paid by these firms is different corresponding to any given level of borrowing. Since revenue received and interest payment would affect corporate tax in different ways - the former increases the amount of tax liability while the latter reduces it - they are considered separately in the equation. The results suggest that for any given level of revenue received, non-domestic companies pay higher taxes. There is no difference in the impact of interest on taxes between these two types of firms.

Table 1: Econometric Year wise Estimates

Variable	2006	2007	2008	2009	2010	2011
Log (interest)						
Log(Borrowings)	0.76***	0.76***	0.77***	0.76***	0.81***	0.83***
Log(borrowings*Dummy)		0.014*	0.014**	0.017**	0.012**	
Constant	-1.15***	-1.15***	-1.05***	-0.87***	-1.22***	-1.40***
R^2	0.7169	0.7054	0.7232	0.7274	0.7869	0.7815
Log (Income)						
Log(borrowings)	0.19***	0.12***	0.2***	0.197***	0.2***	0.23***
Log (borrowings*Dummy)	-0.09***		-0.07***	-0.06**	-0.06***	-0.09***
Log(Gross Fixed Assets)	0.27***	0.32***	0.24***	0.27***	0.28***	0.27***
Log (Gross fixed Assets*Dummy)	0.1***	0.01*	0.09***	0.08***	0.08***	0.11***
Constant	5.04***	5.14***	5.14***	4.99***	4.94***	4.78***
R^2	0.4709	0.4506	0.4684	0.4952	0.5056	0.5282
Log (Corporate Tax)						
Log(Income)	1.33***	1.32***	1.28***	1.31***	1.27***	1.26***
Log (Income* Dummy)	0.05***	0.06***	0.04***	0.04***	0.06***	0.03***
Log (Interest)	-0.2***	-0.16***	-0.17***	-0.2***	-0.17***	-0.17***
Constant	-6.98***	-7.01***	-6.31***	-6.7***	-6.29***	-5.96***
R^2	0.4479	0.4881	0.4882	0.4674	0.5179	0.5382

Source: Based on data extracted from PROWESS

Note: 1. The above are estimates from a simultaneous equation system with three equations using SUR estimation.

2. * significant at 10%, ** significant at 5% and *** significant at 1 per cent. The R^2 reported are adjusted R squares.

Collating the effects across these three results, it appears that for a given level of borrowing, non-domestic firms pay more interest, and earn less revenue. Incorporating these effects into corporate tax, a given level of borrowing would therefore result in lower tax on account of interest for non-domestic companies when compared to domestic companies. In case of revenue, the effect is mixed – for a given level of borrowing, non-domestic companies generate less revenue, but for a unit of revenue, they report higher taxes. The net effect could go in either direction. The net combined effect of borrowing through these two channels on corporate tax can be worked out through the coefficients in the estimated equation as follows:

$$\frac{\partial CT}{\partial borrowing} = \frac{\partial CT}{\partial revenue} * \frac{\partial revenue}{\partial borrowing} + \frac{\partial CT}{\partial interest} * \frac{\partial interest}{\partial borrowing}$$

Table 2 presents the net effect of a one percentage point increase in borrowing on corporate tax for domestic and non-domestic firms. The results indicate that for domestic firms the corporate tax would increase more than that for non-domestic firms, except in 2007. In other words, for a given level of borrowing, domestic firms appear to pay more taxes than non-domestic firms, given other parameters.

Table 2: Net Effect of Borrowing on Corporate Tax

Category of firm	2006	2007	2008	2009	2010	2011
Domestic firms	0.094	0.039	0.126	0.101	0.117	0.154
Non-domestic firms	-0.022	0.044	0.034	0.026	0.051	0.044

Royalty

Turning to royalty, there is some discussion in the press about the sharp rise in the royalty payments by Indian subsidiaries of Multinational Corporations. (See Business Standard June 23, 2013, article titled "Royal Flush".[5]) The article pulls together information from various sources to suggest that subsequent to the relaxation of the cap on royalty and fee for technical collaboration etc. with effect from December 2009, there is consistent increase in the royalty payments out of the country. The article quotes estimates by Espirito Santo Securities to indicate that "payments of 25 top multinationals - including Maruti Suzuki, HUL, Nestle India and Colgate-Palmolive India - have jumped 140 per cent. Maruti's royalties to Suzuki Motor Corporation leapt almost three times from Rs 677.7 crore in 2008/09 to Rs 1,803.1 crore in 2011/12, which was 110 per cent of its profit after tax."

The article also refers to a study by IIAS which indicates that for the top 25 MNCs in India, royalty payments have increased much more sharply than dividend payments: the former doubled between 2008 and 2012 while dividends increased only by 30 percent. Table 3 below summarized the numbers for a few MNCs which highlight this point.

[5] http://businesstoday.intoday.in/story/royalty-payments-by-multinational-companies/1/195398.html

Table 3: Increase in Royalty Payouts: Some Examples

	2011-12	2008-09	Percentage increase
Bosch Ltd.	148	51	190.2
Maruti Suzuki India	1803	678	165.9
HUL	290	116	150.0
ABB	249	125	99.2
Colgate- Palmolive (India)	141	72	95.8
Nestle	289	176	64.2
Glaxo Smithkline Consumer Healthcare	106	70	51.4
Proctor &Gamble Hygeine &Healthcare	63	42	50.0

Source: http://businesstoday.intoday.in/story/royalty-payments-by-multinational-companies/1/195398.html

While it can be argued that there was overall growth in the economy and hence these companies could have shown higher sales and hence higher royalty payments, the following table, summarized from a report by Institutional Investor Advisory Services (IIAS) indicates that the ratio of royalty to net sales has increased quite sharply for some of these companies.

Table 4: Royalty as a percentage of Net Sales

		2007-08	2011-12	Percentage increase
1	Maruti Suzuki	2.80%	5.20%	186%
2	Hindustan	0.60%	1.40%	233%
3	Colgate Palmolive	2.50%	4.50%	180%
4	ABB	2.50%	5.10%	204%
5	Alstom	0.40%	2.20%	550%
6	Bosch	0.70%	1.60%	229%

Source: Annexure A of "Royalty Payments and Minority Shareholders"
http://www.iias.in/downloads/institutional/Royalty%20payments%20and%20minority%20shareholders%20(Final).pdf

An alternative method to ask the same question, is to compare the quantum of royalty payments made by companies which report some payments made for royalty and technical fees. The PROWESS database provides information categorized into three categories: royalty payments, fee for technical services and license fees. Since all three are payments for intangibles, we consider them together as one category. It is postulated that these payments would be related to the turnover of the firm, i.e., the sales of the firm and not the revenue of the firm, since the latter includes incomes from financial instruments which would not be related to royalty payments.

The question being asked once again is whether there is a difference between domestic and non-domestic firms in the amounts of royalty and other such fees paid. For this purpose, a dummy separating the firms into the two categories is used. The results are reported in Table 3. The results indicate that for each of the years considered, while royalty increases with an increase in sales, there is a difference in the level of royalty paid between domestic and non-domestic firms, where the latter pay a higher amount of royalty for a given level of sales.[6] It may be noted that on average the non-domestic companies have higher levels of sales than domestic companies as well.

Table 5: Royalty Payments: A Comparative Analysis

Log(Royalty)						
	2006	**2007**	**2008**	**2009**	**2010**	**2011**
Log(Sales)	0.99***	1.15***	1.04***	0.88***	0.78***	1.05***
Dummy	0.59***	.517**	0.47**	0.92***	0.74***	0.59***
Constant	-6.12***	-7.65***	-6.65***	-5.75***	-4.49***	-6.49***
R^2	0.2957	0.3194	0.29	0.2521	0.4053	0.3611

Note: * significant at 10%, ** significant at 5% and *** significant at 1 per cent. The R^2 reported are adjusted R squares.

Both the sets of results presented here suggest that for interest payments as well as royalty, there are differences in the behavior of domestic and non-domestic firms with the latter showing higher levels of both interest payment and royalty payment corresponding to given levels of borrowing and sales respectively. While these do not directly suggest that there is profit shifting out of the country, they do suggest that there is profit shifting out of the company being analysed.

[6] While these results are consistent across the years, the R^2 values suggest that there could be some more variables contribute to the variations in royalty payments across firms.

Section 3: Cases specific to India

While overall numbers do indicate that there is some evidence of base erosion from India, the specifics of the forms of base erosion can only be ascertained through cases identified by tax authorities in India. Corporate tax case laws available from databases provide the requisite information. In order to get a flavor of the forms relevant for India, summarized below are some cases that have been raised and/or disputed in India.

3.1. eBAY International AG Vs. ADIT[7]

eBay AG is incorporated in Switzerland. eBay AG operated India specific websites providing an online platform for facilitating the purchase and sale of goods and services to users based in India.

Any seller is entitled to list its products for sale on the website. At the time of listing, the seller is required to provide various details regarding the product that it wished to be sold through the website. Any buyer can also register himself for buying of the goods through the website. The buyer is required to choose any of the payment methods for making payment of the product directly to the seller. Once the buyer clicks 'Buy It Now' button after registering with the website and agreeing to the terms and conditions of sale as displayed by the seller on the website, an email is sent by the assessee to the seller confirming the sale of his product listed on the website. The seller then delivers the product to the buyer and settles the payment in respect of sale. The sellers registered on the website are required to pay 'User fee' on every successful sale of their products on the website. On the successful completion of the sale, the assessee raises periodic invoice on the seller for the “user fee”. The sellers are required to make payment of the user fee to eBay India/eBay Motors for the transactions undertaken on the websites. After making collection from the sellers, eBay India/eBay Motors remit the user fee to the Swiss company. For the assessment year 2006-07, eBay AG earned revenue amounting to Rs.4,94,27,530/ - from the operations of its websites in India. The taxpayer claimed that such revenue represented business profits and could be taxed in India as per the provisions of Article 7 of the DTAA between India and Switzerland only if it had a PE in India as per the provision of Article 5.

[7] 2012-TII-169ITAT-MUM-INTL

One of the arguments taken by the Revenue in its efforts to tax the foreign company on its income from India was that the taxpayer had a dependent agent PE in India in the form of the two websites. In that context the Tribunal held that there was no dispute about the fact that eBay India and eBay Motors were providing their exclusive services to the taxpayer; that It has been admitted that these two entities had no other source of income except that from the assessee in lieu of the provision of service eBay India and eBay Motors definitely become dependent agents of the assessee.

At the same time, the Tribunal pointed out eBay India had at no stage negotiated or entered into contract for or on behalf of the foreign company. By providing marketing services to the assessee or making collection from the customers and forwarding the same to eBay AG, it could not be said that eBay India entered into contracts on behalf of the assessee. The Tribunal held that eBay India and eBay Motors do not habitually exercise 'an authority to negotiate and enter into contracts for or on behalf of' the assessee. Therefore, under the extant rules, they could not be called dependent agent PE of the taxpayer and the income could not be taxed in India.

3.2. Asia Satellite Telecommunications Co Ltd vs DCIT[8] & New Skies Satellite NV Vs ADIT[9]

Popular TV channels like STAR TV, STAR Plus, STAR News etc. were being operated in India by *Satellite Television Asian Region Ltd*, Hong Kong which entered into a transponder lease agreement with *Asia Satellite Telecommunication Ltd,* Hong Kong, so that the content developed for the Indian audience could be relayed in the footprint area of the Satellite that covered India. The ultimate territory of commercial exploitation being India, the tax officer held that the taxpayer had a business connection in India thereby making the receipts subject to Indian taxes. On appeal, the Commissioner of Income Tax (Appeal)[CITA] accepted the contention of the taxpayer that, there being no place of operation of the company in India, it was not a case of business connection. However, he held that the income was liable to be taxed as royalty within the meaning of that term under the Indian domestic law.

[8] 2003-TII-03-ITAT-DEL-INTL
[9] 2009-TII77-ITAT-DEL-SB-INTL

On further appeal, the Tribunal held that viewership by the public at large is achieved only through the series of steps taken by receiving the uplinked signals, amplifying them and relaying them after changing the frequency in the footprint area including India. The particular end is achieved only through the series of steps taken in this regard. Accordingly, it held that the TV channels were using the process made available by the assessee through its transponder, giving rise to payment for royalty taxable in India.

Following a different view taken in the case of Panamsat International Systems LLC Vs DCIT[10] , a special Bench was constituted. In New Skies Satellite, the Special Bench dealt with the concept of user. The Tribunal, inter-alia, held: *It is neither practical nor possible to have the physical control over the transponder either by the satellite companies or by their customers. The "control" or "user" if any of the transponder is through the sophisticated instruments either installed in the ground stations owned by the satellite companies or on the earth stations owned by telecasting companies. Therefore, the "control" or "user" of the transponder and its capacity has to be seen from the practical angle. Once the process in the transponder is predetermined & pre guided by the satellite companies, it is made available for "user" to the customers who pay a consideration for the same. Such process is used by the telecasting companies according to their need*."

After the Special Bench decision on October 16, 2009, on 25/11/2009, the OECD issued a discussion draft on the issues specifically arising out of the taxation of telecom companies and suggested changes in the Commentary, reiterating its stand of no change in the context of changing business environment. The OECD was of the view: "Satellite operators and their customers (including broadcasting and telecommunication enterprises) frequently enter into "transponder leasing" agreements under which the satellite operator allows the customer to utilise the capacity of a satellite transponder to transmit over large geographical areas.

Payments made by customers under typical "transponder leasing" agreements are made for the use of the transponder transmitting capacity and will not constitute royalties under the definition of paragraph 2: these payments are not made in consideration for the use of, or right to use, property, or for information, that is referred to in the definition (they cannot be viewed, for

[10] 2006-TII-14ITAT-DEL-INTL

instance, as payments for information or for the use of, or right to use, a secret process since the satellite technology is not transferred to the customer). As regards treaties that include the leasing of industrial, commercial or scientific (ICS) equipment in the definition of royalties, the characterisation of the payment will depend to a large extent on the relevant contractual arrangements. *Whilst the relevant contracts often refer to the "lease" of a transponder, in most cases the customer does not acquire the physical possession of the transponder but simply its transmission capacity*: the satellite is operated by the lessor and the lessee has no access to the transponder that has been assigned to it. In such cases, the payments made by the customers would therefore be in the nature of payments for services, to which Article 7 applies, rather than payments for the use, or right to use, ICS equipment. A different, but much less frequent, transaction would be where the owner of the satellite leases it to another party so that the latter may operate it and either use it for its own purposes or offer its data transmission capacity to third parties. In such a case, the payment made by the satellite operator to the satellite owner could well be considered as a payment for the leasing of industrial, commercial or scientific equipment."

In other words, according to the OECD commentary, payment for transponder leasing by source countries cannot be taxed as royalty and can only be taxed as business income and for business income to be taxed by source countries, there must be a PE. Lest anyone claims that there is a PE because of the satellite being above their space, the move is also preempted by the addition of another Para in the commentary to Article 5 dealing with the permanent establishment as follows: *"Clearly, a permanent establishment may only be considered to be situated in a Contracting State if the relevant place of business is situated in the territory of that State. The question of whether a satellite in geostationary orbit could constitute a permanent establishment for the satellite operator relates in part to how far the territory of a State extends into space. No member country would agree that the location of these satellites can be part of the territory of a Contracting State under the applicable rules of international law and could therefore be considered to be a permanent establishment situated therein. Also, the particular area over which a satellite's signals may be received (the satellite's "footprint") cannot be considered to be at the disposal of the operator of the satellite so as to make that area a place of business of the satellite's operator."*

According to "State of the Satellite Industry Report (August 2010)" sponsored by Satellite Industry Association [SIA], the world satellite revenues in 2009 was of the order of $ 160.9 billion with an average annual growth of 11.7% from 2004 through 2009. Out of this, the share of satellite service industry was $ 93 billion. What is remarkable is that despite worldwide recession, satellite services revenue grew by almost 11% from 2008 to 2009. Satellite technology is invaluable for propelling growth in many areas such as telecom, news, media, and entertainment - to name a few. In India, as perhaps elsewhere, the satellite industry has a symbiotic relationship with the media and entertainment and television. The Indian Media and Entertainment Industry stood at $ 12.9 billion in 2009 and according to a KPMG study, the size of this industry is expected to reach roughly 25 billion $ by 2014.

There is therefore considerable revenue involved in a lot of cross border transactions, which are inevitable for this important sector. And whenever, there is considerable revenue in a cross-country situation, question of sharing the revenue also becomes inevitable. Inevitably, the leading soft power in the world of international taxation, the OECD got into the picture and decided against the assertion of source country taxation rights in such situations.

It may be noted that when the Asiasat case reached the Delhi High Court,[11] the Court upturned the decision of the Tribunal and partly relied on the above commentary of the OECD in its decision rendered on 31.1.2011. The Court inter-alia, held that when the technical terms used in the DTAA are the same which appear in Section 9(1)(vi) of the Income Tax Act that defines royalty, for better understanding all these very terms, OECD commentary can always be relied upon.

3.3. Nimbus Sport International Pte Ltd Vs DDIT[12]:

Nimbus is an Indian group in media and entertainment with channels like Neo Sports, Neo Cricket. A company named Nimbus Sport International Pte Ltd was incorporated in Singapore. It was stated to be wholly managed from Singapore and not have a PE in India. It entered into an agreement with Prasar Bharati for telecasting of cricket events from February 2002 to October

[11] Asia Satellite Telecommunications Co Ltd Vs DIT [2011-TII-05-HC-DEL-INTL]
[12] 2011-TII-178-ITAT-DEL-INTL

2004. One of the issues involved in the case was the taxability of advertisement revenues paid by Indian advertisers- Coca Cola India Pvt Ltd, Seagram Manufacturing Ltd, Hero Honda etc. during the telecasting of matches played in Sri Lanka.

The Assessing Officer took the view that the taxpayer had a PE in India and the source of the receipts lay in India, the Indian team played in these matches that were broadcast internationally including in India. He adopted 20% of gross receipts from the advertisements and estimated 50% thereof as income attributable to the PE in India.

On appeal, the CITA observed that various companies in India like, Coca-Cola, Pepsico Food, LG Electronics etc. signed contracts with the assessee company for advertising their products and since the company provided advertisement to various companies located in India through live telecast which was viewed by customers in India, income arising from advertisement was taxable in India. He also held that the advertisement income was taxable u/s 9(1) of the Income Tax Act as the source of income was in India. Moreover, he held that Article-7(1) of DTAA between India and Singapore has incorporated the principle of "force of attraction" based on the UN Model. Accordingly, the CITA held that the assessee was also taxable under Article 7(1) of DTAA between India and Singapore because the assessee had carried out the core activities of advertisement business through fixed place PE in India.

On appeal, the Tribunal held that the contract was signed by the assessee at Singapore and all the activities relating to this contract were carried out from Singapore; there is no evidence on record that the management and control of the affairs of the company were situated in India, that merely because holding of one board meeting in India will not lead to a conclusion that during the year, the control and management of assessee's affairs was situated only in India; that the assessee's activities at Singapore demonstrated that the affairs of the company were wholly carried out at Singapore; that the residence of two non-residents directors in India will not make the company a resident in. The Tribunal held that the taxpayer did not have a PE in India, the matches were not played in India, the telecast of the matches was not in India and the indirect benefit which might have been derived by some of the Indian viewers could not be held to be incremental for Indian companies on assumption. The Tribunal held that the advertisement revenue had no attribution to India and in the absence of any PE in the traditional definition of the term, this revenue could not be taxed in India.

3.4. LG Electronics India Pvt Ltd Vs ACIT[13]:

Profit can be taken away from a country through myriad ways. Payment for purchases of goods and services is one obvious choice. Similar will be less than adequate compensation to the Indian company for sales or provision of services. In the absence of Transfer Pricing (TP) legislation in India, till the year 2001, not much attention has been paid to these aspects. The attitude of the court/tribunals that the assessee best knows its business also helped. However, with the passing of the TP legislation in India, many such transactions are coming to the notice of the tax department.

There are quite a few other ways which are not very obvious that have come to the knowledge of the Indian tax department in the course of the administration of the TP legislation.

One such less than obvious way is the exaggerated advertisement spends by the Indian subsidiaries of foreign MNCs. The advertisement and brand building expenses of MNCs in India has been on the rise. If these inure for the exclusive benefit of the Indian company, no one can have any quarrel with such spends which are normally tax deductible. However, when it is not the Indian subsidiary that is reaping the benefit, the issue of transfer pricing arises. In this regard, the case of LG electronics decided by the Special Bench of the Tribunal is informative.

L.G. Electronics Inc. is a Korean company, engaged in the business of manufacture, sale and distribution of electronic products and electrical appliances. L.G. Electronics India Pvt. Ltd. is a wholly owned subsidiary of LGK. In terms of a technical assistance and royalty agreement, LGI obtained a right to use the technical information, designs, etc. from the LGK for a royalty at the rate of 1%. The licensor allowed the licensee to use its brand name and trade marks to products manufactured in India during the validity period of the agreement.

One of the international transactions of the assessee was the contribution towards Global Cricket Sponsorship from its AE. The Transfer Pricing Officer (TPO) observed that the assessee had received contribution from its Associated Enterprise for the expenditure incurred on sponsorship of Global Cricket events. The quantum of contribution received was considered as a part contribution for the brand promotion carried out by the assessee on behalf of its foreign AE.

[13] 2013-TII-15-ITAT-DEL-SB-TP

The TPO observed that the Indian subsidiary's expenses on advertisement, marketing and promotion (AMP) was 3.85% of its sales whereas the same was 0.12% in the case of Videocon Appliances Ltd and and 2.66% for Whirlpool of India Ltd giving an average of 1.39%. He held that the Indian subsidiary was promoting LG brand owned by LG, Korea and should have been adequately compensated. Applying the Bright-Line Test, he held that the expenses up to 1.39% of the sales should be considered as having been incurred for the taxpayer's own business and the remaining 2.46% was on brand promotion of the foreign AE. The excess was proposed as a transfer pricing adjustment on account of AMP expenses for brand building. The AO passed order making additions, *inter alia,* of Rs 182.71 crore towards AMP expenses on brand building.

In a majority decision, the Special Bench of the Tribunal upheld the stand of the department although it remitted the matter to the lower authorities to work out the exact adjustments. The importance of the issue can be gauged from the fact that there were 22 interveners in the case including names like Cannon India, Maruti Suzuki, Star India, Sony India, Haier Appliances, Glaxo Smith Kline, Bausch & Lomb, Fujifilm, Haier Telecom, Daikin etc. The judgement of the Tribunal is under challenge in the Courts. However, the case demonstrates the modus of making the Indian subsidiaries pay for the brand promotion expenses of the parent company and thereby erode the tax base of India. The source country allows the deduction for the development or enhancement of the value of marketing intangibles. However, if it does not get the corresponding benefit of revenues that may be attributable to such efforts, its tax base will certainly shrink.

3.5. Perot Systems TSI India Ltd[14]:

Perot Systems TSI (India) Private Limited (PSTSI) is engaged in the business of designing and developing technology enabled business transformation solutions and providing business consulting, systems integration services and software solutions and services.

PSTSI extended two foreign currency loans to its associated enterprises, namely, HPS Global Systems (Bermuda) Limited (HPS Bermuda) and HPS Global Systems Hungary Liquidity Management LLC (HPS Hungary) worth USD 1.5 million and USD 4.6 million respectively.

[14] 2010-TII-03-ITAT-DEL-TP

During the assessment proceedings, the international transactions entered into by the assessee were referred for scrutiny to the TPO. The TPO held that the international transactions undertaken by PSTSI, in relation to the interest free loan were not at arm's length and undertook an upward adjustment to income for the relevant years.

PSTSI contended that income means real income and not fictitious interest income and since it had not earned any income, the same could not be taxed. It was further argued that Transfer Pricing document maintained clearly mentioned that these loans/advances are in the nature of quasi-equity and hence the transaction of granting interest free loan was at arm's length. The loan agreements mentioned that these were interest free loans and authorities had no right to re-write the transaction unless it is held that it was sham or bogus or entered into by the parties to avoid and evade taxes. It was pointed out that the loan had been duly granted by the approval of the RBI. The Income Tax Act, 1961 and OECD guidelines support the contention that the effect of government control/intervention should be considered while determining the arm's length price.

The TPO however held that no two persons in normal business situation would grant interest free loan to the other persons. On the taxpayer’s appeal, the Tribunal held that there was no case for not providing or charging any interest and that if the contention that whenever interest free loan is granted to associated enterprises, there should not be any adjustment was accepted, it will tantamount to taking out such transactions from the realm of section 92(1) and section 92B of the IT Act.

The Tribunal pointed out that it was not the case that there was any technical problem that loan could not have been contributed as capital originally if it was actually meant to be capital contribution. The Tribunal approved the TPO’s view that one of the AEs was situated in a tax haven and not charging of the interest by the assessee from the AEs, would result in higher income in the hands of the AEs, and the income of the assessee in India would reduce by the corresponding amount. Thus this would bring down the overall tax incidence of the group by shifting profit from Indian jurisdiction to Bermuda which is a tax haven with zero rate of tax on corporate profit; that this was a classic case of violation of transfer pricing norms where profits are shifted to tax havens or low tax regimes to bring down the aggregate tax incidence of a multinational group.

3.6. DCIT Vs Dr Reddy's Laboratories Ltd[15]:

The taxpayer was engaged business of manufacturing, trading and exporting of bulk drugs. To market its products in USA and Canada, it was required to get approval from the US Federal Drug Authority and the Therapeutic Product Program Authority in Canada by getting its products tested through certain Contract Research Organisations A report with the study findings was released to the assessee, which was then submitted to the regulatory authorities and if the regulatory authorities were satisfied, then the patents were registered.

The taxpayer made the following payments in two years:

	Amount paid during financial year	
Name of the CRO	**2001-02**	**2002-03**
M/s. Anapharm, Canada	2,84,74,878	16,06,42,979
M/s. MDS Pharma Services Canada	10,55,47,693	12,35,86,857
M/s. Applied Analytical Industries Inc. USA	3,19,32,665	1,54,21,361
M/s. Med Trials Inc., USA	-	42,48,928
TOTAL	**16,59,55,236**	**20,39,00,125**

No tax was deducted therefrom. It was claimed that these payments represented business profits in the hands of recipients and could not be taxed in India in the absence of a PE. The AO treated the receipts as fees for technical services. On appeal, however, on an analysis of the tax treaties, it was held that the income was in the nature of services and no knowledge was made available to the taxpayer and hence the amounts could not also be taxed as fees for technical services.

Thus, in the present scheme of distribution of taxing rights, India did not have a right to tax any part of the income although its tax base was eroded as the Indian taxpayer had to be given the benefit of the payment as business expenditure.

[15] 2013-TII-97-ITAT-HYD-INTL

3.7. ADIT Vs. WNS North America Inc[16]:

The taxpayer, a US based company, rendered marketing and management services to WNS Global Services Pvt. Ltd., its associated enterprise in India. In terms of a marketing and management services agreement with WNS India, it was entitled to receive fees at its cost plus 10 per cent mark up.

The taxpayer claimed that payment for rendering services outside India was not in the nature of 'Fees for Included services' as defined under Article 12 of the DTAA as the assessee had not made available any knowledge, experience or skills etc. to WNS India. Also, as its employees had visited India for providing managerial services, therefore WNS India constituted a service PE under Article 5(2)(1) of the tax treaty. Thus, a small portion of the total receipts was attributable to such service PE for managerial services rendered in India, and the assessee had offered this small amount as income for taxation under Article 7 of the DTAA.

The AO held that the assessee had rendered expertise and technical knowledge for conduct of business of WNS India. Therefore, the payment received on account of marketing and management services rendered by the assessee to WNS India represented 'Fees for Included Services' under Article 12(4)(b) of Indo-US DTAA. On appeal, the CITA decided the issue in favour of the taxpayer by following the decision of the Tribunal in the assessee's own case for the earlier assessment year.

On further appeal, the Tribunal held that the two essential conditions for applying the force of attraction rule are (i) the business activity carried on should be in the other State where the PE is situated (ii) the business activity carried on must be of the same or similar kind as those effected through PE. In the present case, the condition of business activity carried on in the other State where the PE is situated is not satisfied because the marketing and management services in question are provided by the assessee outside India and income of such services cannot be said to have accrued or arisen to the assessee or deemed to have accrued or arisen to assessee in India, the existence of service PE in India would not make it taxable under Article 7 of Indo-US DTAA.

[16] 2013-TII-145-ITAT-MUM-INTL

The total amount involved in the case was Rs Rs.68,15,11,339/- which the Indian subsidiary paid and obtained deduction for. However, in the present scheme of taxation of services in terms of a treaty under the OECD model that does not allow the force of attraction, no tax could be levied.

3.8. Siemens Ltd Vs. CIT[17]:

In pursuance of its tender formalities with the Gujarat Energy Transmission Corporation Ltd and Maharashtra State Electricity Transmission Company Ltd, Siemens Ltd was required to obtain type-testing certificate of the circuit breakers manufactured by it. For this purpose it had sent the circuit breakers to be tested in the Laboratory of one "Pehla Testing Laboratory", Germany where the circuit breakers had to undergo destructive tests in the Laboratories. Once the circuit breakers pass through the test in the Laboratories, PTL gives a certificate for the quality of the product manufactured by assessee. The taxpayer was required to make payment to PTL, Germany for carrying out the type tests of the circuit breakers manufactured by the assessee in order to establish that the design and the product meets the requirement of the International Standards.

For the purpose of making remittance to PTL, the assessee moved an application u/s 195 (2) before the ADIT. It was argued that no income accrues or arises in India as all services were rendered outside India and the payment was made outside India; that the payment was in the nature of business income of Pehla Laboratory and since it did not had any PE in India, the same was not taxable in India as per the DTAA. It was further submitted that even as per the provisions of Explanation 2 to section 9(1)(vii), the payment did not fall in the nature and category of fees for technical services (FTS).

The AO however rejected the contentions on the ground that the type of the services provided by the Pehla Lab was of highly technical nature and the payment was definitely covered by section 9(1)(vii) and secondly, the Explanation 2 to section 9 provides that, where the income was deemed or accrued or arise in India, such income shall be included in the total income of the non-resident, whether or not the non-resident has a residence or place of business or business connection in India. He held that payment would qualify as FTS as per the DTAA between India

[17] 2013-TII-34-ITAT-MUM-INTL

and Germany, as well as per section 9(1)(vii) and he directed the assessee to deduct the tax @ 10% on the gross amount of payment to be made to PTL.

The first appellate authority held in favour of the revenue. However, on further appeal, the Tribunal pointed out that if any person delivers any technical skills or services or make available any such services through aid of any machine, equipment or any kind of technology, then such a rendering of services can be inferred as “technical services”. In such a situation there is a constant human endeavour and the involvement of the human interface. On the contrary, if any technology or machine developed by human and put to operation automatically, wherein it operates without any much of human interface or intervention, then usage of such technology cannot per se be held as rendering of “technical services” by human skills. It is obvious that in such a situation some human involvement could be there but it is not a constant endeavour of the human in the process. Merely because certificates have been provided by the humans after a test is carried out in a Laboratory automatically by the machines, it cannot be held that services have been provided through the human skill.

Although the judgement is in the context of domestic law definition of technical fees, such fees cannot be taxed under the treaties as well considering the fact that treaty definition is narrower.

3.9. ITO Vs. Right Florists Pvt Ltd[18]:

Google’s tax practices in reducing its overall corporate tax liability is one of the important drivers for mobilizing public opinion in the west and the beginning of the BEPS project. Its public hearing before the UK PAC laid bare the oft repeated ‘double Irish Dutch Sandwich’ technique by which it managed to pay very little tax on its profits from the operational income in the UK and elsewhere in Europe. In India, we have had no enquiry about the revenue and taxes paid by various multinationals. However, that does not mean that India’s tax base is not eroded. In this connection, a case decided last year brings into focus the fact that in the absence of a change in the taxation rights of the source and residence countries, the source country tax base will continue to be eroded.

[18] 2013-TII-61-ITAT-KOL-INTL

Right Florists is a small florist in Kolkata. This small company had paid more than INR 30 Lakhs in a year to Google and Yahoo as online advertisement charges. If such is the magnitude of online advertisement from a small company, one can imagine how much Google and Yahoo will generate in the form of total advertisement revenue from India. The Indian company apparently made payments without deduction of tax at source. The question then arose about the allowability of the expenditure in the hands of the Indian company. The assessing authority held that there was no material to establish that these entities belonged to treaty countries and that the taxpayer should have obtained a prior authorization to remit money without deduction of tax at source and in default the sum involved could not be allowed as a deduction.

The question before the Tribunal was whether the amount in question could be taxed as business income or as royalty or as fees for technical services. The Tribunal found that the foreign companies did not have PE in India and that the amount could not be taxed as royalty. The Tribunal found that although technical services were rendered in the case, but in the absence of any human intervention, the same could not be taxed as fees for technical services. The Tribunal, while holding that a web site could not constitute a PE relied on the revised OECD model commentary and ignored India's official position on the said commentary that India did not agree with the OECD view. The logic of India's position was that servers can be placed anywhere thereby making taxation impossible. Moreover servers, by themselves are dumb instruments and can be useful only in conjunction with a website. The Tribunal, while deciding the issue in favour of the taxpayer also made the following observation: "Clearly, *conventional PE test fails in this virtual world even when a reasonable level of commercial activity is crossed by foreign enterprise. It is a policy decision that Government has to take as to whether it wants to reconcile to the fact that conventional PE model has outlived its utility as an instrument of invoking taxing rights upon reaching a reasonable level of commercial activity and that it does fringe neutrality as to the form of commercial presence i.e. physical presence or virtual presence, or whether it wants to take suitable remedial measures to protect its revenue base. Any inertia in this exercise can only be at the cost of tax certainty." (Emphasis added).*The case demonstrated that such kinds of erosion of tax base will not be prevented unless there is discussion on the larger issue of allocation of taxing rights between the countries.

3.10. Besix Kier Dabhol, SA Vs DDIT[19]

Besix Kier Dabhol is a Belgium based company whose sole business was carrying out a project for construction of fuel jetty near Dabhol. Its equity capital was divided in the ratio of 60:40 between two joint venture partners N V Besix SA, of Belgium and Kier International (Investment) Limited of the U.K. The assessee also borrowed from its shareholders in the same ratio as the equity share holding amount of Rs.57.09 crores from NV Basix SA and Rs.37.01 crores from Kier International. The loan was apparently borrowed by the Indian Permanent Establishment directly from the shareholders and was not routed through the head office. The assessee's equity capital was of Rs. 38.00 lacs and debt capital of Rs.9410 lacs. Thus, the debt equity ratio worked out is to 248:1. It paid interest of Rs. 5.73 crores on the borrowing.

The AO noted that the assessee company has no reserves, no provisions, no financial debts, no financial assets, no assets anywhere in the world except in India, that it had a debt equity ratio of 248: 1 whereas debt equity ratio of shareholder companies was not furnished and that the ratio of borrowings was the same as of the equity capital, and in view of these facts, he considered the interest as payment to self and disallowed the claim.

On appeal, the Tribunal held that a company and its shareholders have separate existence, that the contracts between a company and its shareholders are just as enforceable as contracts with any independent person, and that, therefore, interest paid to the shareholder can only be treated as interest paid to independent outside parties.

The Tribunal pointed out that the tax treatment being given to the equity capital and debt capital being fundamentally different, it is often more advantageous in international context to arrange financing of a company by loan rather than by equity. It does affect the legitimate tax revenues of the source country in which business is carried out because while dividends and interest are generally taxable at the same rate in the hands of the recipient in the source country, interest is tax deductible and that results in lower corporate taxes in respect of PE profits. These tax benefits could be further optimized by hybrid financing instruments such as profit participating loans, convertible loans or where instrument is treated as debt in the source country of the income and as equity in the residence country of the lender. That is how tax considerations at

[19] [2010-TII-158-ITAT-MUM-INTL]

times do result in a company being too thinly capitalized, financed by a disproportionate ratio of debts. In order to protect themselves against such erosion in their legitimate tax base, several tax jurisdictions enact ‘thin capitalization rules’. The Tribunal finally held that in the absence of such a rule in India at the relevant time, the interest had to be allowed.

3.11. Dresser Rand India Pvt Ltd Vs. Addl CIT[20]

Dresser Rand India Pvt Ltd is a wholly owned subsidiary of Dresser Rand Co, USA. The Transfer Pricing Officer noticed that it had entered into a ‘cost contribution agreement’ with its parent company in terms of which (a) the assessee should compensate on an equitable basis for the expenses incurred by the holding company on its resources which are being shared with the assessee and other affiliates; (b) the allocation of the cost contribution to various affiliates of the Group depends on two allocation keys, i.e. based on number of headcount, and based on sales proportion ; (c) all the direct and indirect costs, including overheads and termination costs incurred by Dresser Rand Group Inc with respect to the resources shall be computed as cost contribution; and (d) the resources include strategy, administration, finance and treasury, tax and legal services. Asked by the TPO to explain the services rendered by Dresser Rand, for which assessee was to contribute costs, the assessee explained that the services included (i) human Resources services; (ii) legal services; (iii) treasury services; (iv) technical support services; (v) marketing services; (vi) global business oversight services; (vii) internal audit and controls; and (viii) other services such as provision for value added services, sharing for best practices for optimization of services, and safety procedures etc.

It was also explained by the assessee that the assessee had no facilities or manpower in order to handle the above fields, except for a three member team in the field of human resource services, and it was for this reason that it had to avail the services of the holding/parent company and the ‘cost contribution’ allocated by the Dresser Rand Group to the assessee, was justified. However, the TPO rejected the submissions of the assessee for the following reasons –

A. It was incorrect on the part of the assessee to assert that it did not have an audit department since (i) the assessee had two managers and executives in the field of accounts; (ii) the

[20] 2011-TII-101-ITAT-MUM-TP

salaries of these managers and executives in the field of accounts, amounting to Rs 11.65 lakhs, were included in the staff costs; and (iii) the assessee had also paid Rs 21.86 towards audit fees as evident from the profit and loss account.

B. While the assessee had incurred cost contribution allocation of USD 5, 03,660 towards treasury services, the assessee was in fact a cash rich company which did not need any loans or guarantees. The treasury services were thus not related to assessee's requirements.

C. While the assessee had claimed cost contribution allocation of USD 6,37,070 towards 'global business oversight', which were said to be towards 'guidance provided by the global leadership team for efficient management for India operations', the assessee had not furnished any precise details or evidence of the exact services received by the assessee. The TPO noted that the assessee's staff members also included several experts in the field of business management, production and marketing operations, and, as such, the assessee did not really need any services for global business oversight.

D. An analysis of sales, expenses and profitability of the assessee, raised doubts about the genuineness of the arrangement and the cost sharing agreement was an afterthought for the purpose of shifting profits. This conclusion was based on the observations (a) that normally as turnover increases, the ratio of overheads to sales should reduce, but this year, as a result of cost sharing arrangement, the ratio has gone up even as the turnover has gone up; (b) that operating costs in percentage terms, which should come down as a result of turnover increase, has increased this year; (c) the turnover of the assessee should have grown at an accelerated rate as a result of availing these services, but the growth rate has come down this year vis-à-vis the growth rate last year – 21.29% as against 33.07% last year; (d) overall profitability of the assessee should have increased with increase of turnover, but it has reduced from 13.72% to 13.31%.

The TPO thus held that there were no real services availed by the assessee from Dresser Rand US, under the cost contribution arrangement, and hence the payment of Rs. 10.055 crores, under the said arrangement, was not a genuine expenditure incurred for the purposes of business of the assessee and accordingly, the ALP of services availed by the assessee under the cost contribution arrangement was 'NIL'.

The TPO further observed that even if some services were actually availed by the assessee, the cost sharing on the basis of head count was a wholly unacceptable proposition and that cost sharing should be on the basis of actual services availed by the assessee. Moreover, if the assessee wanted to get such services in India, the expenses would be in terms of India employee cost and, therefore, the allocation of the parent company's expenses incurred in USA to an

Indian company on head count basis gave a totally distorted picture and results in excess allocation of such expenses to Indian company.

On appeal, the Tribunal held that-it is not for the revenue authorities to decide what is necessary for an assessee and what is not. An assessee may have any number of qualified accountants and management experts on his rolls, and yet he may decide to engage services of outside experts for auditing and management consultancy; it is not for the revenue officers to question assessee’s wisdom in doing so. The Tribunal held that when evaluating the arm’s length price of a service, it is wholly irrelevant as to whether the assessee benefits from it or not; the real question which is to be determined in such cases is whether the price of this service is what an independent enterprise would have paid for the same. The Tribunal observed that the assessee has given sufficient evidence of the services having been actually rendered to the assessee. There are contemporaneous evidences by way of exchange of emails, reports, guidance notes which show that the assessee received the services from the AE. In the present case, the costs have been shared at average of percentage of (i) head count to the total count and (ii) sales revenue to total revenue. The assessee’s share of head count is 3.90% and of total revenue is 3.30%, and, accordingly, 3.50%, being average of these two parameters, is taken as the cost contribution ratio. The Tribunal found no infirmity in this contribution being taken as an arm’s length contribution to the costs.

Section 4: Indian Perspective and Preparedness

The discussions in the earlier sections give broad indication of base erosion from India. The examples given in the earlier section would indicate that much of the time; India has not been able to tax the base eroding payments owing to the current state of play of the division of taxing rights between the source country (India) and the residence country following the OECD Model tax Convention. In a seminal paper titled *‘Tax Base Erosion and Homeless Income: Collection at source is the linchpin,'* Bret Wells and Cym Lowell of the University of Houston charts the history of the development of the OECD model treaty and points out that the basic tax structure was premised on the belief that the colonial countries would be the source of capital and knowhow and the colonies were the passive suppler of low cost goods and services with very little value addition.[21] The right to tax the residual income was with the home country and the source country was allowed to tax only the routine profits earned there and impose withholding taxes on certain types of payments like royalties and interest. The source country taxes could therefore be easily base eroded. India and other developing countries had no say in the development of such a model.

Therefore, when a new initiative has been taken by the G-20 of which India is a member, ideally the root of the problem of base erosion in the source countries- the allocation of taxing rights- should have been addressed. In fact the Los Cabos declaration mentioned: "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." However, the OECD action plan categorically says that relook at the allocation of taxing rights is not on its agenda. The G-20 having endorsed the OECD action plan, we limit our discussion to the action points as delineated by the OECD.

In the following table, an attempt has been made to summarise the viewpoint that India could take and alongside, there is a discussion of issues of preparedness where relevant. This is followed by a discussion on the administrative dimensions for preparing for effective implementation of the initiatives under the Action Plan.

Table 6: Indian Perspective and Preparedness on Action Points

Action Points	India's Perspective and Preparedness
1.Address tax challenges of digital economy Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules,	The Action Plan talks of a dedicated task force to study the issues. The task force will come out with a report by September 2014. Therefore, it is not possible to predict whether we are equipped to deal with the recommendations. India has had differences with the OECD in the area of e-commerce taxation earlier. In the late nineties, an issue was flagged that it is possible to do extensive business in a country without any physical presence. The 'fixed place of business', which is the cornerstone of the permanent establishment concept would be inapplicable in such cases. India appointed a high-powered committee to examine the taxation issues arising out of e-commerce.

[21] Available at : http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1888397&download=yes

• the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services, • the characterisation of income derived from new business models, • the application of related source rules, • and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector. -	The Committee was of the view that applying the existing principles and rules to e-commerce did not ensure certainty of tax burden and maintenance of the equilibrium in sharing of tax revenues between countries of residence and source. The Committee, therefore, was of the view that the concept of PE should be abandoned and a serious attempt should be made within OECD or the UN to find an alternative to the concept of PE. In this context, the committee endorsed the 'base erosion' approach suggested by Professor Doernberg for an equitable tax sharing between residence and source countries which involved application of a low withholding tax on all tax deductible payments to the foreign enterprise. The OECD had also come up with a Technical Advisory Group (TAG report) on the issue, "*Are the current treaty rules for taxing business profits appropriate for e-commerce*?" Having examined all the proposals including the one from India, the OECD ultimately concluded that the current rules were fine. At Para No 350 the Report concluded: *"As regards the various alternatives for fundamental changes that are discussed in section 4-B above, the TAG concluded that it would not be appropriate to embark on such changes at this time. Indeed, at this stage, e-commerce and other business models resulting from new communication technologies would not, by themselves, justify a dramatic departure from the current rules. Contrary to early predictions, there does not seem to be actual evidence that the communications efficiencies of the internet have caused any significant decrease to the tax revenues of capital importing countries.*" Although OECD now recognizes the problem, it is widely reported that there is a lot of resistance from certain OECD member countries to expand the scope of PE in the context of digital economy (see Sheppard (2013)). In the context of digital economy, the problems are likely to be compounded with the increasing resort to cloud technology. The OECD seems to have rejected proposals like the concept of virtual PE or the suggestions from the French in the Colin and Collin report. In this report, the authors suggested that a new definition of permanent establishment specifically introduced for the data-driven economy, should be based on the notion of users as co-creators of value.[22] It may be interesting to note that a Spanish court has recently used the concept of the virtual PE in the Dell case. In this case, the tax administration pointed out that Dell Products, Ireland sold goods in Spain through a website dedicated to the Spanish

[22] See http://www.redressement-productif.gouv.fr/rapport-sur-fiscalite-secteur-numerique

	market and the Spanish affiliate Dell Spain employed people to translate the website, review the contents and administered the site. It also owned the .es domain name. Thus in the facts of the case the Irish company did not have any physical presence in Spain. The server that hosted the website was not located in Spain. There were no employees of the Irish company in Spain. Nevertheless, the Court held that there was a PE in Spain. As for the OECD prescription that a website per se does not constitute a PE, the Court referred to the observations of Spain: " … Spain and Portugal do not consider that physical presence is a requirement for a permanent establishment to exist in the context of e-commerce, and therefore, they also consider that, in some circumstances, an enterprise carrying on business in a State through a web site could be treated as having a permanent establishment in that State…" India had earlier stated its disagreement with the OECD commentary on the issue by stating its position. In the absence of a satisfactory outcome, we may continue with our position.
2.Neutralise hybrid mismatches Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect (e.g., double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. This may include: (i) changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly; (ii) domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payer; (iii) domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules); (iv) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and (v) where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure. Special attention should be given to the interaction between possible	Hybrid mismatch may not be a special problem for India. However, the Action Plan talks of change in treaty rules and also recommendations relating to design in domestic law including in CFC rules. What contours the change in the OECD model Convention will take is not yet known. Over all, the thrust of the changes seems to be beneficial. As far as changes in domestic law are concerned, for example in denying deduction for a payment that is not includible in income by the recipient, it is certainly a good idea. However, we need to change the provisions of section 90(2) in order to benefit from any such proposed rule. This is because of the fact that section 90(2) as is presently drafted implies that a taxpayer can pick and choose between a treaty provision and a domestic law provision relating to the same issue depending on which provision is more beneficial to him. In such a situation, unless the treaty provision is simultaneously changed, a change in the domestic law does not solve the problem. It may therefore be considered whether to bring back the provision as suggested in the original DTC to the effect: "For the purposes of determining the relationship between a provision of a treaty and this Code,- (a) neither the treaty nor the Code shall have a preferential status by reason of its being a treaty or law; and (b) the provision which is later in time shall prevail." The later in time principle prevails in most countries including the USA.

changes to domestic law and the provisions of the OECD Model Tax Convention. This work will be co-ordinated with the work on interest expense deduction limitations, the work on CFC rules, and the work on treaty shopping.	
3.Strengthen CFC rules Develop recommendations regarding the design of controlled foreign corporation rules. This work will be co-ordinated with other work as necessary.	As far as CFC rules are concerned, in India we do not have CFC rules as yet although the same has been proposed in the DTC. One point to be noted is that OECD obviously finds the CFC rules of its member countries inadequate to deal with the perceived abuses. Therefore, the proposed CFC in the DTC may have to be further modified.
4.Limit base erosion via interest deductions and other equivalent financial payments Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments. The work will evaluate the effectiveness of different types of limitations. In connection with and in support of the foregoing work, transfer pricing guidance will also be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements. The work will be co-ordinated with the work on	The expected outputs here are the recommendations regarding the design of domestic rules and changes to the transfer pricing guidelines. Unlike in most of the OECD countries, in India we still do not have thin capitalization rules as yet. In fact, in one case, the Tribunal has pointed out the lack of such rules in the domestic law and allowed exaggerated interest claims. Transfer pricing rules can take care of excessive claims in the case of related parties. Nevertheless, it is desirable to have thin capitalization rules in the statute.

hybrids and CFC rules.	
5. Countering harmful tax practices more effectively Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.	While the idea of reviewing preferential regimes is welcome, care should be taken as mentioned in the separate note **(Appendix A).**
6. Prevent treaty abuse Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. Work will also be done to clarify that tax treaties are not intended to be used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country. The work will be co-ordinated with the work on hybrids.	The OECD may come up with a model LOB clause. In India, recent treaties mostly have LOB clauses. But these differ wildly. If the OECD suggestion is suitable for India, we may adopt the same in our model for future negotiations. However, the existing treaties need to be revisited. Since these are existing treaties, the multilateral solution envisaged in Action point 15 may not be sufficient. The OECD is also likely to come out with recommendations relating to GAAR in domestic laws. We have GAAR in our Act but the same is kept in abeyance till 2016.
7.Prevent artificial avoidance of PE status Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions. Work on these issues will also address related profit attribution issues.	The OECD work in this area is limited to commissionaire arrangement and some changes in preparatory and auxiliary exception to PE. The commissionaire arrangement is important for civil law countries and arises out of some adverse court cases. It is not an important issue for India. As for restricting the preparatory and auxiliary exemption to creation of PE, the same is welcome, as we have lost many cases relating to Liaison Offices when such offices actually participate quite substantially in the economic activities in

	the country. At the same time, we need to review our domestic law provision contained in Explanation 1(b) to Section 9(1) that gives exemption to operations confined to purchase of goods in India for the purpose of export. As for the most substantial aspect of change in the rules of PE, OECD is unlikely to expand the scope of PE. Therefore, India should continue with its position stated on the OECD Model. India's participation in the BEPS project should not be taken as its acquiescence of the OECD model on this important area.
8.Transfer Pricing: intangibles Develop rules to prevent BEPS by moving intangibles among group members. This will involve:	
(i)adopting a broad and clearly delineated definition of intangibles;	(i) One has to see what exactly the OECD comes up with. In the Indian context, the Finance Act, 2012 has already taken a wide definition of intangible property in section 92B (2). These include –marketing related intangibles, technology related intangibles, artistic related intangible, data processing related intangibles, engineering related intangibles, customer related intangibles, contract related intangibles, human related intangibles, location related intangibles, goodwill related intangibles, methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, technical data etc. Whether OECD accepts the same or not has to be watched.
(ii)ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation;	(ii) This is an important suggestion and should be welcomed. However, what is value creation has not been defined in the action plan. As pointed out by Sol Picciotto, Emeritus Professor of Law on Transfer Pricing, Lancaster University and a view that resonates with the views of big market economies like India and China, "A firm's know-how develops organically and incrementally through its activities as a whole. Although basic research may be carried out in laboratories and research centres, the successful application of the knowledge produced depends to a great extent on the development stages in which saleable products are designed, tested, adapted and marketed. These stages are indeed generally more time-consuming and expensive than the primary research stage. They also involve repeated cycles of interaction involving many of the firm's employees, not only those normally considered to be engaged

	in research and development, but also those involved in production and marketing.”.[23] Adequate return therefore needs to be given to such markets. There are judicial precedents in India upholding value creation in respect marketing intangibles through incurring of advertisement, marketing and publicity expenses
(iii)developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and	(iii) Ideally, the ALP concept should be abandoned in favour of formulary apportionment. However, this is unlikely to be accepted by the OECD. In fact, in India also the ALP is the standard for Transfer Pricing Analysis. In this context, it is interesting to note that the OECD talks of taking special measures “either within or beyond the arm’s length principle” may be required with respect to intangible assets, risk and over-capitalisation. Assuming that a solution outside of the ALP concept is agreed in a particular situation, we may need to change the relevant law.
(iv) updating the guidance on cost contribution arrangements	(iv)Cost contribution arrangements entered into by MNC group with centralization of functions in some group companies and other companies being made to pay for the same are routine. While the expense may be legitimate in some cases, the internal arrangements leave scope for manipulation and base eroding payments. OECD has so far insisted on respecting self -serving agreements. Courts and tribunal in India has also relied on the OECD Transfer Pricing Guidelines in cases to give relief to the taxpayers.
9. Transfer Pricing: risk and capital Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation. This work will be co-ordinated with the work on interest expense	Contractually assumed risk has been observed in India in the following activities: - High-end R&D - Financial Guarantee or Letter of Comfort given by holding companies to its group companies - Performance Guarantee by an Indian Company for the performance of overseas group company entering into the contract Indian Courts are generally reluctant to ignore contractual rights. Many a times the Tribunal has relied on the OECD’s earlier insistence on respecting such rights. How the courts will react to any change in this area remains to be seen. Mere change in the commentary is unlikely to persuade the Courts in India to ignore contractual rights.

[23] Response to OECD Revised Discussion Draft on Transfer Pricing Aspects Of Intangibles available at: http://www.oecd.org/ctp/transfer-pricing/beps-monitoring-group-intangibles.pdf

deductions and other financial payments.	
10. Transfer Pricing: other high-risk transactions Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: (i) clarify the circumstances in which transactions can be recharacterised; (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses.	More guidance is required about this action point. The proposed GAAR permits recharacterisation of transactions in certain circumstances. Transfer pricing involving unique intangibles in an MNC's value chain is a problem area and in the absence of a formulary apportionment option, profit split is a viable option. In India also management fees and head office expenses have been found to be base eroding. In fact, the Indian Income Tax already contains a limitation of head office expenses in section 44C which restricts such payment to 5% of adjusted total income. However, the provision has been somewhat diluted by judgements from Tribunal to the effect that if the expenses are exclusively incurred for the permanent establishment, then no disallowance can be made. Based on the actual recommendations, it may be necessary to relook at the provision. Management fees have been held to be taxable under the domestic law as fees for technical services within the meaning of the term given in Section 9(1)(vii). However, it escapes taxation since under the treaty provisions in most of the cases, it cannot be brought within the definition of such term. Typically in India, information relating to the Indian taxpayer entity is submitted. However, the MNCs are reluctant to share detailed information regarding their associated enterprises and global operations. If the current Plan is implemented, the OECD may, by way of specific legislation/guidance, require taxpayers to submit information on the entire value chain, including information relating to entities in various jurisdictions.
11. **Establish Methodologies to Collect and Analyse Data on BEPS and the Actions to Address It.** Develop recommendations regarding indicators of the scale and economic impact of BEPS and ensure that tools	This is an important action point. In the Indian context, lack of data makes any analysis extremely difficult. The information system in place in the department has been designed for

are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis. This will involve developing an economic analysis of the scale and impact of BEPS (including spillover effects across countries) and actions to address it. The work will also involve assessing a range of existing data sources, identifying new types of data that should be collected, and developing methodologies based on both aggregate (e.g. FDI and balance of payments data) and micro-level data (e.g. from financial statements and tax returns), taking into consideration the need to respect taxpayer confidentiality and the administrative costs for tax administrations and businesses	monitoring and aiding assessment and other functions of the department and is not designed to address policy-related questions. In the present context, for instance, an assessment of the extent of fund flows under various heads and the destination of such flows could have provided vital information for analysis, but was not readily available with the department. Analysis of economic impact of BEPS can only follow once the fiscal impact of BEPS can be identified or assessed.
12 Require Taxpayers to Disclose Their Aggressive Tax Planning Arrangements. Develop recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules. The work will use a modular design allowing for maximum consistency but allowing for country specific needs and risks. One focus will be international tax schemes, where the work will explore using a wide definition of "tax benefit" in order to capture such transactions. The work will be co-ordinated with the work on co-operative compliance. It will also involve designing and putting in place enhanced models of information sharing for international	What exactly is aggressive tax planning arrangement needs to be seen. Depending on the recommendation, such disclosure may be in the income tax return or in some kind of special return. India has experience in such area and appropriate rules can be put in place easily.

tax schemes between tax administrations.	
13. Re-examine transfer pricing documentation Develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNE's provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.	Country by country reporting is essentially a tool for risk assessment by the countries concerned. It is a valuable tool for the tax administration and should be welcomed. On 30/1/2014, OECD has also released draft guidance on Transfer Pricing documentation and country by country reporting and has sought comments by 23rd February, 2014. One of the questions asked by OECD in the draft is whether the reported data should be based on entities or countries. As pointed out by civil society group, entities can trade in many places and hence what is important is what happens in a particular country. Another question is whether data should be top down or bottom up. Again, local data will already be with tax authorities, the reporting should be top down so that meaningful comparison can be done by the tax authorities.[24]
14. Make Dispute Resolution more effective Develop solutions to address obstacles that prevent countries from solving treaty-related disputes under MAP, including the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in certain cases.	While speedy resolution of disputes is welcome, India should be wary of introducing compulsory arbitration in MAP. See separate note in **Appendix B.**
15. Multilateral Instrument Analyse the tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties. On the basis of this analysis, interested Parties will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the	This is a good idea and perhaps will eliminate the need to renegotiate all the existing treaties. But, it will need the other treat partners to also agree to sign the multilateral pact. We have had issues with renegotiating treaties with Mauritius and Cyprus. While OECD has achieved remarkable success in the area of exchange of information, that is mostly because of the threat of sanctions in the form of being branded as uncooperative jurisdiction. In the absence of any such sanctions, it is doubtful whether all the partner countries will be on board. In the Indian context, the exact relationship between a tax treaty, the proposed multilateral treaty and the domestic law

[24] http://www.taxresearch.org.uk/Blog/2014/01/31/country-by-country-reporting-is-open-for-discussion/

global economy and the need to adapt quickly to this evolution.	needs to be sorted out.

Administrative Initiatives

OECD BEPS report indicate that gaps in the national tax regimes of different countries as also the interaction between the tax regimes and the treaties create opportunities that are exploited by multinationals. Hopefully, the final report will put in place some policy prescriptions to minimize such opportunities.

However, the policies are to be implemented on ground. Therefore, it is necessary to examine whether we are administratively prepared for the challenge. Some limited discussion that we had with the officers of the department indicate that this is not an insurmountable problem although concentrated attention needs to be given to the area of international taxation.

Although transfer pricing adjustments have increased in India, it is still relatively new and lot more emphasis needs to be given to this area. For this purpose, deployment of more trained manpower will be necessary. Similarly, the Directorate of international tax also needs to be strengthened. In this connection, it is interesting to note that best brains from the private sector are normally deployed in the transfer pricing since the stakes involved are extremely high.

Prem Sikka of the Essex University points out: “Tax authorities lack the resources to combat the tax avoidance industry. Ernst & Young alone employs over 900 professionals to sell transfer pricing schemes. The US tax authorities employ about 500 full-time inspectors to pursue transfer pricing issues and Kenya can only afford between three and five tax investigators for the whole country”[25] While India may fare better than Kenya, it has to be admitted that the capacity of Indian administration is also severely limited. In all, there are roughly 50 Transfer Pricing Officers all over the country. This needs to be increased at least 10 times in the near term.

Transfer pricing disputes are also increasing phenomenally. Government of India has put in quite a few measures with a view to reducing disputes. One such is the introduction of the process of Advance Pricing Arrangement. However, there are overall only 5 people manning this directorate. Again, the strength needs to be increased manifold. The Income Tax Department is

[25] Shifting profits across borders by Prem Sikka available at : http://www.theguardian.com/commentisfree/2009/feb/11/taxavoidance-tax

carrying out its cadre restructuring. It is hoped that these aspects will be taken care of while doing the exercise.

Apart from augmenting the strength of the directorates, it has also to be ensured that the officers posted here get adequate training. This is also necessary to ensure that consistent stand is taken by the officers across different offices. It is the experience that in a number of cases inconsistent stances are taken by different officers. While this might not be a serious problem in the domestic scenario, in the area of international taxation and transfer pricing, the orders of our officers are now scrutinized all over the world and a certain standard needs to be maintained. The officers posted here should also be encouraged to attend international conferences and trainings.

International taxation and transfer pricing are specialized subjects and it takes at least 2/3 years for the officers to pick up the nuances. However, there are frequent transfers. A minimum tenure of three to four years should be kept for the officers posted here. The department can think of other measures to attract the best brains including offering some special pay, if the rules permit.

One area which will require attention is the state of computerization in the department. Although the department has ambitious plans in this regard, it has to see whether it is geared up to tackle the challenges that will be posed by the added responsibility of automatic exchange of information that has devolved on it as a result of the commitment given under the various agreements that India has signed. Automatic exchange of information will help India in getting information. But, that information has to be processed in a meaningful way. For that necessary processing power has to be acquired. Automatic information also entails responsibility taken up by India to supply information to the treaty partners in a timely manner. Again the information has to be collected preferably online from banks and other institutions and the same has to be processed and then transmitted to the treaty partners. It is therefore necessary to examine holistically the requirements of the department and see whether it is prepared to meet the challenges in an effective manner.

Section 5: Will Investment and Growth in India be Adversely Affected

Given the dependence of the Indian economy on foreign capital inflows and the need for sustained growth, a significant concern for the economy is whether, measures taken to address issues of base erosion and profit shifting would reduce the attractiveness of the Indian economy or for that matter any developing economy as an investment destination. The answer to this question would depend on the contours of the international taxation regime subsequent to the conclusion of the present initiative. Very broadly, if all the countries in the world agree to undertake all the measures that are agreed upon, then the total tax incidence on business would increase, and assuming taxes have less of a roll to play in the new regime, the investment decisions would be more closely aligned with or determined by all the non-tax factors that are argued to influence investment decisions. There is a considerably amount of literature on the determinants of investment decisions, both in the context of Foreign Direct Investment and in domestic investment across states within a country. While taxes do emerge as one indicator for the attractiveness of a particular destination for investment purposes, existing literature suggests that infrastructure, size and growth of market and extent of openness of the economy are important determinants of the quantum of FDI in a jurisdiction. While most of the studies have used number of telephone connections per 1000 population as the proxy for the quality of infrastructure, even in the cases where alternative variables like infrastructure index or installed electricity generation capacity are used, the results suggest a positive relation between infrastructure and FDI. The other important variable considered by these studies is the size of the market. There are two alternative ways in which the size of the market is sought to be measured – by the size of per capita GDP and the rate of growth of per capita or total GDP. These variables in most cases turn out to be significant determinants of the quantum of FDI in the country. It is interesting to note the difference between the use of level and the growth variable. While the former relates the actual size of the economy, the latter conveys information on the functioning of the economy as well, since higher growth would indicate that there are fewer hurdles to investment and growth in the economy. The other variable which emerges fairly consistently is extent of openness of the economy. Once again most of the studies indicate a positive relation between the extent of openness measured as the ratio of trade to GDP and the size of FDI inflows. These results suggest that economic factors other than taxation are important determinants of the size of FDI inflows. Within an open economy, this would also suggest that FDI outflows too would be driven by similar factors in choosing choice of location. The issues of concern therefore remain concentrated on measures to improve infrastructure and growth in the economy.

Table 7: Impact of Key Economic Variables on FDI inflows

Determinant	Country/countries for analysis	Proxy used	Method	Effect	Author(s) (year)
Infrastructure	16 SSA countries	Telephones per 1000 inhabitants	Multivariate Regression	0	Cleeve (2008)
	12 MENA; 24 Developing countries	Telephones per 1000 inhabitants	Multivariate Regression	0	Mohamed and Sidiropoulos (2010)
	44 countries	Telephones per 1000 inhabitants	Panel Regression	Positive	Biswas (2002)
	Developed, emerging and African countries	Telephones per 1000 inhabitants	Panel Regression	Positive	Jordaan(2004)
	22 SSA countries	Telephones per 1000 inhabitants	Panel Regression	Positive	Asiedu (2006)
	SSA	Telephones per 1000 inhabitants	Panel Regression	Positive	Ancharaz (2003)
	14 South African Development Community	Telephones per 1000 inhabitants	Multivariate Regression	Positive	Mhlanga et al. (2010)
	14 South African Development Community	Number of landline and mobile subscribers per 1000 inhabitants	Multivariate Regression	Positive	Mhlanga et al. (2010)
	44 countries	Installed net electricity generation	Panel Regression	Positive	Biswas (2002)
	6 South East European Countries	capacity per capita	Panel Regression	Negative	Botrić and Škuflić (2006)
	BRICS	Infrastructure index	Panel Regression	Positive	Vijayakumar et al. (2010)
Market size	80 DCs	GNP per capita	Multivariate Regression	Positive	Schneider and Frey (1985)
	Baden-Wurttemberg, Catalunya and Lombardia	GDP per capita	LSDV	Positive	Artige and Nicolini (2006)
	22 SSA countries		Panel regression	Positive	Asiedu (2006)
	Belarus	GDP	Multivariate regression	Positive	Pärletun (2008)
	16 SSA countries	GDP per capita	Multivariate Regression	Positive	Cleeve (2008)
	6 South East European Countries	Number of inhabitants	Panel Regression	Negative	Botrić and Škuflić (2006)
	6 South East European	GDP	Panel Regression	Positive	Botrić and Škuflić (2006)

Determinant	Country/countries for analysis	Proxy used	Method	Effect	Author(s) (year)
	Countries				
	Baden-Wurttemberg, Catalunya and Lombardia	GDP per capita	LSDV	Positive	Artige and Nicolini (2006)
	38 countries	GDP per capita	Panel regression	0	Demirhan and Masca(2008)
	12 MENA; 24 Developing countries	Number of inhabitants	Panel regression	Positive	Mohamed and Sidiropoulos (2010)
	BRICS	Industrial Production Index	Panel regression	Positive	Vijayakumar et al. (2010)
	14 South African Development Community	GNP per capita	Multivariate Regression	Positive	Mhlanga et al. (2010)
Market Growth	80 DCs	GDP growth rate	Multivariate Regression	Positive	Schneider and Frey (1985)
	80 DCs	Real GNP growth rate	Multivariate Regression	Positive	Schneider and Frey (1985)
	SSA countries	GDP growth rate		0	Ancharaz(2003)
	non SSA countries	GDP growth rate		Positive	Ancharaz(2003)
	16 SSA countries	GDP growth rate	Multivariate Regression	Positive	Cleeve (2008)
	38 countries	growth of GDP per capita	Panel regression	positive	Demirhan and Masca(2008)
	12 MENA; 24 Developing countries	Real GDP growth rate	Panel regression	Positive	Mohamed and Sidiropoulos (2010)
	BRICS	Industrial Production Index	Panel regression	0	Vijayakumar et al. (2010)
	14 South African Development Community	GDP growth rate	Multivariate Regression	0	Mhlanga et al. (2010)
Openness	6 South East European Countries	Exports plus imports by GDP	Panel Regression	Positive	Botrić and Škuflić (2006)
	22 SSA countries	Openness index by ICRG	Panel Regression	Positive	Asiedu (2006)
	Belarus	Exports plus imports by GDP	Multivariate regression	Positive	Pärletun (2008)
	38 countries	Exports plus imports by GDP	Panel regression	positive	Demirhan and Masca(2008)
	16 SSA countries	Exports plus imports by GDP	Multivariate regression	Positive	Cleeve (2008)
	14 SADC	Exports plus	Multivariate	Positive	Mhlanga et al.

Determinant	Country/countries for analysis	Proxy used	Method	Effect	Author(s) (year)
		imports by GDP	regression		(2010)
	12 MENA; 24 DCs	Exports plus imports by GDP	Panel Regression	0	Mohamed and Sidiropoulos (2010)
	BRICS	Exports plus imports by GDP	Panel Regression	0	Vijayakumar et al. (2010)

In the alternative and more likely scenario, that only some of the countries in the world agree to undertake all the measures agreed to upon in the G20, or even if they agree the decisions are phased out over a long period, then the consequences would depend on the relative strengthens of these economies, which once again would take the discussion back to other economic variables discussed above. On the other hand, it is necessary to increase the tax GDP ratio of India so that taxes gathered can be properly used to finance the physical and social infrastructures that are more important determinants for investment flows. Viewed from that perspective tax base erosion is a serious problem for India and should be tackled whether in tandem with the OECD or even independently of others.

Section 6: Concluding Comments

The discussion in this paper highlights some evidence to support the notion that there is base erosion in India. On the specific action points listed in the OECD's Action Plan, a perspective from India's stand point has been presented along with a brief discussion on the steps needed to prepare for complying with likely proposed measures. A natural question that emerges from such a discussion is what are the likely consequences of such reform initiative**s**. From existing literature, it is fairly clear that while taxes are one important factor in determining location for FDI decisions, there are a host of other factors which influence this decision. Key among them are size and rate of growth of the domestic market and infrastructure. Some studies even suggest that the negative impact of taxes is mitigated to a large extent by public investments in infrastructure. Given the large size of the Indian economy, it is therefore expected that inflows to India would not vanish. Provided the investments do not change substantially, it would be expected that the revenue flows to the government too would increase, since the effort is to stem base erosion and profit shifting.

While welcoming the OECD’s action plan, it is important to keep in perspective the fact that OECD is essentially a forum for rich countries. It is unrealistic for us to expect OECD to change its orientation and focus on issues which do not benefit its members. The interests of capital exporting countries will differ from those of capital importing countries. The OECD will therefore focus on only those issues where there is some convergence in the interests of developed and developing countries. When these interests clash, it is unlikely that OECD will come to the rescue of the developing world. Therefore, we should not expect any paradigm shift from this project.

OECD will also like the rules that it formulates to be the standard model that will apply to all. It is with this end in view that it has possibly engaged BRICS and brought Indonesia and Saudi Arabia on board. If these countries also agree on the basic philosophy of the OECD model, then that becomes the world standard and everybody else will be required to/expected to follow. India’s interests and the interests of the developing world do not coincide with the interests of the OECD countries. Therefore, while supporting the BEPS project, India in conjunction with other BRICs should make it amply clear that these countries should continue to oppose this basic philosophy of the OECD model which gives the taxing rights of the important sources of income to the capital exporting countries while the source countries get only the rights to tax routine income. Two such incomes on which the OECD view is different from the India’s stated position are discussed below.

Under the OECD MC, the right of taxation of royalties is given exclusively to the country of residence with no right for the country of source. The UN model gives a secondary right to the country of source. In all of India’s treaties, India has retained this secondary right whereas the OECD countries have tried to remove the same. Thus, under USA-UK tax treaty or USA-Japan tax treaty, there is no withholding tax for royalties. As a part of the process of becoming observer at the OECD CFA when India was asked to state its positions on the OECD model its commentaries, India obviously reserved its position on the same.

Similar is the case for taxation of services. As is well known, India puts a lot of emphasis on this aspect. India has a fee for technical services clause both in its domestic law as also in most of its treaties. OECD model obviously does not have it while the UN is deliberating on the issue. There is also a service PE clause in most of India’s new treaties. UN model allows for service PE while the OECD model in its commentary, has recently given an option to its members to have such a clause. The scope of the same is restricted in the OECD model. India does not agree with the OECD model and its commentaries and has stated its position.

Following from such differences, it is clear that the OECD Model and its commentaries cannot be binding on India and in the discussions on the Actions Points, it is important for India to maintain this position of independence/difference from the OECD position on issues which protect its revenues.

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Appendix A

Countering Harmful Tax Practices

Action no. 5 talks of countering harmful tax practices more effectively, taking into account transparency and substance. It talks of carrying forward the 1998 OECD initiative on curbing harmful tax practices leading to the race to the bottom amongst states. The 1998 initiative was targeted against tax havens and preferential tax regimes granted by OECD member states. Such preferential regimes within the OECD countries were to be eliminated. As for tax havens, the work involved identifying the tax havens and making them commit to transparency and exchange of information. Initially there was also talk of imposing sanctions against non-cooperative regimes which was not really followed up.

This time around, the action plan talks of harmful tax practices generally. The review of such regimes will not only be of the OECD countries but of the G-20 countries as well and perhaps subsequently to other countries.

While action against dubious practices adopted by tax havens to attract headquarters of companies to these jurisdictions that cause base erosion from the source countries are certainly welcome, there needs to be clarity on the kind of regimes that are being targeted here. The action plan talks of across the board corporate tax reduction on certain types of income, such as income from financial activities or from the provision of intangibles. Again, it is not clear if these are the only types of income that will be considered. Moreover, reduction in corporate tax rates seems to be a sovereign decision of the countries concerned and may not be subject to scrutiny.

Many developing countries including India give incentives for investment. Of course, there is substantial activity in such areas as a result. Similar is the case of the Special Economic Zones where investors including multinationals set up their activities. It has to be ensured that such provisions do not come under any restrictions.

The action plan talks of compulsory spontaneous exchange on ruling related to preferential regimes. It is not clear who will give such rulings. The idea of exchange of information about the rulings is welcome since the affected countries, if they so desire, will be in a position to take action. To be effective though, the kind of action to be taken also needs to be coordinated, particularly in the treaty context. If a holding company structure set up in a treaty country is found to be harmful, it needs to be specified what action can be taken by the partner country without necessarily rescinding the treaty.

Appendix B

Compulsory Arbitration

Action 14 of the BEPS project mentions about the need to address obstacles that prevent countries from solving treaty related disputes under MAP, including absence of arbitration provision in most treaties and the fact that access to MAP and arbitration may be denied in some cases.

This action plan is not related to the basic theme of base erosion and profit shifting. The rationale of its inclusion in the action plan is not very clear. Apparently, this was included at the instance of powerful businesses.

It may be noted that the idea of compulsory arbitration in cases where competent authorities are unable to reach an agreement within a specified time period has been on the agenda of the OECD for some time. In the 2010 version of the OECD Model, a new paragraph 5 was incorporated in Article 25 relation to Mutual Agreement Procedure, which states that where Competent Authorities are unable to reach an agreement on an issue within two years of submission of a request, the unresolved issue shall be submitted to arbitration if the taxpayer so requests. The Commentary then gives the methodology of the arbitration process.

As compared to the OECD model, the UN model did mention the possibility of arbitration but it was left to the states concerned to consider the same. However, the business community has been putting pressure on having such a provision. Settlement of tax disputed through compulsory arbitration has been one of the demands of the multinationals, represented by the international Chamber of Commerce. In fact even in 1995, the ICC submitted its representation to the United National Committee of Tax Experts. Commenting on the Mutual Agreement Procedure, ICC submitted: "The ICC is not satisfied with the mutual agreement procedure as now set out in both the OECD Model and the UN Model. The procedure required significant changes in order to achieve fair and equitable treatment of all parties involved. In particular, the tax authorities should be required to reach agreement on a solution (e.g. by way of arbitration) and the taxpayer's involvement should be guaranteed by provisions that allow him to participate in the process and to approach the tax authorities of both countries." Thus, ICC wanted compulsory arbitration and also the involvement of the taxpayers in the process.

However, the UN Model till 2001 did not contain any provisions for arbitration. In the commentary, it was merely mentioned that it has been suggested that the Contracting States may provide an arbitration clause through which controversies concerning the interpretation and application of the Convention may be resolved. After the incorporation of the provision relating to arbitration in the OECD model in 2010, there was pressure for the adoption of the same in the UN Model as well. However, it is well known that developing countries are wary of the arbitration process and no consensus could be reached on the issue even after elaborate discussions. Finally, in the 2011 UN Model, two versions of Article 25 relating to Mutual Agreement Procedure has been proposed. It is not exactly known whether all the developing countries were against the proposal or not but the fact that there are two versions shows that there was no consensus. Version 25A is without compulsory arbitration clause while version 25B contains such a clause. However, there are some minor differences even in version 25B as compared to the OECD model. Thus, the period after which arbitration sets in is 3 years as compared to 2 years in the OECD Model. Secondly, unlike the OECD Model, it is the Competent Authority that sets it in motion. And, unlike in the OECD Model, the Competent Authorities are allowed to depart from the arbitration decision if they agree to do so within six months after the decision has been communicated to them.

Under the OECD model, each of the parties nominates an arbitrator who then nominate a third one who will function as the chair. In case, they are not in a position to do so within one month of finalization of the terms of reference, the Director CTPA will nominate the Chair. The costs are to be borne by the two states. The OECD commentary also allows the taxpayer to participate in the arbitration proceedings either directly or through representative.

Under the OECD Model, although the taxpayer initiates the arbitration process, the arbitration order is not ultimately binding on it.

These aspects of the arbitration process have come in for criticism from commentators.[26] The UN Model, 2011, while having some differences, also more or less follows the OECD Model in the details. Here instead of the Director, CTPA, the Chairman of the group of experts will nominate the Chair.

Allison Christians argues that the primary significance of the arbitration process is the naming of the experts and the elevation of these private sector individuals to de facto decision making position in matters of state-to-state tax revenue allocations. She adds: “This privatization of international tax lawmaking should make everyone wary, but it should be especially troubling to developing countries, since experts seem all too often to be identified solely in the developed world.” Commenting on the importance of the selection of arbitrators, Allison points out: “As one arbitration expert put it, just as “location, location, location” comprise the three key elements in sustainable real estate value, so it has been observed that “arbitrator, arbitrator, arbitrator” endure as the most critical factors in the integrity of any arbitration.”

A look at the literature on arbitration in other contexts shows that there is cause of worry. In the Indian context, the arbitration case in White Industries Australia Limited and the Republic of India is worth remembering. Very briefly, in this case, White Industries had entered into an

[26] For example- Comments on the OECD proposal for secret and mandatory arbitration of international tax disputes- Michael J. McIntyre available at : http://faculty.law.wayne.edu/McIntyre/text/mcintyre_articles/Treaties/McIntyre_OECD_Arbitration_Proposal.pdf

agreement with the public sector Coal India for supply of equipment and knowhow for an open caset mine. The agreement allowed for bonus for White Industries for exceeding the production target or penalty for default. Subsequently a dispute arose and Coal India encashed a bank guarantee by way of penalty. In the arbitration proceedings that ensued in ICC, White Industries won although there was a dissenting note by Justice Jeevan Reddy from India. Coal India wanted the award to be set aside and applied to the Calcutta High Court and there was protracted litigation and the matter was pending before the Supreme Court. In the circumstances, White Industries brought a complaint against India for the alleged violation of the of the provisions of the India-Australia BIPA. The arbitration proceedings under the UNCITRAL rules took place in London and the arbitrators, although did not find merit in the other charges of White Industries, nevertheless held that the India judicial system's inability to deal with White's jurisdictional claims for over nine years, and the Indian Supreme Court's inability to head the White's jurisdictional appeal for over five years amounted to undue delay and constituted a breach of India's voluntarily assumed obligation of providing White with "effective means" of asserting claims and enforcing rights. The arbitration Tribunal awarded compensation to be paid by the Government of India.

As Allison Christians points out, "The determination of the arbiters is the resolution of the case. That is not to say that experts from developed countries will always and necessarily make decisions that favour developed countries; the opposite could be true, despite the UN's stated fears. But a look at the literature in other contexts suggests that there is cause for worry – at the very least, there is cause for being vigilant about the structure that is being adopted for states to allocate revenues cooperatively going forward. This is especially true in cases involving things like transfer pricing in which disputes are regularly likely to hit the big and hotly contested issues of international tax policy."[27]

[27] Allison Christians (2012),"Putting Arbitration on the MAP: Thoughts on the New UN Model Tax Convention", Tax Notes, April 27.

Base Erosion and Profit Shifting

- An Indian Perspective

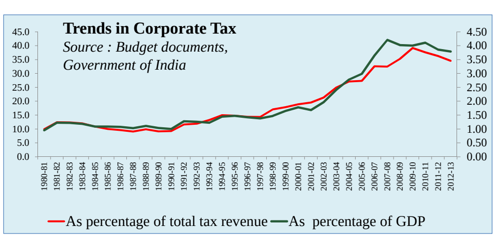
D. P. Sengupta

Background

- Greater integration with the Global Economy. Sharp increase in trade to GDP ratio [From 20% to about 45%] over the last decade. Deficit Partly met by FDI
- Increase in FDI flows from less than US$ 10 billion to over US$ 25 billion over the last decade
- Over 53 percent of FDI into India comes from havens/quasi havens
- Effect on Corporate Tax [38% of total revenue, 3.5%of GDP]

Background

- Corporate tax rose sharply since 2000 and has settled at 3.5 percent of GDP
  - High dependence on corporate tax revenues: need to protect these revenues



A Critical Review of Recent Proposals for a Destination-Based Cash Flow Tax as an Global International Tax Reform Option

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A note to participants of Sydney BEPS conference:

The following contains the introduction and section 1 of a paper still being written. The introduction outlines the arguments of the paper, and section 1 contains a critical discussion of some current proposals for a destination-based cash flow tax. I apologize for the incomplete and preliminary nature of the draft here, but believe that for a practically-oriented audience, Section 1 (and correcting the errors in it) may be the most important.

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Introduction

In the past year, a growing body of academic literature has emerged offering evaluations of the BEPS project from theoretical and normative perspectives. This literature is at once insightful and controversial. Clearly, in a policy initiative led by governments and international organizations and having immediate bearings on taxpayers and the global tax profession, theoretical insights, whether positive or normative, are predictably short in supply and therefore much needed. Yet the BEPS initiative may have also put theorists on the defensive: it might demonstrate weaknesses in existing theories, as well as much disagreement among scholars writing on international taxation.[1]

The present paper focuses on one strand of the academic response to the BEPS initiative, as represented in a number of recent articles (and probably aired more often at conferences).[2] According to this response, the BEPS initiative is superficial in that it deals with the symptoms but not the causes of the ills in the international tax system. What should receive more public attention are more fundamental reforms of the system. Among writers who express this view, many also make reference to the destination-based, cash flow (or "flow-of-funds") corporate tax that was introduced as a reform option in the 2010 Mirrlees Review.[3] Interest in this more "radical" reform option has also been expressed by some policymakers.[4]

I attempt to separate the substantive from the rhetorical in this recent literature. I proceed in a "backward" fashion relative to the typical style of argumentation in the literature. The standard style is to first highlight the inadequacies of the current international tax system, and then to describe the various reform options. Instead of first pursuing a debate about how best to identify the most fundamental flaws of the current system, I first examine what we know about the proposed destination-based, cash flow corporate tax (which I will sometimes abbreviate below as "DCT"). Specifically, what are the main theoretical motivations for advocating such a tax? What are its basic mechanisms and the main challenges that might prevent its implementation? Are the challenges merely technical, which might be overcome or mitigated by careful institutional design (including through legal devices), or are they more fundamentally conceptual? And, last but not the least, how do these challenges—whether conceptual, technical, administrative, or political—compare with the constraints that might have led to all the flaws in the existing international tax system?

[1] Richard Vann, "Policy Forum: The Policy Underpinnings of the BEPS Project—Preserving the International Corporate Income Tax?" (2014) Canadian Tax Journal 62:2, 433-41.

[2] See, e.g. Michael Devereux and Rita de la Feria, "Designing and Implementing a Destination-Based Corporate Tax" (2014) Oxford University Centre for Business Taxation Working Paper 14/07; Michael P. Devereux and John Vella, "Are We Heading towards a Corporate Tax System Fit for the 21st Century?" (2014) Oxford University Centre for Business Taxation Working Paper 14/25; Clemens Fuest, Christophe Spengel, Katharina Finke, Jost Heckemeyer, and Hannah Nusser, "Profit Shifting and 'Aggressive' Tax Planning by Multinational Firms: Issues and Options for Reform" (2013) World Tax Journal, pp. 307-324.

[3] Alan Auerbach, Michael Devererux and Helen Simpson, "Taxing Corporate Income", in *Dimensions of Tax Design: The Mirrlees Review* (Inst. for Fiscal Studies ed., 2010), 837-893 (hereinafter ADS 2010). For references to some literature on the destination-based cash flow tax that preceded ADS 2010, see Devereux and de la Feria, supra note 2, fn. 1. Missing from the list of references is an important body of U.S. economic literature that discussed implementing a cash-flow tax on consumption either on a destination or an origin basis. See, e.g. David Bradford, "The X Tax in the World Economy" (2003) CEPS Working Paper 93, Princeton.

[4] See, e.g. IMF Policy Paper, "Spillovers in International Corporate Taxation" (May 2014).

In relation to the substance of DCT proposals, I first consider several versions of the DCT that can be found in recent expositions, and raise a number of specific technical questions regarding them (Section 1). I then consider the following more general theoretical objections (Section 2). First, the strongest theoretical case that has been made for the DCT is that it allows the simultaneous achievement of a number of neutralities. In other words, the design of DCT is an exercise in avoiding trade-offs among different kinds of inefficiencies, instead of balancing various trade-offs. Whether this should be the aim of the design of international tax system (and of fundamental reform) can be questioned. Second, theoretically, there is a close connection between destination-based commodity taxation and residence-based capital income taxation. Given this connection, destination-based and residence-based taxation ought to have many similar information requirements. This raises the question of why an optimal destination-based tax is feasible but an optimal residence-based tax is not. Third, existing elaborations of the DCT strongly suggest that its implementation pre-supposes the possibility of revenue transfers among national governments, some countries giving up the taxation of location-specific rents, close international cooperation, or a combination of these possibilities. Not only is it questionable whether the theory of international taxation should make these pre-suppositions, it also is unclear why, if they are made, the existing international tax system cannot be improved without a radically new paradigm.

Besides substance, there has also been a good amount of rhetoric in the literature advocating a DCT. Instead of engaging with all or most of these rhetorical arguments, I will discuss just one (Section 3). Although strong cases have been made in the economic literature that, in numerous circumstances, source-based taxation can be inefficient, it has been increasingly popular for theoreticians to claim that the concept of "source" is empty, meaningless, or indeterminate at the core (and not just at the margin). Of course, these two views—that source-based taxation is definitely inefficient, and that the concept of source is indeterminate—seem mutually contradictory. Noting this contradiction, I suggest that most arguments to the effect that the concept of source is meaningless are rhetorical, and offer insufficient motivation for proposals for DCT.

It should be clear that the aim of this paper is not to voice skepticism about international tax reform. (At most, it voices skepticism about skepticism about reform.) But to phrase things more positively, my aim is to contribute to the emerging academic discussion of how to formulate the fundamental conceptual framework for evaluating international tax reforms (Section 4).[5]

1. How Would a DCT Work?

Proponents of DCT have stressed its conceptual motivations and theoretical advantages; proposals for detailed implementation are still supposed to be work in progress. However, to fix ideas, it is important to consider some simple versions of the proposal. Let us start with one version that is not

[5] For recent examples of such discussions, see Dhammika Dharmapala, "What Do We Know About Base Erosion and Profit Shifting? A Review of the Empirical Literature" (2014) CESifo Working Paper, No. 4612; Dharmapala, "Base Erosion and Profit Shifting: A Simple Conceptual Framework" (2014) University of Chicago Law School Coase-Sandor Institute for Law and Economics Working Paper No. 703; Katharina Finke, Clemens Fuest, Hannah Nusser and Christoph Spengel, "Extending Taxation of Interest and Royalty Income at Source – an Option to Limit Base Erosion and Profit Shifting?"(2014) ZEW Discussion Paper No. 14-073.

favored but is nonetheless illustrative (call this Version 1).[6] Consider a scenario where a corporation X situated in country O makes sales to final consumers in country D, whereas the income earned by X is ultimately owned by (to be distributed to) individuals in country R.[7] In one version of a DCT, sales to final consumers in D are identified. Such sales create a potential tax liability for sellers, including X. Since the tax is not a commodity tax but on corporate profit, however, the extent of the X' tax liability in D would have to depend on X' costs that are incurred in O but are allocable to the sales in D. Essentially, the profit that would have been taxed (in the first instance) in country O under the current, source-based international tax regime is made taxable (in the first instance) in D instead.

Although it is clear in this simple scenario what it means to switch from source- to destination-based taxation, what would be the point of this switch? What is the purpose of giving D a tax base that used to belong to O? The proposal assumes that where final consumers reside is a matter that is essentially a given for any multinational corporate group (MNC). The MNC does not have any choice on the matter. And if the MNC knows that the locations of the final consumers are the only thing that will determines the tax rates at which its profits will be taxed, it will not make decisions about where to locate its production and its profits based on tax considerations, but only on other real economic considerations. Thus if the final consumers are known to be located in D, then X will not locate production in O just because O has a lower tax rate. It will also not to try to shift profit out of O, for example to a tax haven country, since that will not prevent its profits from being taxed in D.

However, the mechanism for the DCT described above may not accomplish this purpose. This is because X may over-state its costs in O to reduce its taxable profit in D. In order to verify that O's stated costs attributable to sales in D are true costs, D's tax authority may need the cooperation of the tax authority in O. Moreover, since X may be making sales to many countries, a lot of international cooperation in tax administration (and not just tax policy-making) would be needed.[8]

Therefore, proponents of DCT have favored a second version of the tax (Version 2). The Mirrlees Review gave a succinct summary:[9]

> "A more plausible alternative would be to organize the tax in the same way as a destination-based VAT. Indeed, value added as measured by VAT is equal to the sum of economic rent and labour income. In a closed economy, a VAT which also gave relief for labour costs would be equivalent to an R-based cash flow tax. All real costs, including labour costs…would be deductible from the tax base. In an open economy, a destination-based VAT which also gave relief for labour costs would be a destination-based, R-based, flow-of-funds tax…

[6] This version of destination-based taxation is suggested on ADS 2010, p 883. It is said to be a form of formulary apportionment based only on final sales.
[7] The labels for the countries reflect DTC proponents' preferred characterization of these facts: R is the country of residence of the income's ultimate owner; O is the country of the origin of the productive activity generating the income, and is also conceived as the "source" country of income. D is the destination country, and is neither the residence nor the source country. See ADS 2010, p 870.
[8] A further, and related, question is how profits from firms making sales of intermediate goods and services will be taxed. If profits from intermediate sales are also taxed in the country of the purchaser, then the tax burden on corporate profit will clearly depend on the place of production (i.e. the location of the user of purchased business input). Both sellers and buyers of intermediate goods and services may gain from reducing the tax on such profits.
[9] ADS 2010, pp 883-4.

"How would such a destination-based cash flow tax allocate costs between countries? It would relieve those costs in the exporting country in which they were incurred. Just as for VAT, an exporting company would not be taxed on its exports... Any VAT [sic] a company had already paid on intermediate goods would be refunded. A destination-based cash flow tax would need additionally to give a refund to reflect the cost of labour. A company which exported all its goods would therefore face a negative tax liability, reflecting tax relief for the cost of its labour."

What this description suggests is that a company's tax base is determined by the tax systems of different countries. In the country of sale (D), only income/revenue will be taken into account, which would clearly over-state corporate profit. However, in the country of production (O), all production costs will be subtracted from the tax base. In contrast to the first version of the DCT above, whether such costs are over-stated can be verified by O's tax authority alone, without D's tax authority's involvement.

A number of questions can be raised about this second version of the DCT. DCT proponents purport to have answered (some of) them, but the answers are not always clear, and further elaboration would be beneficial—certainly more beneficial, I would argue, than many of the rhetorical arguments against the concept of source (examined in Section 3) that have been used to motivate DCT proposals.

Does the tax rate in O matter? On the face of it, X's tax liability, as well as the nominal tax rate on its profit, will depend partly on the tax rate in O, not just the tax rate in D. For example, suppose D's tax rate is t_D and O's tax rate is t_O (both are expressed in tax-exclusive terms).[10] If X has R dollars of sales in D ($R^* (1+t_D)$ dollars in tax-inclusive terms), and P dollars of non-labor input cost of in O ($P^* (1+t_O)$ dollars in tax-inclusive terms)—assume for the moment negligible labor costs—then its net tax payment under the destination-based tax will be $R^*t_D-P^*t_O$. Whether we express this as a percentage of before-tax profit ($=R^* (1+t_D) - P^* (1+t_O)$) or of after tax profit (= R-P), the percentage will depend on t_D as well as t_O.

However, as the example above illustrates, whatever values t_D and t_O take, after-tax profit will always be R-P. The value of t_O in particular will not change X's bottom line. In this sense, the tax rate in O does not matter to X (and therefore will not influence X's location decisions). This appears to be the argument offered by Devereux and de la Feria.[11] But this argument provokes two further questions. First, the above example—*if* it illustrates Devereux and de la Feria's argument—also seems to show that whatever taxes are levied in D and O, X's after-tax profit will always be the same and equal R-P. D's tax rate t_D does not matter, either. This would undermine an understanding of their proposal as being for a tax *on* the corporate profit of X. Traditionally, the idea of a tax *on* corporate (pure) profit is that it alters the amount of pure profit that accrues to the company's shareholders.[12] But if a given tax only changes

[10] The invoice-credit VAT usually expresses tax rates in tax-exclusive terms, whereas the subtraction-type VAT usually uses tax-inclusive expressions. Devereux and de la Feria, supra note 2, at 10-11, state that their proposal does not rely on the invoice-credit method of administration. Many other expositions of the cash flow tax also proceed as though an analogue of the subtraction-type VAT would be adopted. See, e.g. Alan J Auerbach and Michael P Devererux, "Consumption and cash-flow taxes in an international setting" (2013) NBER Working Paper 19579 (hereinafter AD 2013); Bradford, supra note 3. In the simple example given here, tax-exclusive rates and prices can be converted simply into tax-inclusive ones.
[11] Devereux and de la Feria, supra note 2, at 4.
[12] For example, this underlies the idea that a tax on pure profit can be close to 100% without being distortionary.

the prices of a company's inputs and outputs (and the amounts of its tax payments), without changing its after-tax profits, then the tax does not seem to tax profits in the normally understood sense.[13]

Second, in the simple example above, we pretended that labor cost was zero. If the value of labor does contribute to value added but the cost of labor is excluded from the DCT base (that is, the value of labor is not subject to any tax), would it still be the case that a higher tax in O merely increases the cost of production in O, which offsets the effect of the tax refund on labor costs (more on this immediately), such that X's after-tax profit is not affected by the tax rate in O?[14] The cash flow tax on business profits has often been described as having the effect of a VAT plus a wage subsidy (i.e. the value of non-labor inputs is taxed, but labor is not). It seems surprising that the effect of this subsidy is that wage rates move in the same direction and in the same proportion as the prices of other inputs used in production.[15]

Why isn't this an export subsidy? Suppose that company X in country O produces a unit of a good while incurring material costs of 10 (in tax-exclusive terms) and labor cost of 5. Suppose that the world producer (i.e. after-tax) price of the good is 14. X's production of the good thus earns a 1 dollar of negative rent. However, under the proposed DCT, not only should X be refunded all previous tax borne by its non-labor inputs (thus making sure that the material cost is 10 and no more), but it should also get a tax credit for its labor cost. Suppose that O's domestic tax rate is 20%. Then O's "tax relief" for labor cost would allow X to break even. It would seem, then, that the cash flow tax has the effect of an export subsidy. However, the Mirrlees Review simply asserts that it does not, in brief parenthetical language.[16]

In the U.S. tax policy literature on implementing cash-flow consumption taxes,[17] it has been generally recognized that the destination version of such taxes would give rise to export subsidies.[18] For example, under the so-called "X-tax" devised by David Bradford, wage payments are removed from the cash flow tax base of a business (including but not limited to corporations), and such payments would be

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[13] A similar question can perhaps be raised about the mathematical derivation of the properties of the DCT offered in AD 2013 (at 19-20). Auerbach and Devereux show through the derivation that the "destination-based tax is equivalent to a lump sum tax on the pure profits received by domestic residents". This seems to make intuitive sense: a regular destination-based consumption VAT imposed by country D would tax all consumption arising out of economic rent and labor (wherever generated) received by the residents of D. A DCT that further excluded labor compensation from its tax base would then be equivalent to a tax on economic rent (pure profit). However, in Auerbach and Devereux's model, multinationals are equally owned by resident and non-resident individuals. If a DCT imposed by a country is equivalent only to a lump sum tax imposed on the pure profit accruing to its *own* individual residents, then the tax is not a tax on the pure profit of a multinational owned by residents and non-residents.

[14] In the formal model in AD 2013, Auerbach and Devereux assume that when a country imposes a tax t on imports, wages and other prices will go up by t. AD 2013, at 20. There is no separate discussion of wage (and the justification for its rise along with other prices) in the model. In the theoretical VAT literature, it is not commonly assumed that a rise in the VAT rate would be accompanied by an equal rise in the wage rate.

[15] Once again, I am not suggesting that these questions, or the ones that follow, cannot be answered by DCT proponents. But it would be good to see these answers spelled out more fully, at least for laymen like myself.

[16] ADS 2010, at 884 ("countries would not be subsidizing exports (since the export price would be unaffected)…". See an equally cryptic dismissal of the export subsidy concern in Michael Devereux and Stephen Bond, "Cash Flow Taxes in an Open Economy" (2002) CEPR Discussion Paper 3401, at 23.

[17] Especially in the 1990s, several different legislative proposals for such taxes were extensively examined, to a level of technical detail that I believe exceeds that of the recent DCT literature.

[18] David Weisbach, "Does the X Tax Mark the Spot?" 56 SMU L. Rev. 201 (2003); Stephen E. Shay & Victoria P. Summers, "Selected International Aspects of Fundamental Tax Reform Proposals," 51 U. Miami L. Rev. 1029 (1997).

taxed to the wage earners at progressive rates capped at the business tax rate. The actual tax collected from wages would thus be less than the reduction in the amount of business tax resulting from the deduction for wages. If an exporting business nonetheless gets a tax refund for the wage it pays (and for the value of business input purchase that are created by the workers of previous domestic suppliers), then the refund exceeds the previous taxes paid and constitutes a subsidy. This was generally regarded as being in conflict with the GATT prohibition on export subsidies.[19] It would seem that a DCT with the simple removal of wage payments from the tax base (with no corresponding mechanism to tax the wage component) would generate even greater subsidies.

Several different responses to this problem were offered in the U.S. literature. One was that the cash-flow business tax should be designed on an origin-basis in order to be consistent with the GATT.[20] Proponents of this response resorted to the theoretical equivalence of destination- and origin-based commodity taxes to support this position. Others argued that that the GATT is unreasonable and should be revised.[21] In one version of this argument, an origin-based cash flow tax was administratively unacceptable (and therefore for administrative reasons, destination- and origin-based commodity taxes are far from equivalent), but GATT is unreasonable in ruling out an important policy option. However, it is admitted that GATT is perhaps not entirely erroneous in suspecting that export subsidies may come into play.[22]

It is worth noting that recent expositions of the DCT is ambivalent about whether destination- and origin-based commodity taxes are likely to be equivalent. On one hand, equivalence would seem to undermine the case for switching to a destination-based tax. Therefore, proponents of the switch tend to point to arguments for non-equivalence. However, most of the theoretical arguments for non-equivalence are not very relevant for the DCT proposed as an international tax reform option.[23] In particular, the most fundamental way in which equivalence may fail for commodity taxes—that different commodities tend to be taxed at different rates[24]—does not seem to be a given for a tax on corporate profits. On the other hand, if the equivalence between destination- and origin-based cash flow taxes fails to hold, should we not be more sensitive to the possibility that a destination-based tax may give rise to export subsidies (at least for some sectors and some businesses)?

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[19] General Agreement on Tariffs and Trade, Oct. 30, 1947, 67 Stat. A-11, T.I.A.S. 1700, 55 U.N.T.S. 194. In addition, there was a concern that any type of subtraction-type cash-flow tax that does not sufficiently track whether previous purchases of non-labor input have been subject to tax would create export subsidies. See, e.g. Shay and Summers, supra note 18, at 1052-6.

[20] Id.; see also Bradford supra note 3.

[21] Some of these latter writers argued that GATT is unreasonable *because* destination- and origin-based commodity taxes could be equivalent. Daniel Shaviro, "Replacing the Income Tax with a Progressive Consumption Tax," Tax Notes 2004, 91-113.

[22] See, e.g. Weisbach, supra note 18, at 219 (writing from the U.S. perspective, as if it is country O in our example above: "trading partners will rightly claim that we are subsidizing certain exports (although we would be penalizing others because exchange rates would adjust on average.")

[23] For example, ADS 2010, at 884, point to the requirements of a single tax rate on all goods and no cross-border shopping or labor mobility for equivalence to hold. The DCT as described in ADS 2010, however, do not make any assumption that implies that such requirements may be violated. Indeed, the requirement of consumer immobility (i.e. no cross border shopping) is presupposed by the claimed efficiency of the DCT). Likewise, AD 2013 points out that imperfect competition may also defeat equivalence, but assumes perfect competition in its own model.

[24] See, e.g. Michael Keen and Walter Hellerstein, "Interjurisdictional Issues in the Design of a VAT," 63 Tax L. Rev. 359 (2010), at 363.

Whether the DCT creates export subsidies is not only an issue of expositional clarification. If it does have this effect (and if for some reason the resulting subsidy is not constrained by the GATT), then some countries may have incentives for adopting the tax—in their self-interest, even if the result is adverse to global welfare. This is significant because one general question for DCT proposals is whether countries acting in their own self-interest would adopt it. This question apparently holds special importance for DCT proponents because they claim that the problem with the current system is that it is not incentive-compatible in terms of the incentives of individual nations.[25] However, no argument has been made that the DCT is incentive-compatible.[26] The possibility of export subsidies points to an incentive compatible but arguably undesirable arrangement.

Are negative tax liabilities due to the exclusion of wages tolerable? DCT proponents seem to believe that the strongest reservation one might have against the DCT is that for countries with net exports, the exclusion of wage payments from the tax base—and granting refunds for tax credits associated with such payments—creates a negative tax base and drains revenue.[27] Interestingly, this problem was not emphasized when the U.S. debated the implementation of (relatives of) the DCT in the 1990s, whereas the subject of export subsidies was. Perhaps this was because the U.S. was—and expected to be for some time to come—a net importer: it would have loved to have this negative tax base (i.e. a “subsidy base”) to export more. Another set of countries that may not care are those whose net exports are small relative to the country’s GDP—there would be a large enough domestic tax base to absorb the negative tax base.[28] But there may indeed be countries with positive trade balances that are large relative to their respective domestic tax bases, for whom the DCT would create an intolerable revenue drain.

Before we can take this difficulty at its face value, a number of more basic design issues have to be considered. For example, the wage subsidy implied by any cash flow tax (whether destination- or origin-based) raises a question that applies in the purely domestic context as well, independently of cross-border issues. Consider the above example of a business with inefficient production that generates negative rent. A government will want to tax pure profit because it raises revenue without causing distortions, but why would the government want to refund taxes when there is negative rent? There is no reason. It seems, therefore, that a cash flow tax must include devices to prevent the subsidy of negative rents. Such devices would then need to be made implementable cross-border transactions. Moreover, note that the ideal cash flow tax, like the ideal income tax, would give tax refunds for losses. Real world income taxes as well as VATs do not give such refunds. Under the VAT, even though a given taxpayer may receive a net refund (if input exceeds output), that simply is a refund of tax previously collected. The government is never out of pocket. A real-world cash flow tax presumably would have similar features, reflecting universal, genuine administrative concerns.

Yet another version of the DCT (Version 3) may be relevant in addressing these issues—and, some DCT proponents claim, the problem of negative tax liabilities. Under this version, the country of production (O) would actually collect tax on its exports, but at the rates set by the destination countries. This will ensure that the profits of a multinational are still taxed to the same extent as they are under

[25] Devereux and Vella, supra note 2, at 2.
[26] Devereux and Vella, supra note 2 make a cryptic reference to AD 2013 for arguments that this would be the case (at 20, fn 71). However, I find no argument to this effect in AD 2013.
[27] ADS 2010, at 884; Devereux and Vella, supra note 2, at 10 and 21.
[28] This raises the question of whether it is desirable for a subset of countries (those who can tolerate the negative tax base created by net exports) to adopt the DCT.

Version 2 of the DCT. However, the revenue from exported sales (R^*t_D in the earlier example) would go in the first instance to the country of origin. This is not dissimilar to a few recent proposals for implementing the destination-based tax on an origin basis within the European Union.[29] Devereax and de la Feria discuss this option and note a few of its advantages, including that it would preserve the efficiency (but not the distributional) properties of Version 2 of the DCT, and that it may prevent types of fraud observed under the destination-based VAT system.[30] However, it is not clear how the option deals with the problem of negative tax liability. If country O does not transfer the gross revenue it collects on exports to the destination countries, and if these destination countries nonetheless allow deductions for imported input goods, the destination countries that are net importers will face a similar issue of aggregate negative tax liabilities. If country O does transfer the gross revenue it collects on exports to the destination countries, it will still face aggregate refunds as a net exporter. It is not clear how Version 3 offers an improvement over Version 2 in this regard. Moreover, Version 3 contemplates country D allowing deductions to importers even when it does not know whether the seller/exporter has included the revenue, which gives rise to another set of administrative concerns.

Other challenges, and, what is "destination"? DCT proponents have identified a number of other issues that may face DCT proposals. Some of these issues are clearly secondary. For example, Devereux and de la Feria examine the question of whether a destination country has the substantive and administrative jurisdiction to tax a foreign corporation's profits that makes sales in the country. This question is perhaps worth raising for Version 1 of the DCT discussed at the start of this section (recall that, under that version of the DCT, the corporate base is simply shifted from the origin/source country O to D). But for Version 2 of the DCT, the question should not arise any more than it does for the destination-based VAT. And for Version 3, the question also should not arise, if country O is collecting tax on its own exporters. [31]

Finally, Devereux and de la Feria have noted that (on any version of it) the DCT must be able to articulate the concept of destination, and that this concept itself has been debated within the VAT, which has been implemented on a destination-basis for a long time.[32] This is certainly a crucial issue. In fact I believe Devereux and de la Feria underplay its significance: if the concept of destination turns out to be as slippery as the concept of source, or as manipulable as corporate residence, then DCT will be vulnerable to many of the objections its proponents have volleyed at the existing international tax system. The next Section will try to put this problem into a theoretical framework, in terms of the relation between the residence/source and origin/destination dichotomies.

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[29] Devereux and de la Feria supra note 2, at 19-20. Other cites.
[30] Devereux and de la Feria supra note 2, at 10 and 22.
[31] Another example of a secondary question is whether a DCT would be creditable under the existing foreign tax credit framework embodied in tax treaties. ADS 2010, at 886. When a corporate cash flow tax (either on a destination or origin basis) is offered as a tax reform option for a single country (such as the U.S. or UK), this question is worth asking. But when it is proposed as an item of global tax reform, there is clearly no need to take the tax treaty framework for granted.
[32] Devereux and de la Feria supra note 2.

A conceptual critique of proposals for destination-based cash flow taxation as a global international tax reform option

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- One strand of the academic/theoretical response to BEPS is that BEPS merely deals with the symptoms, and not the underlying causes, of a dysfunctional international tax system.
  - Oxford: Devereux and de la Feria 2014; Devereux and Vella 2014
  - "More fundamental" reform options also referred to in IMF "spillover" paper (2014), Fuest et al WTJ 2013 article, etc.
- A frequently cited option is a destination-based cash flow tax (DCT):
  - Summarized in Auerbach, Devereux and Simpson's chapter in the Mirrlees Review; further developed in Auerbach and Devereux 2013
- Discussed (though with less enthusiasm) in a wide range of other policy papers, e.g. Boadway 2014 review of Canadian corporate tax reform options; Grubert/Altshuler 2013 review for the U.S..

- Motivations of this paper:

1. To clarify the basics of various DCT proposals;
2. To reflect on what insights are gained by introducing "indirect tax concepts" into (international) corporate taxation;
3. (To reflect on the skepticism about source used to motivate DCT proposals; and
4. To reflect on some of the basic theoretical parameters for international tax reform.)

- Critical (but tentative) conclusions: DCT proponents may have mis-stated the motivation and thrust of the proposal, as well as what further work needs to be done. In particular:
  - Destination isn't the magic word.
  - The skeptical arguments about source are very weak.
  - Many controversial assumptions that are nonetheless important for policymakers to reflect on: the nature and extent of international tax competition; efficiency v. distribution; etc.

How does the DCT work: three versions

- DCT proposals are not entirely new; the U.S. debate in the 1990s of legislative proposals of the cash-flow consumption tax touched on many similar issues.
- Three versions (am I missing any?)
- Corporation X incorporated and operating in country O makes sales to final consumers in country D. The income earned by X is ultimately owned by individuals in country R.
- DCT version 1: D (the country of the final consumer) taxes X's cash flow profit (revenue minus all non-financial expenditures, including wage payments). Essentially, the profit that would have been taxed (in the first instance) in O under the current system is made taxable (in the first instance) in D.

- Motivation: if the MNC knows that the locations of the final consumers alone will determine the tax rates at which its profits will be taxed, it will not make decisions about where to locate production and profits based on tax considerations, but only on real economic considerations.
- However, not administrable: how to prevent the overstatement of costs? What about intermediate supplies?
- Version 2: "In a closed economy, a VAT which also gave relief for labor costs would be equivalent to an R-based cash flow tax. All real costs, including labor costs…would be deductible from the tax base. In an open economy, a destination-based VAT which also gave relief for labor costs would be a destination-based, R-based, flow-of-funds tax." Mirrlees Review

- If X has R dollars of sales in D (R* (1+t_D) dollars in tax-inclusive terms), and P dollars of non-labor input cost of in O (P* (1+t_O) dollars in tax-inclusive terms)—assume for the moment negligible labor costs—then its net tax payment under the destination-based tax will be R*t_D-P*t_O. R*t_D is claimed by D; P*t_O is refunded by O.
- Whether we express this as a percentage of before-tax profit (=R* (1+t_D) - P* (1+t_O)) or of after tax profit (= R-P), the percentage will depend on t_D as well as t_O.
- However, whatever values t_D and t_O take, after-tax profit will always be R-P.
- Is this a tax *on* X's profit?

- A regular destination-based consumption VAT imposed by country D would tax all consumption arising out of economic rent and labor (wherever generated) received by the residents of D. A DCT that further excluded labor compensation from its tax base would then be equivalent to a tax on economic rent (pure profit). But this would be a tax on one's own residents—not on the profit of a foreign corporation, which may be owned by residents and non-residents.

- Further issues:

1. An impermissible export subsidy under GATT?

- Suppose X produces a unit of a good while incurring material costs of 10 (in tax-exclusive terms) and labor cost of 5. World producer price is 14. X thus earns 1 of negative rent. However, under the DCT, not only should X be refunded all previous tax borne by its non-labor inputs (thus making sure that the material cost is 10 and no more), but it should also get a tax credit for its labor cost. Suppose that O's domestic tax rate is 20%. Then O's "tax relief" for labor cost would allow X to break even.

2. Destination-origin equivalence:

- DCT proponents tend to make assumptions that support equivalence. But if equivalence holds, why is destination special?
- If equivalence fails, shouldn't we care more about trade effects?

3. Negative tax base for net exporters

- How serious is this problem? If it is the only problem, could those countries that do not care about this problem jointly implement DCT?
- DCT version 3: O collects tax on exports at D's rate; then transfers revenue to D.
- This may have administrative advantages; but how does it solve the revenue problem?

Why should the origin v. destination dichotomy matter for reforming the corporate tax?

- There is a close connection between income taxation based on residency and the *economic characterization* of the destination principle.
  - "The total tax paid in relation to a commodity is determined by the tax rate levied in the jurisdiction of its final sale… [and] that all the revenue accrues to the government in the jurisdiction where that sale occurs." Ebrill et al, The Modern VAT (2001), pp. 176
- What is the connection? Keen and Wildasin 2003:
  - Income taxation sets different tax rates for consumption in different periods (the further away is the period, the higher is the tax rate).
  - Resident income taxation, therefore, is basically setting consumption tax rates (for different periods) for one's residents.
  - If we assume relative immobility of consumers, the destination principle also sets the consumption tax rate (for all periods) for one's residents.
  - Both satisfy production efficiency.

- So how come residence-based taxation is in such trouble, while destination-based VAT works for the most part?
  - Both are currently imposed on the *same* patterns of international trade and investment.
- One obvious reason: it's simpler to tax consumption than to tax income.
- Another less obvious reason: the main problem for residence-based taxation is…corporations (and other business entities). See Mirrlees Review Chapters 9 and 10.
- Why don't corporations raise problems for the VAT?
- Business entities are the strength, and not the weak spot, of the VAT as a withholding tax. The VAT isn't about identifying final consumers; it is about identifying businesses that should withhold.

- Most international rules of the VAT have to do with its nature as a withholding tax, and not the economist' destination principle.
- The economist's destination principle can be implemented through a retails sales tax (i.e. sales to final consumers taxed at the rate of the country of consumers' residence (for the most part)).
- But, if the economist's destination principle had been implemented by a RST, we would not know the principle as it is normally understood, institutionally, i.e. zero-rating exports, taxing imports.
  - Relative few goods are imported by retail customers; most import of goods involves B2B transactions.
  - Cross-border supply of services to final consumers: the destination principle has, at least up till now, been largely unenforceable.

- There is thus a fundamental distinction between the economist's version of the destination principle and the institutional meaning of the destination principle (imports/export). The latter is a matter of administrative design.
- Version 2 above of DCT relies on this aspect, whereas version 3 varies it. Version 1 is rejected for administrative reasons.
- If we are to have a cash flow tax, we may choose the destination version over the origin version for administrative reasons, but do their efficiency properties really differ? (Recall DCT proponents' ambivalence about equivalence theory.)
- "Destination" is not the magic word!

- Two mis-statements of DCT proposals:

1. The DCT isn't about taxing consumption; it is about finding a relatively immobile factor related to the corporate activities of multinationals. Devereaux and de la Feria, 2013.
   - Most corporations' activities (including rent-generating ones) have nothing to do with final consumers; final consumption cannot be a relevant factor for deciding where to tax such activities!
2. Designing DCT requires finding appropriate proxies for consumption. Id.
   - Destination, as an administrative manner, is mostly not about tracking final consumption and therefore not a "proxy" for the latter.
   - This claim may be false even for the design of the VAT.

Source skepticism; underlying assumptions

- The meaning of "source" is empty at the core.
- This claim is not completely unique to DCT proponents, but the latter tend to use it to motivate DCT.
- What are the arguments, though?
  - Mirrlees Review (ADS 2010): example of two subsidiaries from two countries contributing components to a valuable product, which components independently would not have value.
  - Obvious response: There are many bargaining situations where there is no market price. Does the existence of such situations show that the notion of market price is empty at its core?
  - Many other rhetorical arguments (e.g. Ault and Bradford 1990, …)
- Most discussions assume that "source" has meaning, including demonstrations of the inefficiency of source taxation.

- Fundamental assumptions in designing international taxation:
  - Residence-based taxation is not administrable—what defines the parameters of administration?
  - Source-based taxation is not incentive compatible: should we assume tax competition theoretically (despite mixed evidence)? Is DCT incentive-compatible (why then bother to analyze a cooperative version)?
  - DCT leaves all decision margins undistorted: is this a sufficient reason for pursuing it? What about the international distribution of tax revenue?

The Politics of BEPS – What does Apple's International Tax Structure Reveal?

Introduction

The OECD aims to provide an "internationally co-ordinated approach" to address the issues of base erosion and profit shifting ("BEPS").[1] In particular, failure to "collaborate in addressing BEPS issues could result in unilateral actions that would risk undermining the consensus-based framework for establishing jurisdiction to tax …".[2] This goal was reiterated in the Explanatory Statement to the 2014 Deliverables (emphasis added):[3]

> … the OECD/G20 BEPS Project aims to create a single set of *consensus-based* international tax rules to address BEPS …

As the US has the highest corporate income tax rate among developed countries, one may expect that the country would be a prime victim for BEPS and therefore should be a strong supporter of the BEPS Project.[4] However, a study of the international tax structure of Apple Inc suggests that the US government has been knowingly facilitating its MNEs in avoiding foreign income tax, thus creating double non-taxed income.[5] A recent US congressional hearing on Caterpillar further suggests that US politicians are even willing to support their

[1] OECD, *Addressing Base Erosion and Profit Shifting* ("BEPS Report") (2013), at 9.

[2] Ibid, at 48. This emphasis on the consensus-based framework and collaboration among countries was reiterated in: OECD, *Action Plan on Base Erosion and Profit Shifting* ("BEPS Action Plan") (2013), at 24 and 25.

[3] OECD, *OECD/G20 Base Erosion and Profit Shifting Project - Explanatory Statement - 2014 Deliverables* ("Explanatory Statement") (2014), at 3.

[4] Mindy Herzfeld, "Will the BEPS Project Succeed?" (2014) *Tax Notes International* Vol. 75 No. 12, at 996.

[5] US Senate Permanent Subcommittee on Investigations, *Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.)* ("Apple Hearing Report") (2013), at 17. Of course, Apple is only one of the many multinational enterprises that are engaged in international tax planning. For instance, the same Subcommittee held a similar hearing in September 2012 to investigate the international tax planning of Microsoft and Hewlett-Packard. Source countries such as the UK had also held hearings on the issue with respect to several US multinationals including Google, Amazon and Starbucks: see for example the numerous documents available at UK House of Commons Public Accounts Committee website (http://www.parliament.uk/business/committees/committees-a-z/commons-select/public-accounts-committee/); and UK House of Lords Select Committee on Economic Affairs, *Tackling corporate tax avoidance in a global economy: is a new approach needed?* (2013). However, Apple is a particularly interesting case partly due to the relative simplicity of its tax structure as compared to other US multinationals, as well as the quantum involved: Apple's worldwide gross income is equivalent to the California state budget: Lee A Sheppard, 'Apple's Tax Magic', *Tax Notes Worldwide Tax Daily* 26 May 2013 967, at 967.

MNEs to avoid *US* income tax. This attitude towards BEPS by its MNEs seems to persist in the country's involvement in the BEPS Project.

The primary aim of the BEPS Project is to eliminate double non-taxation.[6] The absence of strong support from the US may affect the effectiveness of the Project's deliverables in two ways. First, the US may influence the final design of the deliverables through its involvement in the consultation and negotiation process. Second, if it is not happy with the final products, it may refuse to adopt them in its domestic tax law.

This paper aims to highlight the US attitude towards BEPS that is revealed by the hearings of the international tax structures of Apple and Caterpillar, and suggests that the attitude does not seem to have changed during the BEPS Project so far.

This paper first reviews Apple's tax structure, focusing on the politics in the US that enabled the structure to create US$44 billion double non-taxed income between 2009 and 2012. This is followed by an analysis of the tax structure of Caterpillar, highlighting the political will in the US to support its MNEs to avoid domestic income tax. This paper then reviews the US involvements and positions in the BEPS Project so far, attempting to detect any change of its attitude towards BEPS.

Before proceeding, a caveat is in order. Tax structures of MNEs are dynamic and subject to change over time. This is especially true when the army of highly intelligent tax advisors constantly looks for tax avoidance opportunities. For example, Ireland has recently announced that it will change the definition of corporate residence in its tax law.[7] Apple would have to respond and change its tax structure. Nevertheless, a study of its tax structure – which is effectively a snapshot in time – is still important and relevant, as it provides insight into the US attitude towards BEPS that could be critical to the ultimate success of the BEPS Project.

[6] Explanatory Statement, note 3 above, at 3.

[7] Ireland, Finance Bill 2014, Section 38. For MNEs with existing subsidiaries in Ireland, they will enjoy a long grandfather protection: the new rule would not apply to them until 1 January 2021.

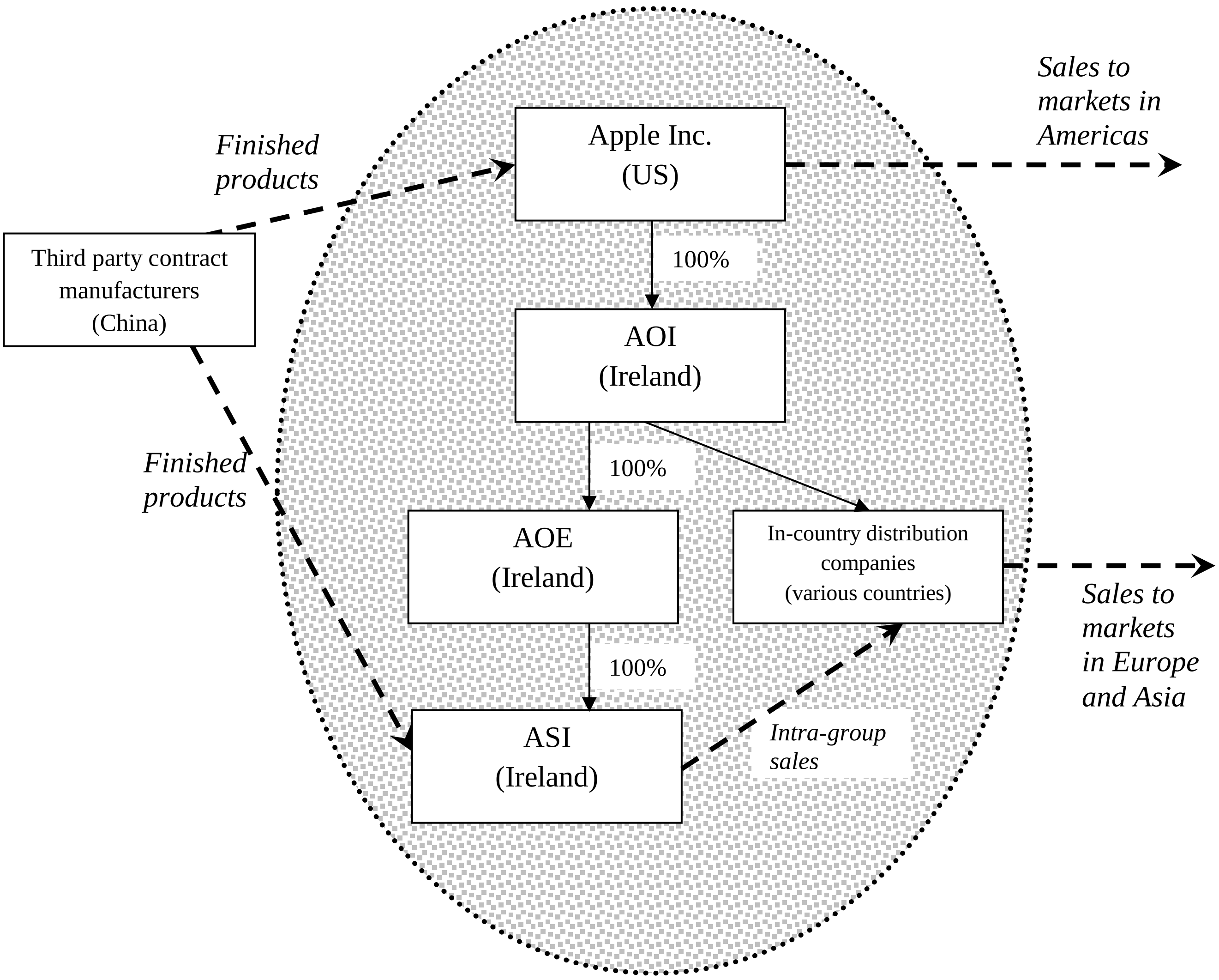
Apple's "iTax" structure

Apple's tax structure, dubbed "iTax", was critically analysed in detail in a paper published earlier this year.[8] The following paragraphs are drawn from the paper to highlight the political influence on the tax law in the US, which should provide some important insights into the country's attitude towards the BEPS Project.

The iTax structure – which successfully sheltered US$44 billion from taxation anywhere in the world from 2009 to 2012 – is depicted in the diagram below:[9]

[8] Antony Ting, "iTax - Apple's International Tax Structure and the Double Non-Taxation Issue" (2014) *British Tax Review* Number 1, pp. 40-71 (available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2411297).

[9] The diagram is prepared based on information in Apple Hearing Report, note 5 above, in particular the chart at 20.



One single enterprise

The double non-taxation of the profits booked in Apple Operations International ("AOI") and Apple Sales International ("ASI") was achieved primarily by the combined effect of the followings:

(1) Definition of corporate residence in Ireland and the US;

(2) Transfer pricing rules on intangibles;

(3) CFC regime in the US;

(4) Check-the-box regime in the US; and

(5) Low-tax jurisdiction.

As this paper focuses on the political factor in the US that contributed to the creation of the double non-taxation, the following paragraphs review the political history of the check-the-box regime. Detailed discussion of the other issues is beyond the scope of this paper.

History of the check-the-box regime

The US introduced its CFC regime in 1962 and was the first country to do so.[10] Given the general impression that the US is aggressive in attacking tax avoidance, one may be inclined to believe that its CFC regime should be rigorous and effective. The Apple hearing, together with hearings on other US MNEs, reveals that this is not the case at all.

The US CFC regime has proved ineffective in dealing with the iTax structure primarily for two reasons. First, the regime contains a number of exceptions which denies the applications of the regime to iTax.[11] Second, and more importantly, the check-the-box regime in the US often effectively disables the CFC regime. The following discussion focuses on the second reason, as it highlights the US attitude towards BEPS by its MNEs.

Though with a relatively short history, the check-the-box regime represents a fascinating example of the significant influence of politics on the US tax system. The regime was introduced in 1997.[12] It allows taxpayers to elect the classification of an eligible entity either as a corporation or a pass-through entity.[13] The regime was intended to "relieve both taxpayers and the IRS from the need to expend considerable resources in determining the proper classification of … entities, when classification was effectively elective for well-advised taxpayers".[14] The US government basically gave up the fight with MNEs in the battle of entity classification.

[10] IRC Sections 951-965.

[11] For example, ASI could potentially be qualified for the manufacturing exception due to its contract manufacturing activities. For a discussion of this exception, see Ting, note 8 above, at 50-51. However, as discussed below with respect to the check-the-box regime, ASI in fact did not have to rely on this exception to escape from the CFC net. This illustrates ironically that the US tax law provides multiple shields to "protect" ASI's income from US taxation.

[12] Treasury Regulations sec. 301.7701-2.

[13] For a summary of the check-the-box rules, see US Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (2010), at 47-49.

[14] Ibid, at 48.

Just one year after the introduction of the regime, the Treasury and the Internal Revenue Service ("IRS") recognised that the flexibility allowed by the regime was excessive, creating significant tax avoidance opportunities to circumvent the CFC regime by using hybrid entities (that is, entities treated as a separate entity under foreign tax law but elected to be a pass-through entity in the US).[15]

In essence, the CFC regime is effectively "gutted" by the check-the-box regime. The CFC regime is designed to capture profits shifted to a subsidiary incorporated in a low-tax country through, say, intra-group sales, and is premised on the separate entity doctrine under which each group company is treated as a separate taxpayer. Going back to the iTax structure, ASI sells products to other group distribution companies which in turn sell the products to end customers in Europe and Asia. In this way, a substantial portion of the profits on the sale of the products in those markets is shifted to ASI and that amount, in the absence of the check-the-box regime, would have been subject to the CFC regime.[16] However, by simply "checking the box" for all the subsidiaries (including ASI) of AOI, those companies are deemed to have disappeared and become part of AOI for US tax purposes.[17]

Through the magic of checking the box, AOI was regarded as having derived sales income directly from the end customers under US tax law and the income was exempted from the CFC regime under the active business exception.[18] The intra-group sales between ASI and the distribution companies were effectively ignored and the CFC regime became irrelevant. In other words, the check-the-box regime effectively disables the CFC regime to a large extent by deeming intra-group transactions as non-existent.

In 1998, one year after the check-the-box regime was introduced, the US Treasury and the IRS attempted to close the loophole by issuing Notice 98-11 and corresponding temporary and proposed regulations which would basically treat various hybrid entities as subject to the

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[15] Hybrid entities have been identified by the OECD as one of the key tax avoidance tools in its BEPS project: BEPS Report, note 1 above, at 40.

[16] This is the typical target of the "foreign base company sales income" provisions in the US CFC regime: IRC sec. 954(d)(1). For a summary of the relevant rules, see for example Paul McDaniel, Huge Ault and James Repetti, *Introduction to United States International Taxation* (2005), at 117-119.

[17] Apple Hearing Report, note 5 above, at 35. The effect is very similar to the single entity rule in Australia's tax consolidation regime. For a discussion of the rule, see Antony Ting, *The Taxation of Corporate Groups under Consolidation: An International Comparison,* Cambridge Tax Law Series (2013), at 73-75.

[18] Apple Hearing Report, note 5 above, at 35-36.

CFC regime.[19] Those documents "provoked controversy among taxpayers and *members of Congress*" (emphasis added).[20] It did not take long before the IRS issued another notice in the same year to redraw Notice 98-11 and the regulations.[21] It appears that business lobbying and political influence won a swift battle against the tax administration.

Proponents of the check-the-box regime not only successfully blocked the introduction of the specific anti-avoidance measures to deal with the hybrid entity issue in 1998, but even managed to convince Congress to enact the "CFC look-through rule" in 2006.[22] The rule specifically excludes from the CFC regime certain payments of passive income between two CFCs. In other words, the look-through rule effectively enacted the effect of the check-the-box regime – which was introduced through Treasury regulations that can be revoked or revised at any time[23] – with respect to passive income.

Through the recent congressional hearings, one may wonder whether the US as the residence country may have woken up and realised that its indulgence of its MNEs to avoid foreign income taxes has backfired. However, it is doubtful if the US government has the political will to close the loopholes. The indulgent attitude of the US government is forcefully summarised in the testimony of a US tax lawyer before a US hearing (emphasis added):[24]

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[19] For a discussion of the notice and the regulations, see US Joint Committee on Taxation, note 13 above, at 48-49.

[20] Ibid, at 49. The business reaction to those documents was described as "a firestorm [as] multinationals went to Congress to complain about the notice and the proposed rules": Lee Sheppard, "Apple's Tax Magic", *Worldwide Tax Daily* 26 May 2013, at 969. It was observed that the issues of the check-the-box regime "were exacerbated by Congressional actions restricting a response to the problem": Stephen Shay "Testimony before the US Senate Permanent Subcommittee on Investigations – Hearing on Offshore Profit Shifting and the Internal Revenue Code" (21 May 2013), at 12.

[21] US Joint Committee on Taxation, note 13 above, at 49. The Joint Committee report did not explain explicitly why the IRS decided to withdraw the documents. The episode reminded the author of a scene in the Oscar-winning documentary "Inside Job" in which after the US Commodity Futures Trading Commission proposed to strengthen the regulations on derivatives, the head of the Commission received a phone call from the then US Treasury Secretary – with 13 bankers in his office – demanding immediate abortion of the proposal. A witness described how he saw the "blood had drained from the face" of the committee head.

[22] IRC sec. 954(c)(6). For the interesting history of the "quiet and surprising" passage of this provision, see Apple Hearing Report, note 5 above, at 14-15.

[23] Apple Hearing Report, note 5 above, at 14.

[24] Paul W Oosterhuis, "Statement of Paul W Oosterhuis, Partner, Skadden, Arps, Slate, Meagher & Flom LLP - Testimony before the House Committee on Ways and Means" (13 June 2013), at 5-6. The accommodating attitude of the US government to the "avoiding-foreign-tax" practice of its MNEs is not a secret to many source countries. For example, that attitude was described by a UK tax lawyer in a House of Lords hearing in the UK: Answer by Steve Edge to Question 79 in UK House of Lords, 'Unrevised transcript of evidence taken before the Select Committee on Economic Affairs - Inquiry on Taxing Corporations in a Global Economy: Is a New Approach Needed?' (4 June 2013). In the same hearing, the UK tax lawyer attempted to defend the double non-taxation outcome by putting forward the argument that "if we change our rules so as to … collect the tax foreign

> Returning to the examples of Starbucks, Amazon, and Google – the companies that were the focus of the enquiries in the UK – all of them were earning income from their UK sales … if that income is not the Unites States' to tax, *why should we – rather than the UK tax authorities – worry if those companies are employing strategies to minimize their UK taxes?*
>
> Indeed, that was the position taken in the past when, for example, Congress put the brakes on Treasury and the IRS's efforts to write regulations that would limit the use of the check-the-box rules to achieve foreign tax minimization. When the IRS announced its intent … the negative reaction was widespread and the effort was abandoned in the face of congressional scrutiny. And thereafter *Congress effectively codified the permissibility of foreign-tax minimization* through its enactment of the look-through rules of section 965(c)(6), *whose primary purpose is to allow multinational corporations to achieve foreign tax minimization without triggering an immediate resulting US tax liability*.
>
> Ultimately, in considering the appropriate reaction to profit shifting and base erosion whose primary impact is *foreign* tax minimization, *we must consider carefully whether the Unites States has an interest in imposing and enforcing rules whose primary beneficiaries are foreign fiscs, rather than the US treasury*.

If one believes that the best prediction of future behaviour is past behaviour, it is unlikely that the US will take any effective action to address the double non-taxation issue.[25] The history of the check-the-box regime suggests that political lobby from MNEs seems to have such a significant influence on the government that it may surprise observers from abroad. If the US political environment dictates that the US will be likely continue to facilitate the creation of double non-taxation, what can source countries do to tackle the issue? This is a very difficult question and a major challenge for the BEPS Project.

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jurisdictions are not collecting, actually we discourage inward investment into the UK": ibid, answer to Question 84.

[25] It is observed that US MNEs "have done an excellent job of framing the competitiveness issue in terms of US [MNEs] competing against foreign [MNEs]": Richard Harvey Jr, "Testimony before the US Senate Permanent Subcommittee on Investigations" (21 May 2013), at 9. Another commentator predicted that the hearing on Apple "provided little hope that Congress will find the motivation to do anything about [the problematic tax provisions]": Marie Sapirie, "As American as Apple", *Worldwide Tax Daily* 3 June 2013.

Insight from the Caterpillar hearing[26]

The US congressional hearing on Caterpillar Inc held on 1 April 2014[27] not only revealed difficult-to-find information that would not be available otherwise to the public or even to the US tax authority,[28] but also provided the important insight that, possibly to the surprise of foreign observers, many US politicians are willing to openly and publically support their MNEs to avoid *US* income tax. This seemingly unthinkable position highlights the attitude of the US in the war on BEPS and may be important for other countries in the design of their anti-BEPS rules.

Despite learning that Caterpillar has successfully shifted US$8 billion taxable income from the US to Switzerland from 2000 to 2012,[29] three out of the four Senators that were the panel members in the hearing *defended* Caterpillar. One Senator even declared in the hearing that (emphasis added): [30]

> I would like to take my time to apologize to Caterpillar for this proceeding … Rather than having an inquisition, we should probably bring Caterpillar here to give them *an award*.

A brief outline of the Caterpillar hearing is in order before its implications on the BEPS project is analysed.[31] In essence, the tax structure is nothing new, and is in fact quite basic. Caterpillar Inc. is an iconic US MNE in the business of manufacture of industrial equipment and engines. The hearing revealed that Caterpillar paid US$55 million to PwC for the design and implementation of a tax structure under which, in broad terms, Caterpillar Inc was replaced by its subsidiary in Switzerland, Caterpillar SARL ("CSARL"), as the principal in

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[26] Material in this section is drawn from the paper: Antony Ting, "Old wine in a new bottle: Ireland's revised definition of corporate residence and the war on BEPS" (2014) *British Tax Review* Number 3, pp. 237-247 (available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2472445).

[27] US Senate Permanent Subcommittee on Investigations, "Caterpillar's Offshore Tax Strategy" (2014) ("Caterpillar Hearing Report").

[28] It was acknowledged in the hearing that some of the information presented to the Senate subcommittee would not have been available to the IRS: Jaime Arora, "Caterpillar, PwC under fire at Senate hearing" (2014) *Tax Notes International* 74(1) 22, at 23.

[29] Caterpillar Hearing Report, note 27 above, at 41.

[30] Arora, note 28 above, at 22.

[31] As this paper focuses on the implications of the findings from the hearing in the context of the BEPS project, a detailed analysis of the tax structure of Caterpillar – which was primarily about avoiding US corporate tax instead of foreign income tax – is outside the scope of this paper.

the sales of replacement parts.[32] The changes involved were largely paperwork, while the actual operations remain substantially unchanged.[33]

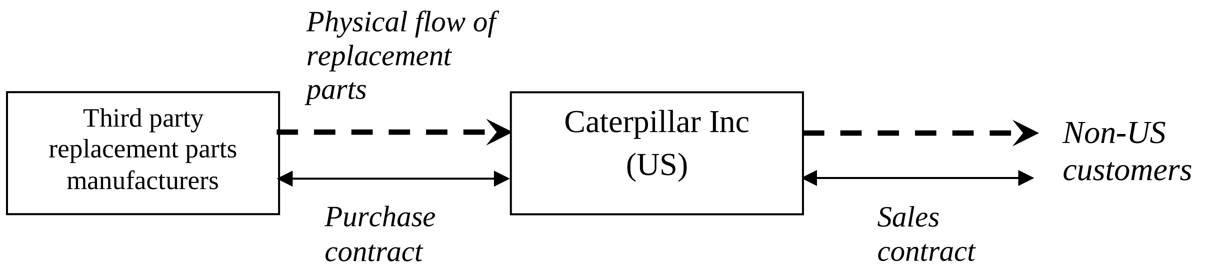
The replacement parts sales of Caterpillar before and after the implementation of the tax structure are depicted in the following diagram:[34]

[32] In particular, before the implementation of the tax structure, Caterpillar Inc reported almost all of its profits from the sale of replacement parts to non-US customers in its US tax returns. Afterwards, it reported only 15% of the profits while 85% was shifted to Switzerland: Caterpillar Hearing Report, note 27 above, at 1. For the ownership structure of CSARL, see: ibid, 50. The hearing also revealed that "Caterpillar had received a Swiss government ruling that allows it to pay the statutory [tax] rate on only 20% of its non-Swiss source income, resulting in an effective tax rate of 4%": ibid, fn.227.

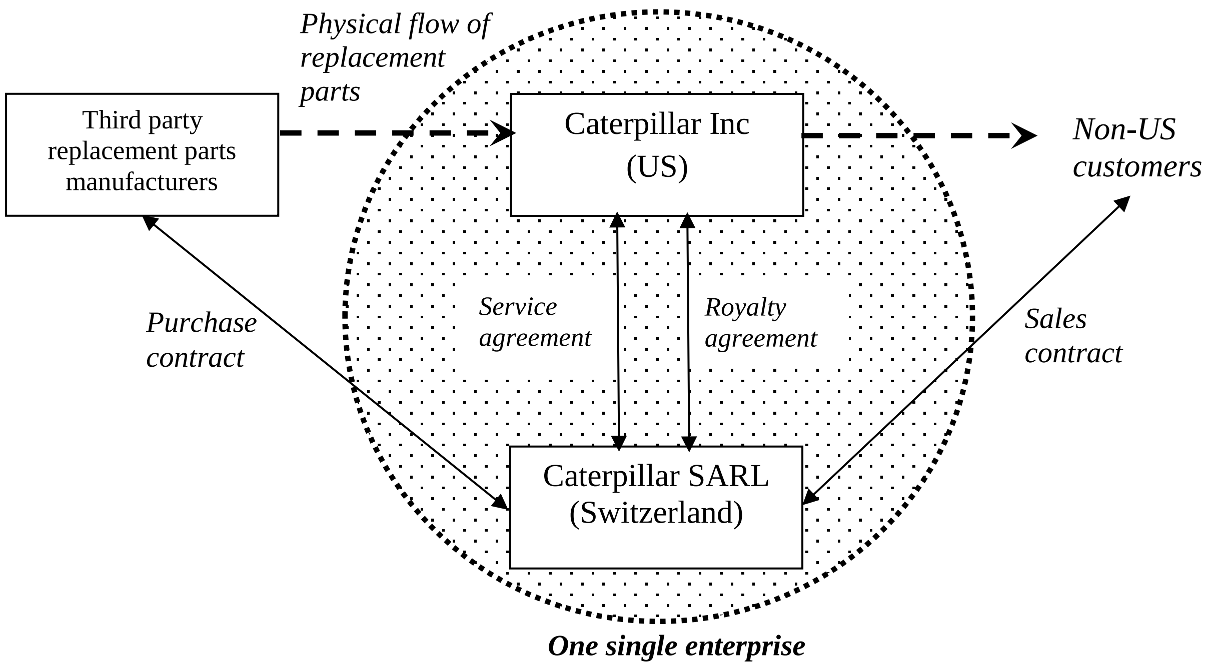
[33] Ibid, at 4. Interestingly, the hearing revealed that PwC stated in the document proposing the tax structure that it would involve only "relatively simple re-invoicing requirements": ibid, at 44. For a description of the disproportionate allocation of the profits to Switzerland as compared to the location of management, staff, and assets, see ibid, at 1-2. For example, in 2012, only 66 out of the 8,300 Caterpillar employees involved in the parts sales operations were located in Switzerland: ibid, at 40.

[34] For clarity, the diagram is a simplified version of the actual structure. For example, before the implementation of the tax structure, Caterpillar Inc sold the parts to customers through its subsidiary Caterpillar Overseas S.A. which was incorporated in Switzerland and whose profits were subject to immediate US tax under the CFC regime. For a detailed description of the structures, see ibid, at 46-61.

Before implementing the tax structure:



After implementing the tax structure:



While the tax structure of Caterpillar may not be as elaborate as those of its counterparts in Apple and other US MNEs, it has been effective in shifting profits out of the US. More importantly, it reveals that the US government appears to be willing to facilitate its MNEs in the avoidance of not only foreign tax, but also *US* tax. This is surprisingly obvious when it is considered that out of the four Senators who appeared in the hearing, only one – the Chairman of the hearing – posed difficult questions to the representatives of Caterpillar and PwC. All of the other three Senators defended Caterpillar and its tax structure; instead, they reserved difficult questions for the tax academics who supported the investigation of the tax structure.[35]

The attitude of the US politicians in the Caterpillar hearing leads to several questions. If they are willing to openly support a MNE to avoid *US* income tax, what is the probability that they will support effective anti-BEPS rules to prevent US MNEs from avoiding *foreign* income tax? If we believe that it is unlikely to receive whole-hearted support from the US, what should other countries do to address the BEPS issues? This paper does not aim to, and will not attempt to, answer these difficult questions. Nevertheless, the answers to these questions will be important in shaping the outcomes of the BEPS Project and possibly unilateral actions by some countries.

US position in the BEPS Project

The BEPS Project is ongoing and the situation is fluid. Difficult negotiation and compromises are inevitable. It is therefore difficult to predict the outcomes. It may be even more difficult for an "outsider" from the BEPS Project to gain a complete and accurate picture of the behind-the-scene negotiations. Nevertheless, the following media reports may shed some light on the position of the US in the Project.

Objective of the US involvement

It appears that the primary objective of US involvement in the BEPS Project is not to avoid double non-taxation, but to minimise the impact of the Project on the country and its MNEs. In a speech by the former Deputy Assistant Secretary for International Tax Affairs of the US Treasury, the following point was made to remind audience in the US (emphasis added):[36]

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[35] For interested readers, the video recording of the full hearing is available at the Senate Committee website: http://www.hsgac.senate.gov/subcommittees/investigations/hearings/caterpillars-offshore-tax-strategy. One of the justifications of the US politicians supporting BEPS by US MNEs is the top US corporate tax rate of 35% which is the highest statutory rate among OECD countries: Caterpillar Hearing Report, note 27 above, at 9. However, it begs the question of whether that should justify the US of "exporting" the problem to other countries by facilitating its MNEs to avoid paying taxes. The three Senators in general attempted to redirect the focus from Caterpillar's tax avoidance to the problems of the US tax system which should be reformed. However, as the Chairman of the hearing pointed out, one could not wait for a fundamental reform of the US tax system to close the loopholes which allow MNEs to shift profits from the US to tax havens, because "you'd be waiting forever": Arora, note 28 above, 24.

[36] Manal Corwin, "Sense and Sensibility: The Policy and Politics of BEPS" (19th Annual Tillinghast Lecture delivered on 30 September 2014), at 9.

> Politicians at the highest levels of government have made it abundantly clear that they will not accept the status quo, or wait for the US to implement tax reform … By accepting this reality, stakeholders and policymakers [in the US] will be able to focus on developing sensible policy solutions and *minimizing the damage* from expedient political action.

She supported the point with the example that US engagement in the BEPS Project has "proved successful in narrowing the scope of both [hybrid mismatch and country-by-country reporting] proposals.[37] This position was echoed by the current Deputy Assistant Secretary for International Tax Affairs of the US Treasury, who claimed that in respect of the country-by-country reporting proposal, "I think we've been very successful in convincing the rest of the world that for risk assessment, you can have less data".[38]

US always win?

The US seems quite determined to argue that if tax law is to be changed to assign taxing right on double non-taxed income of US MNEs, the US should have the taxing right instead of source countries. In particular, the current Deputy Assistant Secretary for International Tax Affairs of the US Treasury argued that "if a US company uses a cash box in Bermuda … it is the US position that the return to the entity in Bermuda should be allocated back to the United States under subpart F rules…".[39]

The US Treasury official provided an alternative argument for the US to have the taxing right on the double non-taxed income. He argued that "transfer pricing [should] follow from the people functions … The United States says [the double non-taxed income] goes to … the high-value people functions. That … often comes back to the United States, where all of this development is done, where the strategic decisions are made".[40]

In other words, it appears that US would like to insist that, if the double non-taxed income that it facilitates to create would eventually be taxed somewhere, US should collect the tax revenue.

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[37] Ibid, at 12.

[38] Marie Sapirie, "Stack Reviews BEPS Digital Economy Report" (2014) *Tax Notes International* **75**(5) 354, at 355.

[39] Margaret Burow, et al, "Stack Provides Insights on BEPS Reports, Outlines Next Steps" *Tax Notes International* 75(13) 1087 , at 1088.

[40] Ibid, at 1088-1089.

Who is the problem?

In a seminar held in the US on 2 October 2014, International Tax Counsel of the US Treasury claimed that, in the discussion regarding BEPS Action 3 on CFC rules, "some countries have touted the absence of CFC regimes as a way to lure multinationals to locate their headquarters in those jurisdictions".[41]

The comment is interesting, as the CFC regime in the US – as revealed in the iTax structure above – has been effectively disabled to a large extent by the check-the-box regime. In other words, its own CFC regime is also effectively absent.

Conclusion

The following comments by US Treasury's former Deputy Assistant Secretary for International Tax Affairs (who is now KPMG's national tax service line leader) reinforces the belief that the US is less than enthusiastic about implementing effective anti-BEPS measures (emphasis added):[42]

> While prospects for US tax reform *do not seem imminent*, it is not inconceivable that progress on these issues in the OECD, will have an indirect if not a direct impact on US tax reform efforts *when we finally get around to it*.

It appears that the OECD has accepted this reality. When asked about comments of US Treasury's current deputy assistant secretary for international tax affairs that the US would not amend its tax law in response to the OECD recommendations in the near future, Director of the OECD's Centre for Tax Policy and Administration replied, "well then, too bad for that country".[43]

The OECD admits that there "is no magic recipe to address BEPS issues".[44] The BEPS project is likely to be a long and winding road. What is certain is that MNEs and their tax advisors will not stop pursuing tax avoidance so long as tax arbitrage opportunities exist. The political will of the US government to facilitate its MNEs in avoiding income tax poses

[41] Kristen Parillo, "U.S. to Push for Minimum Standard for CFC Rules, Treasury Official Says" *Worldwide Tax Daily* (6 October 2014).

[42] Corwin, note 36 above, at 12.

[43] Margaret Burow, "Australia Ready to Take the Lead on BEPS" *Worldwide Tax Daily* (24 September 2014).

[44] BEPS Report, note 1 above, at 48.

another significant challenge to the BEPS Project. If history is a guide, this "accommodating" attitude of the US government towards BEPS is unlikely to change in the near future. It is therefore important for other countries to work together, under the lead of the OECD, to take effective measures to counter BEPS transactions.

The Politics of BEPS

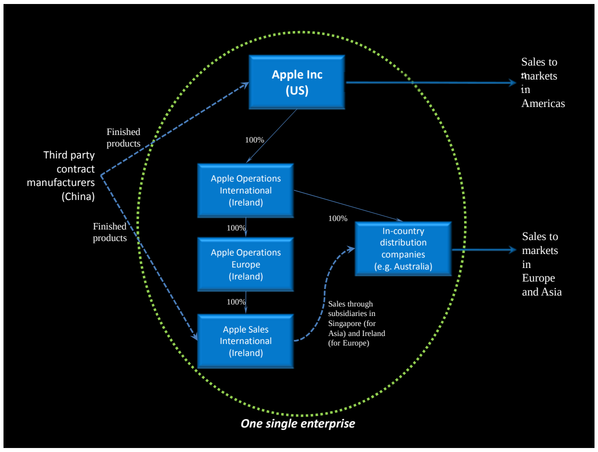
Dr Antony Ting, University of Sydney

The politics of BEPS

- OECD/G20 BEPS Project
  - aims for “a single set of consensus-based international tax rules to address BEPS”
- US attitude towards BEPS
  - Case study on Apple’s “iTax” structure
  - Case study on Caterpillar
- US position in the BEPS Project

Case study: iTax

How did Apple shelter US$44 billion from taxation anywhere in the world?



The tale of the check-the-box regime

- 1997:
  – the regime was introduced through Treasury regulations
- 1998:
  – US Treasury and IRS recognised the mistake
    - The CFC regime is effectively disabled to a large extent
  – Issued Notice 98-11 and corresponding proposed regulations to close the loophole
    - These documents “provoked controversy among taxpayers and members of Congress”: “firestorm”
  – The documents were promptly withdrawn:
    - Reminded of a scene in “Inside Job” (the Oscar-winning documentary)

US attitude towards BEPS

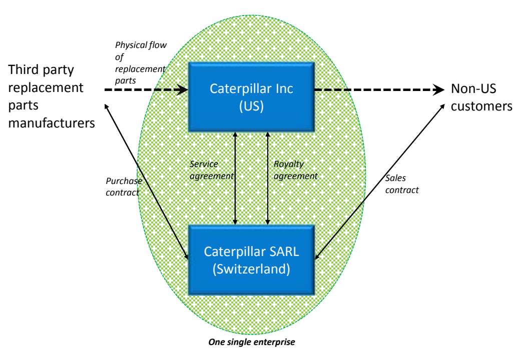
- Testimony of a prominent US tax lawyer before a US congressional hearing (emphasis added):

> Why should we – rather than the UK tax authorities – worry if [US MNEs] are employing strategies to minimize their UK taxes? … Ultimately, in considering the appropriate reaction to [BEPS] whose primary impact is foreign tax minimization, we must consider carefully *whether the United States has an interest in imposing and enforcing rules whose primary beneficiaries are foreign fiscs*, rather than the US treasury.

- A very simple structure
  - successfully avoided *US income tax* by shifting US$8 billion taxation income from the US to Switzerland

Before

After



US attitude towards BEPS

- Caterpillar hearing: further evidence of the US attitude
  - 3 out of the 4 Senators in the hearing *defended* Caterpillar, even after learning that Caterpillar has successfully avoided *US income tax* by shifting US$8 billion taxation income from the US to Switzerland
  - One Senator even declared in the hearing (emphasis added):

    I would like to take my time to apologize to Caterpillar for this proceeding … Rather than having an inquisition, we should probably bring Caterpillar here to give them an *award*.

US position in the BEPS Project

- Hints:
  - Objective of its involvement in the Project seems to be "minimizing the damage"
  - Argued that, if double non-taxed income (which was created to a large extent by its attitude towards BEPS) is to be taxed, the US should have the taxing right
  - Accused that "some countries have touted the absence of CFC regimes as a way to lure multinationals to locate their headquarters in those jurisdictions"

A Preliminary Analysis of Potential Options to Address the Tax Challenges Raised by the Digital Economy

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Finalising and Implementing the BEPS Agenda
17 and 18 November 2014
University of Sydney Law School

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1. Introduction

A growing concern continues to be expressed by political leaders, media organisations and society in general that governments are losing substantial corporate tax revenues because of tax planning activities which are aimed at shifting profits to low (or no) tax jurisdictions where little or no economic activities may be performed. Recent news stories such as The World Today's "Apple pays $193m tax in Australia on $27b revenue",[1] The Australian Financial Review's "Amazon and the missing $1.7b" and "From Luxembourg with love",[2] Bloomberg's "Google joins Apple Avoiding Taxes with Stateless Income"[3] and the Guardian's "Tax Gap" series[4] represent some examples of the increased attention mainstream media has been paying to corporate tax affairs.

As the world's technologies continue to rapidly expand and become increasingly interconnected, national tax laws have arguably not kept pace mobile capital and contemporary business models used by multinational corporations in the digital economy. This has created gaps that have be exploited by companies who can avoid taxation in their home countries by relocating activities abroad to low or no tax jurisdictions. These activities

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[1] Will Ockenden, 'Apple pays $193m tax in Australia on $27b revenue as Federal Government vows to capture lost taxes' *The World Today* (online), 6 Mar 2014 < http://www.abc.net.au/news/2014-03-06/tax-expert-explains-how-apple-pays-193m-tax-on-27b-revenue/5303426>.

[2] Neil Chenoweth, 'Amazon and the missing $1.7b' *The Australian Financial Review* (online), 7 November 2014 <http://www.afr.com>; Neil Chenoweth, 'From Luxembourg with love' The Australian Financial Review (online), 8 November 2014 <http://www.afr.com>.

[3] Jesse Drucker, 'Google joins Apple avoiding taxes with stateless income' *Bloomberg* (online), 22 May 2013 <http://www.bloomberg.com/news/2013-05-22/google-joins-apple-avoiding-taxes-with-stateless-income.html>.

[4] Available at <http://www.theguardian.com/business/series/tax-gap>. In Australia, a report in September 2014 estimated that $8.4b in taxes per annum might be foregone as a result of tax avoidance activities of ASX 200 companies: Tax Justice Network Australia and United Voice, *Who Pays for Our Common Wealth? Tax Practices of the ASX 200*, September 2014.

are commonly now referred to as 'base erosion and profit shifting' ('BEPS') which undermines the fairness and integrity of tax systems.

The OECD has defined BEPS as follows:

> Base erosion and profit shifting (BEPS) refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profits 'disappear' for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low, resulting in little or no overall corporate tax being paid.[5]

In an effort to address BEPS in a comprehensive manner, and at the request of the G20, the Organisation Organisation for Economic Co-operation and Development ('OECD') published an *Action Plan on Base Erosion and Profit Shifting* in July 2013 ('BEPS Action Plan').[6] The BEPS Action Plan provided for 15 actions which are scheduled to be finalised in three phases: September 2014, September 2015 and December 2015. The focus of this paper is on Action 1which is directed at addressing the tax challenges of the digital economy.

The technical work on BEPS has been undertaken by the OECD Committee on Fiscal Affairs ('CFA') through its subsidiary bodies. A Task Force on the Digital Economy ('TFDE') was established by the CFA to carry out the work in relation Action 1 and in September 2014 the first set of reports and recommendations were delivered. These reports address seven of the actions in the BEPS Action Plan.

One of these reports, *Addressing the Tax Challenges of the Digital Economy*,[7] ('Action Plan 1 report') provides a detailed analysis of the digital economy including a description of its key features. It also explaining common business models which are encountered in the digital economy. More specifically, the report aims to respond to Action 1 of the BEPS Action Plan which included the following work to be undertaken in relation to the digital economy:

> **Action 1 – Address the tax challenges of the digital economy**
>
> Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location relevant data through the use of digital products and services, the characterisation of income derived from new business models, the application of related source rules, and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector.[8]

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[5] OECD BEPS website <http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm>.

[6] OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing <http://dx.doi.org/10.1787/9789264202719-en>.

[7] OECD (2014), *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing <http://dx.doi.org/10.1787/9789264218789-en>.

[8] OECD (2013), above n 6, 14.

This paper provides a preliminary analysis of the potential options to address the tax challenges raised by the digital economy which were identified in the Action Plan 1 report. While the report posits potential solutions that cover both direct tax and indirect tax options, this paper is only concerned with the potential direct tax options which are discussed in the report.

The structure of this paper is as follows. The next part will cover the digital economy and identify some key features which are relevant from a tax perspective. Following this discussion, the paper will examine some of the broader tax policy issues that are raised by the digital economy and will then identify specific BEPS issues in the digital economy. The framework for conducting a preliminary analysis will then be identified. The paper will then examine and analyse the options put forward in the Action Plan 1 report. Finally, the paper will offer some concluding comments.

2. The digital economy and some key features from a tax perspective

This section of the paper examines the nature of the digital economy and in particular will explore the nature of electronic commerce before identifying key features of the digital economy which are relevant from a tax perspective.

2.1 The nature of the digital economy and electronic commerce

The digital economy continues to rapidly evolve and is the result of a transformative process which has made technologies cheaper, more powerful, and widely standardised. This in turn has improved business processes and increased innovation across all sectors of the economy.[9] The continued growth of the digital economy poses challenges for international taxation. As noted in the BEPS Action Plan:

> The digital economy is characterised by an unparalleled reliance on intangible assets, the massive use of data (notably personal data), the widespread adoption of multi-sided business models capturing value from externalities generated by free products, and the difficulty of determining the jurisdiction in which value creation occurs. This raises fundamental questions as to how enterprises in the digital economy add value and make their profits, and how the digital economy relates to the concepts of source and residence or the characterisation of income for tax purposes. At the same time, the fact that new ways of doing business may result in a relocation of core business functions and, consequently, a different distribution of taxing rights which may lead to low taxation is not *per se* an indicator of defects in the existing system. It is important to examine closely how enterprises of the digital economy add value and make their profits in order to determine whether and to what extent it may be necessary to adapt the current rules in order to take into account the specific features of that industry and to prevent BEPS.[10]

Before undertaking an analysis of potential options to address the challenges that are created by the digital economy, it is both instructive and necessary to have an understanding of the

[9] OECD (2014), above n 7, 11.

[10] Ibid 10.

digital economy including especially electronic commerce and also to appreciate the key features that are relevant from a tax perspective.[11]

Discussions relating to the digital economy and electronic commerce normally begin with a pronouncement that it represents a fundamental and revolutionary development in communications which is likely to dramatically change the way business is conducted.[12] This is usually followed by highly variable, speculative and often mind-numbing estimates of the expected growth of the Internet. In this regard, Doernberg *et al* have noted that providing figures to document the growth of the Internet and electronic commerce is simply stating the obvious – their summation that '[e]lectronic commerce is here; it is growing; and it poses new questions for all aspects of society'[13] is arguably all that can be usefully said regarding the present state of electronic commerce.

Much of the variance in the estimates of the predicted growth of the Internet and electronic commerce can be attributed to the lack of a universal definition of electronic commerce.[14] Some definitions are very broad and seek to cover *any* commercial transaction that is effected via electronic means, including such means as facsimile, telex, electronic data interchange ('EDI'), the Internet, and the telephone.[15] The Australian Taxation Office ('ATO') on the other hand, has defined electronic commerce more narrowly as 'the buying and selling of

[11] What follows on this point draws from the author's PhD thesis: Dale Pinto, *The Continued Application of Source-Based Taxation in an Electronic Commerce Environment* (PhD Thesis, The University of Melbourne, 2002). This work was subsequently published by the IBFD in its Doctoral Series: Dale Pinto, *E-Commerce and Source-Based Income Taxation* (IBFD – Doctoral Series, Volume 6), 2003. See also: Howard E Abrams and Richard L Doernberg, 'How Electronic Commerce Works' (1997) 14 *Tax Notes International* 1573.

[12] United States Department of Commerce, *The Emerging Digital Economy* (1998), < http://www.ecommerce.gov> 4 (observing that the Internet's pace of adoption has eclipsed technologies that preceded it: 'Radio was in existence 38 years before 50 million people tuned in; TV took 13 years to reach that benchmark. Sixteen years after the first PC kit came out, 50 million people were using one. Once it was opened to the general public, the Internet crossed that line in four years'). See also, Richard Doernberg *et al*, *Electronic Commerce and Multijurisdictional Taxation* (2001) 2 (noting that while some suggest that the Internet is just the latest technological advance and may therefore not signal a revolutionary advance, there are differences between the birth of the Internet and technologies that preceded it, as indicated by the rates of adoption referred to earlier in this footnote).

[13] Richard Doernberg *et al*, *Electronic Commerce and Multijurisdictional Taxation* (2001) 2-3.

[14] US Department of Commerce, *The Emerging Digital Economy II* (1999),<http://www.ecommerce.gov> n 1, 2 ('Disparities among private estimates result from differences in definitions, methods, data, model and sampling error, and product coverage. Variations also reflect the research needs of customers. While data used for estimates and forecasts are based on a combination of surveys and interviews, the survey questions and answers are not made public, sample sizes vary considerably across surveys, and little information is available on the respondents').

[15] Report of the Electronic Commerce Expert Group ('ECEG') to the Attorney-General, 'Electronic Commerce: Building the Legal Framework' (31 March 1998), <http://www.law.gov.au/aghome/advisory/eceg/single.htm> [1.21]; United States, Department of the Treasury, Office of Tax Policy, *Selected Tax Policy Implications of Global Electronic Commerce* (22 November 1996), <http://www.ustreas.gov/taxpolicy/internet.html> [3.2.1] ('US Treasury Report') ('Electronic commerce is the ability to perform transactions involving the exchange of goods and services between two or more parties using electronic tools and techniques').

goods and services on the internet.'[16] For the purposes of this paper, a more focused definition will be adopted whereby electronic commerce will be taken to mean commercial transactions involving the production, distribution, sale and delivery of goods and services that are carried out over open networks like the Internet.[17]

Though it is beyond the scope of this paper to examine the history[18] and operation[19] of the Internet and digital economy in detail, a brief examination of how electronic commerce may be conducted through the Internet is necessary in order to undertake the analysis that will be presented later in the paper in relation to how electronic commerce may impact on existing international tax rules.

Electronic commerce is conducted mainly through global computer networks. The architecture of the Internet, with its open, distributed network, system of packet switching and universal communications protocol has led to a world-wide network of networks, where the individuals and organisations that comprise it are independent from one another.[20] There is no central, world-wide technical control point. Yet, by means of this system, a computer situated in one location can communicate with any other computer that is also connected to the network no matter where in the world it might be located, providing the illusion that all users are on the same network. The communication is made possible by the digitisation[21] of data, including text, sound and visual images, that is then transmitted around the world via the Internet.

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[16] Australian Taxation Office, Electronic Commerce Project Team, *Tax and the Internet – Volume 1* (1997) 12 ('First Australian Report').

[17] This definition includes elements of definitions provided by others, notably: OECD Policy Brief No 1 (1997), <http://www.oecd.org/publications/Pol_brief/9701_pol.htm> 1; Abrams and Doernberg, above n 11; OECD (2014), above n 7, 74.

[18] The following sources of information provide an excellent analysis of the history of the Internet and the World Wide Web ('WWW'): Pierre J Bourgeois and Luc Blanchette, 'The Internet, Electronic Commerce and Taxes – Some Reflections: Part 1' (1997) 45(5) *Canadian Tax Journal* 1129; Michael A Geist, 'The Reality of Bytes: Regulating Economic Activity in the Age of the Internet' (1998) 73 *Washington Law Review* 526; Edward A Morse, 'State Taxation of Internet Commerce: Something New Under the Sun?' (1997) 30 *Creighton Law Review* 1118; Deloitte & Touche LLP and Information Technology Association of America ('ITAA'), *Taxation of Cyberspace* (2nd ed, 1998) 297.

[19] A comprehensive description of how the Internet works may be found in Abrams and Doernberg, above n 11, 1573; Doernberg *et al*, above n 11, 9-66.

[20] Patrick Gallagher, 'Case Study: A Practical Analysis of Electronic Commerce Revenue Flows' (Paper presented at an International Tax Symposium organised by the Australian Taxation Studies Program ('ATAX') of the University of New South Wales, Sydney, 17-18 March 1998) 58 (observing that the Internet is essentially a network of computer networks interconnected by means of telecommunication facilities using common protocols and standards that allow for the exchange of information between each connected computer).

[21] Digitisation is the process of converting information (including music, text, and speech) into a sequence of numbers. Once converted, the information can be sent at the speed of light throughout the world where a recipient can convert the information back into its original format or otherwise manipulate it: Richard Doernberg and Luc Hinnekens, *Electronic Commerce and International Taxation* (1999) 48.

A popular way of conducting business on the Internet is through a Web site. Web sites are computer programs that reside on computers, known as servers, which are in turn connected to the Internet. These servers are commonly maintained by Internet Service Providers ('ISPs') but this need not be the case as computer servers can sometimes be owned, operated and maintained by businesses directly. They possess Internet Protocol ('IP') numbers, which are somewhat like telephone numbers, uniquely identifying devices attached to the Internet. Every device connected to the Internet has an IP number that allows communications to occur with other devices connected to the Internet. This is achieved by one computer dialling the IP number of the device or computer sought to be contacted. Specialised protocols are available enabling secure communications to occur between clients and servers when, for example, on-line payments involving the transmission of credit card details are made by a customer.

Electronic commerce activity can be classified as either business-to-business or business-to-consumer electronic commerce. In business-to-business electronic commerce, businesses commonly use the Internet to integrate the value-added chain which can extend from the supplier of raw materials to the final consumer.[22] Business-to-business electronic commerce dominates the total value of electronic commerce activity, accounting for about 80 per cent at present,[23] though some estimates place this figure at closer to 75 per cent.[24] The predominance of business-to-business electronic commerce partly reflects the fact that electronic links between businesses are not new[25] and the advantages of businesses adopting electronic commerce are relatively obvious.[26]

Although business-to-business electronic commerce represents the bulk of all electronic commerce, most attention has been directed on the business-to-consumer segment – that is, the retailing or 'e-tailing' segment as it has come to be known. And while much media attention has focused on on-line merchants selling books, wine and computers, an increasing majority of products that are marketed electronically to consumers are intangibles such as travel and ticketing services, software, entertainment (on-line games, music, gambling), banking, insurance and brokerage services, information services, legal services, real-estate services, and increasingly health-care, education and government services.[27]

[22] OECD, *The Economic and Social Impact of Electronic Commerce: Preliminary Findings and Research Agenda* (1999) 34 ('OECD Economic and Social Report').

[23] Ibid 36.

[24] See eg, *The eCommerce: B2C Report and The eCommerce: B2B Report*, <http://www.emarketer.com/ereports/ecommerce>, as cited in Doernberg *et al*, above n 11, 6 (n 17).

[25] Such electronic links have existed for decades, in the form of electronic data interchange ('EDI') supplied by value-added networks ('VAN') operated over leased telephone lines.

[26] Including a reduction in transaction costs and improvement of product quality/customer service.

[27] OECD Policy Brief No 1 (1997),<http://www.oecd.org/publications/Pol_brief/9701_pol.htm> 2.

Generally, electronic commerce conducted through the Internet consists of three parties, namely the ISP, the trader and the customer.[28] The ISP will normally maintain a server located either in or outside the relevant country (which is becoming increasingly possible with cloud computing) although bandwidth (capacity) restrictions in some jurisdictions may mean that local servers are necessary. A server fulfils the function of being a computer that physically hosts a Web site and which has access to the Internet. The Web site for a trader is in many ways similar to a mail-order catalogue, providing details about the trader, his or her products, and their prices. The ISP typically charges the trader a fee for hosting the Web site, usually at a flat rate or on a time basis.

A customer, after logging on to the Internet thorough their ISP, selects the Internet address of the trader, thereby accessing the trader's Web site. The customer acquires a product or service listed on this site generally by entering his or her credit card information on-line. A transaction can be completed wholly on the Internet (called 'on-line' or 'direct electronic commerce') with intangible products – for example, digital products such as music or software can both be purchased and delivered completely on-line through the Internet. However, with the purchase of tangible products, physical delivery is still necessary once the site registers the order on the merchant's sales system (this is referred to as 'off-line' or 'indirect electronic commerce'). Currently, advertising on Web sites (called banner advertisements) and the off-line sale of goods and services constitute two major sources of Internet generated revenue in business-to-consumer transactions.[29]

2.2 Key features of the digital economy from a tax perspective

A threshold issue in considering how to address the challenges raised by the digital economy necessarily involves an analysis of the key features of the digital economy from a tax perspective.

In many ways the digital economy does not really represent anything new, however, while many digital economy business models have parallels in traditional business, modern advances in information and communications technologies have made it possible to conduct many types of business at substantially greater scale and over longer distances than was previously possible (so-called 'scale without mass'[30]).

Likewise, many would argue that the search for principles in international revenue and tax-base allocation is nothing new.[31] An initial issue that needs to be considered is how best to

[28] What follows is adapted from 'Taxation of Internet Trading: A Survey of Tax Treatment in the United Kingdom, Ireland, Italy, Germany, Spain, The Netherlands and Sweden' (1998) 25(2) *Tax Planning International Review* 3.

[29] David L Forst, 'The Continuing Vitality of Source-Based Taxation in the Electronic Age' (1997) 15 *Tax Notes International* 1455.

[30] OECD (2014), above n 7, 12 and 86.

[31] See, for example, R.A. Musgrave and P.B. Musgrave, 'Inter-nation Equity', in Modern Fiscal Issues – Essays in honor of Carl S. Shoup, (R. M. Bird and J. G. Head, editor), page 63, at 64. As an example, these authors referred to the 13th century discussions, between Italian theologians, of the allocation of property as a tax base between situs and owner's domicile.

conceptualise the digital economy – should it be treated separately (ring-fenced) or merely regarded as part of the existing economy, albeit representing an ever-increasing part of the economy?

It is submitted that seeking to treat the digital economy as a separate sector of the economy would be fraught with difficulties as it would require distinctions to be made between what is digital and what is not. In many cases this would be problematic and would arguably give rise to arbitrage opportunities which arise whenever characterisation of something comes into play.

Recognising that it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes, the OECD has suggested the following approach to address BEPS concerns which are raised by the digital economy in its Action Plan 1 report:

> BEPS concerns raised by the digital economy are better identified and addressed by analysing existing structures adopted by multinational enterprises (MNEs) together with new business models and by focusing on the key features of the digital economy and determining which of those features raise or exacerbate tax challenges or BEPS concerns.[32]

This is a sensible approach which reflects the difficulty of trying to ring-fence the digital economy from the rest of the economy for tax purposes. It also accommodates the reality that as the digital economy continues to grow, it is increasingly becoming the economy and therefore it should not be ring-fenced. And while the digital economy is in a continuous state of development which means that future developments in business models will need to be monitored, adopting this approach will allow a consideration of all tax challenges (including those raised by the digital economy) within the context and framework of the existing set of tax rules which exist, albeit that these rules might need to be reconceptualised due to the challenges that are presented by the digital economy.

Turning to features of the digital economy which are relevant from a tax perspective, these may be summarised as follows:[33]

- *Mobility*

  Mobility is greatly enhanced in the digital economy in relation to three main areas: (i) intangibles, (ii) users, and (iii) business functions.

  In relation to intangibles, the development and exploitation of intangibles is a key characteristic of the digital economy. Intangibles are also a core contributor to value creation and economic growth for companies which operate in the digital economy. Against this background, the digital economy provides an easy, accessible and quick platform to locate and relocate intangibles which presents challenges under existing tax rules as the rights to intangible assets can often be

[32] OECD (2014), above n 7, 12.

[33] What follows on this point is based on the OECD's analysis of the main features as contained in their Action Plan 1 report: Ibid 13, 84.

easily assigned and transferred among associated enterprises, with the result that the legal ownership of the assets may be separated from the activities that resulted in the development of those assets.

Likewise, continued developments in digital technologies means that users are increasingly able to carry on commercial activities remotely. For example, an individual who is resident in country A can purchase an application while visiting country B which is delivered from country C. These challenges are exacerbated by the ability of the internet to offer anonymity (e.g., through the use of virtual currencies (such as bitcoin) as well as virtual personal networks or proxy servers that may disguise the location at which the ultimate sale took place.

Finally, businesses are able to increasingly access remote markets more easily with a minimal (or no) need for personnel to be present in a target market (so-called 'scale without mass'[34]). This has been evident in many Internet businesses which have been able to access large numbers of customers while maintaining very small workforces in the market jurisdiction. The ability to manage businesses remotely while maintaining substantial flexibility over the location of business functions has also increased the ability of businesses to spread (and split) functions and assets among multiple different countries. In this way, businesses are increasingly able to more easily choose the location for productive activities and assets, even if that location may be distant from the location of customers or the location of other stages of production.

- *Reliance on data*, including the use of 'big-data': the massive use of data which has been facilitated by an increase in computing power and storage capacity which has been accompanied by a corresponding decrease in data storage cost.

- *Network effects* which refer to the fact that decisions of users may have a direct impact on the benefit received by other users.

- Use of *multi-sided business models* in which the two sides of the market may be in different jurisdictions.

- Tendency toward *monopoly or oligopoly* in certain business models relying heavily on network effects.

- *Volatility* due to low barriers to entry and rapidly evolving technology.

Apart from these key features, the digital economy has facilitated greater integration allowing companies to operate more as global firms. Previously, a multinational group wishing to operate in another jurisdiction would often need to establish a subsidiary in each target market country in which it did business in order to manage the group's business in that country. Establishing physical presences in target markets was also necessary due to a number of factors including slow communications, customs duties, foreign exchange rules, and relatively high transportation costs that made integrated global supply chains difficult to

[34] Ibid 86.

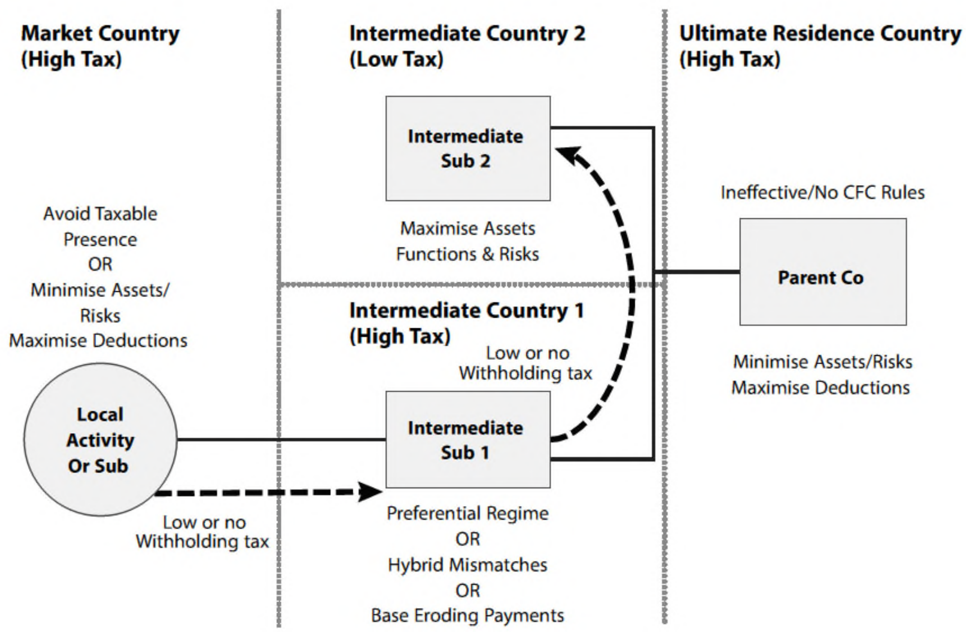
operate. In a digital context this has all changed, as noted by the OECD in its Action Plan 1 report:

> … the move to digital products and a service-based economy, however, combined to break down barriers to integration, allowing MNE groups to operate much more as global firms. This integration has made it easier for business to adopt global business models that centralise functions at a regional or global level, rather than at a country-by-country level. Even for small and medium enterprises (SMEs), it has now become possible to be "micro-multinationals" that operate and have personnel in multiple countries and continents. ICT technologies have been instrumental in this major trend, which was further exacerbated by the fact that many of the major digital companies are young and were designed from the beginning to operate on an integrated basis at a global scale.[35]

Having examined the features of the digital economy which are relevant from a tax perspective, the next section will examine some of the specific and broader tax policy issues which are raised by the digital economy in light of these features.

3. Tax issues raised by the digital economy

Direct tax issues[36] (including BEPS) that are raised by the digital economy are best understood by considering a typical business model used by businesses which operate in the digital economy. The following diagram summarises a typical corporate structure which involves BEPS planning in the context of income tax.[37]



[35] Ibid 13.

[36] Tax issues raised by the digital economy in the context of indirect taxation are outside the scope of this paper.

[37] OECD (2013), above n 7, 101.

The strategies depicted in the above diagram can be broken down into four elements as described in the February 2013 OECD Report *Addressing Base Erosion and Profit Shifting*: [38]

- Minimisation of taxation in the market country either by (i) avoiding a taxable presence, or (ii) in the case of a taxable presence, either by shifting gross profits via trading structures or by reducing net profit by maximising deductions at the level of the payer.
- Low or no withholding tax in the source country.
- Low or no taxation at the level of the recipient (which can be achieved via low-tax jurisdictions, preferential regimes, or hybrid mismatch arrangements) with an entitlement to substantial profits often built-up via intra-group arrangements.
- No current taxation of the low-tax profits at the level of the ultimate parent.

Against the background of such a typical business model as depicted above, the next section of the paper will examine some of the broader tax policy issues that are raised by the digital economy and will also identify specific BEPS issues in the digital economy.

3.1 Broader tax policy issues

As a result of the digital economy, non-resident companies can now operate in a market jurisdiction in a profoundly different manner today than they could when the international tax rules were designed. While non-resident companies have always been able to operate in jurisdictions without maintaining a physical presence there, continued advances in the digital economy has substantially increased the ease and scale at which such activity is now possible.

Also, in a traditional sense, for companies to operate in a market jurisdiction, a local physical presence in the form of manufacturing, marketing, and distribution was often required. These in-country operations typically would have included procurement, inventory management, local marketing and other activities. These activities traditionally would have generated local income that would have been subject to tax in the market country. Now, with advances in the digital economy, businesses can centrally manage many functions that previously required a local presence, rendering the traditional model of doing business in market economies vulnerable.

Despite the digital economy allowing for businesses to operate in a market jurisdiction without maintaining a physical presence in it, existing thresholds for taxation still principally largely rely on establishing a physical presence to base taxing rights upon. As observed by the OECD, this reliance on a physical presence has been partly due to the need for many traditional businesses to maintain a local physical presence in order to conduct substantial sales of goods and services into a market jurisdiction formed and also due in part to the need to ensure that the source country has the administrative capability of enforcing its taxing

[38] OECD (2013b), *Addressing Base Erosion and Profit Shifting*, OECD Publishing <http://dx.doi.org/10.1787/9789264192744-en> 44.

rights over a non-resident enterprise.[39] Now less physical presence is required in market economies and this therefore raises challenges for international taxation.

Also, many contemporary business models rely on data and intangibles which raises significant tax challenges, both in terms of characterisation of and also in relation to the attribution of value from data.

In general terms, the main broad tax policy challenges raised by the digital economy fall into three broad categories:[40]

- *Nexus*: The continual growth in digital technologies and the reduced need for physical presences in order to carry on business in a market jurisdiction raises questions as to whether the current rules to determine nexus with a jurisdiction for tax purposes are appropriate.

- *Data*: The growth in sophistication of information technologies has permitted companies in the digital economy to gather and use information across borders to an extraordinary degree. This raises issues of how to attribute value created from the generation of data through digital products and services.

- *Characterisation*: The development of new digital products or means of delivering services creates uncertainties in relation to the proper characterisation of payments made in the context of new business models, particularly in relation to cloud computing. For example, how should a person or entity's supply of data in a transaction as a free supply of a good, as a barter transaction, or some other way be characterised for tax purposes?

These challenges raise broad questions about the efficacy of the current international tax regime to deal with the changes brought about by the digital economy to ensure that profits are taxed in the jurisdiction where economic activities occur and where value is generated. This in turn raises important questions regarding what standard should be used to determine where economic activities are carried out and where value is generated for tax purposes, which traditionally has been based on an analysis of the functions, assets and risks involved.

The discussion will now turn to some of the specific BEPS issues raised by the digital economy.

3.2 Specific BEPS issues raised by the digital economy

As noted, while it has always been possible for non-resident companies to operate in jurisdictions without maintaining a physical presence there, the digital economy has substantially increased the ease and scale at which such activity is now possible. While this does note of itself generate unique BEPS issues, some of the key features of the digital economy exacerbate BEPS risks.

[39] OECD (2014), above n 7, 124.

[40] Ibid 125. What follows on this point relies on this source.

For example, the growth of intangibles in the context of the digital economy, combined with the mobility of intangibles generates substantial BEPS risks in the area of direct taxes. Further, the ability to centralise operations at a distance from a market jurisdiction and conduct substantial sales of goods and services into that market from a remote location generates opportunities to achieve BEPS by fragmenting physical operations to avoid income tax. This is exacerbated by the opportunities the digital economy provides that allows for the minimal use of personnel that may now be required in a market jurisdiction.

With these concerns in mind, the OECD has identified the following specific issues linked to the digital economy that need to be considered for tax purposes:[41]

(i) Ensuring that core activities cannot inappropriately benefit from the exception from permanent establishment ('PE') status, and that artificial arrangements relating to sales of goods and services cannot be used to avoid PE status

In the Action Plan 1 report, the OECD expressed its view that the separate work on Action 7 (preventing the artificial avoidance of PE status) should consider whether certain activities that were previously considered preparatory or auxiliary for the purposes of these exceptions may be increasingly significant components of businesses in the digital economy. This work will also consider the circumstances under which such activities may be considered core activities and whether a reasonable, administrable rule to this effect can be developed.

The work on Action 7 will also consider whether and how the definition of PE may need to be modified to address circumstances in which artificial arrangements relating to the sales of goods or services of one company in a multinational group effectively result in the conclusion of contracts, such that the sales should be treated as if they had been made by that company. This would be relevant where, for instance, an online seller of tangible products or an online provider of advertising services uses the sales force of a local subsidiary to negotiate and effectively conclude sales with prospective large clients.

(ii) The importance of intangibles, the use of data, and the spread of global value chains, and their impact on transfer pricing

Many BEPS structures in the digital economy involve the transfer of intangibles or rights to intangibles to tax-advantaged locations that imposes little or no tax. It is often argued that these contractual allocations, together with legal ownership of intangibles, justify large allocations of income to the entity allocated the risk even if it performs little or no business activity. Often this is accomplished by arguing that other entities in the group are contractually insulated from risk so that a low-tax affiliate is entitled to all residual income after compensating other low risk group members for their functions even if this affiliate has no capacity to control the risk.

In response, the OECD has stated in its Action Plan 1 report that in addition to examining existing transfer pricing guidelines, the BEPS work in the area of transfer pricing should take these issues in account and also consider the relationship between that work and the heavy

[41] Ibid 14-16. What follows on this point is summarised from this source, excluding indirect tax issues which are outside the scope of this paper.

reliance on collection, analysis and monetisation of data that characterises many companies in the digital economy.

In addition, the Action Plan 1 report states that work in this area should devote attention to the implications of the increased integration of MNEs and the spread of global value chains, in which various stages of production are spread across multiple countries. Part of this work will involve the evaluation of the need for greater reliance on functional analyses (assets used, functions performed, and risks assumed) and on value chain analyses and will need to address situations where comparables are not available because of the structures designed by taxpayers and/or the unique intangibles involved.

(iii) The possible need to adapt CFC rules to the digital economy

Income which is earned in the digital economy can include income generated from the remote sale of digital goods and services. Such income may be particularly mobile due to the importance of intangibles in the provision of such goods and services and the relatively few people which are required to carry out online sales activities. Accordingly, a business enterprise operating in the digital economy can earn income in a controlled foreign company ('CFC') in a low (or no) tax jurisdiction by locating key intangibles there and using those intangibles to sell digital goods and services without that income being subject to current tax, even if the CFC itself does not perform significant activities in its jurisdiction.

In response, the Action Plan 1 report notes that although CFC rules vary significantly from jurisdiction to jurisdiction, income from digital products and services provided remotely is frequently not subject to current taxation under CFC rules. In developing recommendations regarding the design of CFC rules, the report accordingly states that consideration should be given to CFC rules that target income typically earned in the digital economy, such as income earned from the remote sale of digital goods and services.

4. Framework for analysis

Having now examined the general and specific issues raised by the digital economy in relation to direct taxation, the paper will consider what might be an appropriate framework for considering the possible options discussed by the OECD in its Action Plan 1 report.

Prior work by the OECD on electronic commerce is instructive in deciding on what might be an appropriate framework to analyse different possible options to address the challenges created by the digital economy. The 1998 Committee on Fiscal Affairs Report, *Electronic Commerce Tax Framework Conditions*[42] set out the following taxation principles ('Ottawa Taxation Framework Principles') that should apply to electronic commerce:

Neutrality: Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

[42] Available at <http://www.oecd.org/tax/consumption/1923256.pdf> 4.

Efficiency: Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible.

Certainty and Simplicity: The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.

Effectiveness and Fairness: Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to the risks involved.

Flexibility: The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.

The Action Plan 1 report accepted these principles as continuing to be appropriate and specifically considered two additional principles: equity [43] and proportionality.[44]

In relation to equity, the Action Plan 1 report noted that:

> Equity is also an important consideration within a tax policy framework. Equity has two main elements; horizontal equity and vertical equity. Horizontal equity suggests that taxpayers in similar circumstances should bear a similar tax burden. Vertical equity is a normative concept, whose definition can differ from one user to another. According to some, it suggests that taxpayers in better circumstances should bear a larger part of the tax burden as a proportion of their income. In practice, the interpretation of vertical equity depends on the extent to which countries want to diminish income variation and whether it should be applied to income earned in a specific period or to lifetime income. Equity is traditionally delivered through the design of the personal tax and transfer systems.
>
> Equity may also refer to inter-nation equity. As a theory, inter-nation equity is concerned with the allocation of national gain and loss in the international context and aims to ensure that each country receives an equitable share of tax revenues from cross-border transactions (OECD, 2001). The tax policy principle of inter-nation equity has been an important consideration in the debate on the division of taxing rights between source and residence countries.[45]

In relation to proportionality, the Action Plan 1 report observed that:

> Potential options will be evaluated with respect to their proportionality to the tax challenges they are intended to address. The existing tax framework has endured in part because it has historically been possible to adapt within that framework to new business developments. Where the digital economy has raised tax challenges with respect to the application of that existing tax framework, it will be important to evaluate not only whether the proposed options address those tax challenges, but also what broader

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[43] OECD (2014), above n 7, 31.

[44] Ibid 151.

[45] Ibid 31. The report also noted that the principle of inter-nation equity was recognized at the time of the Ottawa work in 1998 by stating that “any adaptation of the international taxation principles should be structured to maintain fiscal sovereignty of countries, [...] to achieve a fair sharing of the tax base from electronic commerce between countries...”: see further, OECD (2001), *Taxation and Electronic Commerce-Implementing the Ottawa Framework Conditions*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264189799-en>.

> impact those options may have. Potential options should ideally be tailored to the scope of the particular challenges they are intended to address.[46]

While there are inevitable trade-offs in trying to simultaneously satisfy all of the above principles, the Action Plan 1 report somewhat idealistically, in the view of the author, promotes the position that:

> In evaluating potential options, no single principle can be given greater priority than any other. Instead, the assessment under this framework shall be based on an overall consideration of the individual factors that are part of the framework.[47]

Despite this, the above tax policy principles represent a useful theoretical framework within which different options may be considered and will accordingly be adopted for the analysis of the options discussed by the OECD in its Action Plan 1 report which will be undertaken in the next section of the paper.

5. A Preliminary analysis of options put forward by the OECD to address the challenges raised by the digital economy to direct taxes

This section of the paper first examines the approach taken by the OECD in suggesting options to address the challenges raised by the digital economy. It then turns specifically at the five options put forward in the OECD Action Plan 1 report to address the challenges raised by the digital economy.

5.1 The Approach

The Action Plan 1 report recognises that the changes brought about by the digital economy raise systemic challenges regarding the ability of the current international tax framework to ensure that profits are taxed where economic activities occur and where value is created.

In terms of the approach taken in the report, while it recognises that the digital economy does not generate unique BEPS issues it does recognise that some of its key features does exacerbate BEPS risks. The best way to address these risks in the view of the report is not by trying to ring-fence the economy from the rest of the economy for tax purposes. Instead, the OECD has taken the following approach:

> … the tax challenges and BEPS concerns raised by the digital economy are better identified and addressed by analysing existing structures adopted by multinational enterprises (MNEs) together with new business models and by focusing on the key features of the digital economy and determining which of those features raise or exacerbate tax challenges or BEPS concerns.[48]

It is submitted this approach is the appropriate approach for analysing the tax issues raised by the digital economy as seeking to ring-fence the digital economy from the rest of the

[46] OECD (2014), above n 7, 151.

[47] Ibid 149.

[48] Ibid 12.

economy would cause many issues including issues of characterisation as to what is digital and what is not as well as possibly raising broader policy issues if different tax results eventuated for similar businesses that operated in a traditional vs digital mode.

As a result, the tax challenges and BEPS concerns raised by the digital economy are analysed by the Action Plan 1 report by identifying existing structures adopted by multinational enterprises ('MNEs') together with new business models and by focusing on the key features of the digital economy and determining which of those features raise or exacerbate tax challenges or BEPS concerns.

As noted earlier in the paper, it is submitted that this approach is a sound one. What has fundamentally changed in the digital economy is not the basis for taxation but the ease and scale with which businesses can now operate in jurisdictions without maintaining physical presences in those jurisdictions.

As the author has argued elsewhere,[49] while existing tax rules continue to be theoretically justifiable for income that arises from international transactions which are conducted in an electronic commerce environment, the *way* in which they apply for electronic commerce transactions may need to be reconceptualised. This is because the practical application of existing tax principles may be rendered difficult in light of characteristics of electronic commerce that are significant from a tax perspective.

5.2 Two caveats

Before analysing each of the options canvassed by the OECD in the Action Plan 1 report to address the challenges created by the digital economy, two caveats need to be noted.

First, to develop the direct tax measures envisaged in the base erosion and profit shifting BEPS Action Plan, the OECD has stated that it will take into account the key features and business models that have emerged in the digital economy, and this should therefore effectively address the BEPS concerns that arise in the digital economy. This may result in substantial changes to existing international tax rules in order to address stateless income and practices that artificially segregate taxable income from the activities that generate it. Consequently, addressing BEPS concerns in the digital economy can also possibly affect the scope of several of the broader tax challenges raised by the digital economy, including those relating to nexus, data and characterisation that were discussed earlier in the paper.

Second, a limitation of trying to conduct an evaluation of the options put forward by the OECD in its Action Plan 1 report relates to the staggered time frame of the BEPS Project, the interaction among the various BEPS outputs, and their actual impact on BEPS which make it difficult to evaluate the ultimate scope of the broader tax challenges of the digital economy in the area of direct taxation. One result of this is that if the BEPS issues outlined earlier in the paper are fully addressed through the measures envisaged in the BEPS Action Plan, then addressing the broader challenges of nexus, data and characterisation may become less urgent.

[49] Pinto, above n 11, 7.

With these necessary caveats, the paper now turns to conducting a preliminary analysis of the options put forward by the OECD in its Action Plan 1 report.

5.3 The five options canvassed by the OECD to address the tax challenges created by the digital economy to direct taxes

The following five options were canvassed by the OECD in its Action Plan 1 report as possible responses to address the challenges presented by the digital economy in relation to direct taxation:[50]

i. Modify the exemptions from PE Status contained in Article 5(4) of the OECD Model Tax Convention
ii. Establish a new nexus for determining PE status based on establishing a significant digital presence
iii. Replace the PE threshold concept with a ‘significant presence’ test
iv. Create a withholding tax for digital transactions
v. Introduce a bandwidth or “Bit” tax

As a preliminary point in relation to analysing these options, they can be broken down into changes that would not require a fundamental modification of existing rules (option (i)) on the one hand through to other options which could require fundamental modifications to existing international tax rules (options (ii) to (v)).

The paper will now undertake an analysis[51]of the above five options using the framework for analysis which was described in the previous part of the paper.

5.3.1 Modify the exemptions from PE Status contained in Article 5(4) of the OECD Model Tax Convention

This option may be described as one which would not necessarily involve a fundamental modification of existing rules but rather would involve a modification/clarification of an existing rule, name Article 5(4) of the OECD Model Tax Convention which provides:

> Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:
>
> a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
>
> b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

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[50] OECD (2014), above n 7, Chapter 8. In the ensuing discussion in this section, the description of each option is a summary of the main options put forward in the report excluding those relating to indirect taxes which are outside the scope of this paper.

[51] A comprehensive analysis of many of the issues associated with the five options covered in the Action Plan 1 report was undertaken in the following report: OECD (2005), *Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce? Final Report*. The analysis in this section draws from this source, particularly in relation to the evaluation of options (i) to (iii).

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

Under this option, the exceptions contained in Article 5(4) of the OECD Model Tax Convention would be modified to take account of the fact that as the economy has evolved some of the activities described in subparagraphs (a) through (d) of paragraph 4 that were previously preparatory or auxiliary in the context of conventional business models (such as sales through a storefront) may have become core functions of certain businesses that operate in the digital economy.

The Action Plan 1 report considers the following ways this option could be implemented:

- Eliminate Article 5(4) entirely.

- Eliminate subparagraphs (a) through (d), or make their availability subject to the overall condition that the character of the activity conducted be preparatory or auxiliary in nature, rather than one of the core activities of the enterprise in question.

- Eliminate the word 'delivery' in Articles 5(4)(a) and (b) in order to exclude certain types of warehouses from these subparagraphs.

Since the Action Plan 1 report was released in September 2014, separate work has already commenced under Action 7 of the BEPS Action Plan to determine whether modification or elimination of Article 5(4) is necessary to ensure that the exceptions to PE do not allow the artificial avoidance of PE status, for example by fragmenting operations among different locations or group entities.

On 31 October 2014, the OECD released a discussion draft, *Action 7 (Preventing the Artificial Avoidance of PE Status) of the BEPS Action Plan*[52] ('PE Discussion Draft') which includes the preliminary results of the work carried on with respect to issues related to the artificial avoidance of PE status and includes proposals for changes to the definition of permanent establishment found in the OECD Model Tax Convention. Consultations on this draft are open until 9 January 2015.

Two items from the PE Discussion Draft of relevance provide as follows:[53]

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[52] <http://www.oecd.org/ctp/treaties/action-7-pe-status-public-discussion-draft.pdf>.

[53] Ibid. What follows on this point is in this section of the paper is summarised from this source.

(a) Artificial avoidance of PE status through *commissionnaire* arrangements and similar strategies

According to the PE Discussion Draft, it is clear that in many cases *commissionnaire* structures and similar arrangements were put in place primarily in order to erode the taxable base of the State where sales took place. As a matter of policy, the OECD states in this report that where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a sufficient taxable nexus in that country unless the intermediary is performing these activities in the course of an independent business. The report then states that changes are therefore needed to the wording of paragraphs 5 and/or 6 of Article 5 in order to address such strategies. Four alternative options are provided in the PE Discussion Draft that would amend the wording of paragraphs 5 and 6 of Article 5 of the OECD Model Tax Convention in order to reflect that policy without allowing the types of avoidance strategies that have taken place under the current wording of the Article.

(b) Artificial avoidance of PE status through the specific activity exemptions

According to the PE Discussion Draft, some aspects of Article 5(4) of the OECD Model Tax Convention give rise to BEPS concerns.

First, the report notes that as some parts of Article 5(4) do not expressly refer to preparatory or auxiliary activities this does not seem to conform to the original purpose of the paragraph, i.e. to cover only preparatory or auxiliary activities. One option presented in the report to remedy this would be to make *all* the activities currently listed in Article 5(4) subject to the condition of being preparatory or auxiliary.

If that option is not adopted, the report states that more targeted changes could be made to address concerns:

- arising from the reference to ‘delivery’ in subparagraphs (a) and (b) of paragraph 4, e.g. where an enterprise maintains a very large warehouse in which a significant number of employees work for the main purpose of delivering goods that the enterprise sells online (one option in the report provides for the deletion of the word ‘delivery’ to give effect to this)

- arising from the exception applicable to ‘purchasing offices’ in subparagraph (d) of paragraph 4 (another option in the report provides for the deletion of the exception applicable to the purchasing of goods for an enterprise whilst a separate option provides for the deletion of the entire subparagraph (d)).

Second, the PE Discussion Draft notes that concerns have been expressed with respect to the application of paragraph 4 where activities are fragmented between related parties.

Analysis of eliminating the existing exceptions in Article 5(4) or making these exceptions subject to the overall condition that they be preparatory or auxiliary

While seeking to completely delete all of the exceptions contained in Article 5(4) may be seen by some to be a radical option, a reason for seeking to delete all of the exceptions is that if, on a functional analysis, these activities are conducted through a fixed place of business in a country and capable of generating significant profits, then the exception is arguably redundant.

A potential problem with the current wording of Article 5(4) is that it allows for the possible fragmentation of functions in order to take advantage of the various exceptions in paragraph 4. This arises because paragraph 4 is drafted in relation to functions carried on at *each* particular place of business. Article 5(4) thereby creates a distinction between the case of activities carried on at the same location which, when taken together, go beyond the preparatory auxiliary threshold and the case where the same activities could be carried out at different places in the same country so as to take advantage of the various exceptions of paragraph 4.

In relation to the fragmentation of activities, the PE Discussion Draft notes that while paragraph 27.1 of the Commentary on Article 5 currently deals with the application of Article 5(4)(f) in the case of a single enterprise that divides a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity, it does not apply where such operations are carried on by related parties. The report suggests that such situations could be addressed by a rule that would take account not only of the activities carried on by the same enterprise at different places but also of the activities carried on by associated enterprises at different places or at the same place.

An alternative option to completely deleting all of the exceptions contained in Article 5(4) canvassed by the Action Plan 1 report is to subject the activities covered by the exception to the overall limitation that they be of a preparatory or auxiliary nature. The reason for this option is based on the same rationale as seeking to delete paragraph 4 altogether but is arguably more in line with the purpose of paragraph 4, which is described as follows in paragraph 21 of the Commentary:

> The common feature of these activities is that they are, in general, preparatory or auxiliary activities" [...] "Thus the provisions of paragraph 4 are designed to prevent an enterprise of one State from being taxed in the other State, if it carries on in that other State, activities of a purely preparatory or auxiliary character.[54]

In this way, this option may be better targeted as it implicitly would restrict the exceptions to activities that contribute only marginally to the profits of a business.

Neutrality

Assuming both options applied to all business (and not just limited to business which operated in the digital economy) then the proposed changes would arguably not offend the principle of neutrality. Appling both options to all businesses would also be consistent with not trying to ring-fence the digital economy from the rest of the economy for tax purposes.

Efficiency

The option to delete all of the exceptions would result in many more PEs being found to exist. This would create concerns under efficiency as it would impose a significant additional compliance burden on businesses. Also, tax authorities would be seeking to pursue many additional PEs, many of which would likely have very limited functions, and therefore profits, attributable to them.

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[54] OECD (2014b), *Model Tax Convention on Income and on Capital: Condensed Version 2014*, OECD Publishing. <http://dx.doi.org/10.1787/mtc_cond-2014-en> 103.

The alternate option of seeking to make all the exceptions subject to the overall condition that they be preparatory or auxiliary would involve less of a compliance burden for business but would still require an examination of whether or not activities meet the overall condition. As this option might give rise to more permanent establishments, it can be expected that more disputes between taxpayers and tax authorities may eventuate which would increase the compliance burdens on taxpayers as well as the cost to tax administrators in resolving these disputes.

Certainty and Simplicity

One the one hand, the option to delete all existing exceptions would likely provide more certainty and simplicity in determining whether or not a PE exists as there would be fewer disputes as to whether a place of business is used only for the activities currently covered by Article 5(4) or for such activities and other non-preparatory or auxiliary functions. The option would also eliminate a number of technical uncertainties arising under the current wording of paragraph 4. These uncertainties include the extent to which the reference to 'goods or merchandise' in Article 5(4) (a), (b) and (c) can apply to digital products or, more generally, data. It is also unclear to what extent the words 'storage' and 'delivery' can apply to digital products downloaded from servers through computer networks. A further uncertainty exists as to whether or not paragraph 4 would apply where various activities listed alternatively in subparagraph (a) and (b) are carried on at the same location and these activities go beyond the preparatory or auxiliary threshold so as to preclude the application of subparagraph (f).

On the other hand, the option to delete all exceptions could arguably create greater uncertainty in relation to the determination of the profits attributable to a PE as there would be a need to attribute profits to PEs that perform minor functions.

Also, the alternative option to make all the exceptions subject to the 'preparatory or auxiliary' condition may reduce certainty by subjecting the existing exceptions that currently apply automatically to a condition that is likely to be more subjective. The change may increase the potential for disputes between taxpayers and tax authorities thereby adding to compliance and administrative costs. On the other hand, and in light of paragraph 21 of the Commentary on Article 5, it could be argued that there is already some uncertainty as to whether or not all the existing exceptions are implicitly subject to this condition and this proposed change would remedy that uncertainty by clearly specifying in the Article that they *all* conditions are subject to the 'preparatory or auxiliary' condition.

Effectiveness and Fairness

In considering this principle, as both options are directed at curtailing some forms of tax planning which involve the disaggregation of functions in a country they could be said to comport with effectiveness and fairness.

That said, eliminating all of the exceptions may not appear to be fair for some foreign businesses, such as those who need to perform limited storage activities in a country in order to export to that country or businesses that merely display goods for sale in a country. Because of concerns like this, the alternative option to subject all Article 5(4) exceptions to an overriding condition that they be preparatory or auxiliary may be preferable.

Flexibility

If the policy imperative is to exempt from source taxation places of business where only minor business activities are performed, the alternative option to apply the overall preparatory or auxiliary condition to all the exceptions that appear in the paragraph would seem to be a more flexible approach. Also, the option would allow greater flexibility by not ruling out that certain activities (e.g. delivery) could be core activities in certain cases which might be more relevant in a digital setting than a traditional one.

On the other hand, the option to eliminate all of the exceptions listed in Article 5(4) would have much wider impacts than merely dealing with perceived difficulties arising from the practical application of paragraph 4.

Equity

In terms of equity considerations, it may be argued that any business activity carried on in a country contributes to the overall profitability of an enterprise and should therefore be considered as giving right to the country to tax a share of the business profits of the enterprise. Viewed this way, the option to eliminate all exceptions would ensure a greater conformity with such a standpoint.

On the other hand, it may be axiomatic to assume that while each part of an enterprise contributes to the productivity of the whole enterprise, it does not follow that there should be a right to tax such activities on this basis: see paragraph 3 of the Commentary to Article 5 of the OECD Model Tax Convention. Indeed, to promote international trade and commerce countries must exercise a reasonable level of accommodation in relation to physical presences by enterprises of another contracting state. An exclusion of auxiliary and preparatory activities has hitherto been found to be a reasonable line to draw. This reasoning would of course not preclude restricting the existing exceptions to the condition that they be of a preparatory or auxiliary nature.

Proportionality and broader considerations

In terms of broader impacts, the two options would not appear to raise particular concerns as regards their compatibility with international trade rules. At the same time, the implementation of either option would require modification of existing treaties.

Conclusion

It is submitted that of the two options, it is unlikely that countries would agree to an option to eliminate all Article 5(4) exceptions. This is because it would create administrative burdens of trying to tax places of business where minor activities take place and countries would also be concerned about exposing their taxpayers to source taxation where only a very small amount of profits might be taxed.

Analysis of eliminating the exceptions for 'delivery' in Article 5(4)

Under this option, the word 'delivery' in Articles 5(4)(a) and (b) would be deleted in order to exclude certain types of warehouses from these subparagraphs.

The reason for this option is to ensure that certain activities associated with warehouses which are regarded as significant in the context of particular businesses and, based on a functional analysis, are capable of having reasonably significant profits attributed to them should not be included in the exception.

Removing the exception for 'delivery' is consistent with the position under the U.N. Model Tax Convention. The U.N. Commentary says that 'delivery' was deleted because:

> the presence of a stock of goods for prompt delivery facilitates sales of the product and thereby the earning of profit in the host country by the enterprise having the facility. A continuous connection and hence the existence of such a supply of goods should be a permanent establishment, leaving as a separate matter the determination of the amount of income properly attributable to the permanent establishment.[55]

The Commentary goes on to acknowledge that some developed countries disagree with this conclusion that since only a small amount of income would normally be allocated to a permanent establishment whose only activity is delivery.

Another reason for seeking to delete this exception in the case of e-commerce is the fact that the infrastructure for the delivery of goods may be a substantial part of business operations. In this context, if one accepts that Article 5(4) is aimed at activities that are essentially preparatory or auxiliary, it does not seem appropriate to apply the paragraph to an activity which forms a core part of the activity of the enterprise.

Another reason to support this exception relates to concerns with the possible fragmentation of business functions to take advantage of this exception. For example, a business could maintain a place of business solely for display, storage and delivery in a country but sell the goods stored at, and delivered from, that place from another location in the same country. Since Article 5(4) is drafted in relation to functions carried on at *each* particular place of business, it creates a distinction between the case of activities carried on at the same location which, when taken together, go beyond the preparatory or auxiliary threshold and the case, illustrated in the above example, where the same activities are carried on at different places in the same country so as to take advantage of the various exceptions of Article 5(4).

Neutrality

Assuming this option applies to all businesses it would arguably not offend the principle of neutrality principle. What might be questioned is whether e-commerce should in itself provide a justification for making such a change as delivery activities may not necessarily always be more important for e-commerce than it is for traditional forms of carrying on business.

Efficiency

This option could result in additional compliance burden for some businesses – e.g., for exporters of products that currently store goods in destination countries pending final delivery. Also, tax administrations would be pursuing additional permanent establishments, many of which would likely have limited profits attributable to them.

Certainty and simplicity

On the one hand, it could be argued that this option might provide more certainty as there would be fewer arguments as to whether a place of business which is used only for delivery should be regarded as a PE or not. On the other hand, however, there would be more uncertainty about the amount of profits attributable to the new type of PE which would be created by this option.

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[55] United Nations (2001), *United Nations Model Double Taxation Convention between Developed and Developing Countries*, para 17, 80.

The option also raises the question of the extent to which facilities used, or goods or merchandise maintained, for delivery could be covered by the general preparatory or auxiliary exception in Article 5(4)(e).

As noted earlier, there are already a number of technical uncertainties related to the exceptions dealing with delivery activities. For example, it is not clear to what extent the reference to ‘goods or merchandise’ in Article 5(4) (a), (b) and (c) can apply to digital products or, more generally, data.

Another question arises as to whether or not Article 5(4) would apply where various activities listed alternatively in subparagraph (a) and (b) are carried on at the same location and these activities go beyond the preparatory or auxiliary threshold so as to preclude the application of subparagraph (f).

Effectiveness and fairness

An advantage of this option is that it could curtail some forms of tax planning involving the disaggregation of functions in a country. At the same time, the delivery of some types of goods may well require some limited storage or delivery facilities (e.g. in a harbour) in the destination country and in such cases it may not seem fair to subject the foreign seller of such goods to source taxation.

Flexibility

On the one hand, the option would allow greater flexibility by not ruling out that delivery could be more than a preparatory or auxiliary activity. On the other hand, a greater volume of deliveries of physical goods as a result of greater market penetration via electronic means would not *per se* appear to justify a greater proportion of profits being attributed to the delivery function.

Equity

As in the case of the previous alternative, it could be argued that any business activity carried on in a country contributes to the overall profitability of an enterprise and should therefore be considered as giving the right to the country to tax a share of the business profits of the enterprise. Thus, the option to eliminate delivery activities from the list of exceptions would ensure a greater conformity with equity considerations.

On the other hand, one could justify maintaining these activities in the list of exceptions on the basis that very limited business profits originate from the performance of these activities. One could also argue that the advent growth in the digital economy should not of itself be the catalyst for any such changes, as one element of many e-commerce business models is to reduce delivery costs, thereby in fact making delivery less of a ‘core’ function.

Proportionality and broader considerations

The option would not appear to raise particular concerns as regards its compatibility with international trade rules. The implementation of the option would require modification of existing treaties.

Conclusion

Since the U.N. Model already has removed delivery from the list of the preparatory or auxiliary exceptions to the permanent establishment definition, the option would likely be agreed to by a large number of developing countries. It is not clear, however, whether a majority of developed countries would agree to it.

5.3.2 Establish a new nexus for determining PE status based on establishing a significant digital presence

Unlike the first option, this option is a more fundamental proposal that goes to the broader issues of establishing nexus. Under this option, an alternative nexus for determining PE status would be established to address situations in which certain business activities are conducted wholly digitally. According to the Action Plan 1 report, an enterprise engaged in 'fully dematerialised digital activities' could be deemed to have a taxable presence in another country if it maintains a 'significant digital presence' in the economy of that country. Focusing on fully dematerialised digital activities is intended to target only those businesses that require minimal physical elements in the market jurisdiction for the performance of their core activities, regardless of the fact that physical elements (such as offices, buildings, or personnel) may be present in the market jurisdiction to conduct secondary functions.

According to the Action Plan 1 report, potential elements of a test for when a 'fully dematerialised digital activity' is conducted could include the following:

- The core business of the enterprise relies completely or in a considerable part on digital goods or digital services.
- No physical elements or activities are involved in the actual creation of the goods or of the services and their delivery other than the existence, use, or maintenance of servers and websites or other IT tools and the collection, processing, and commercialisation of location-relevant data.
- Contracts are generally concluded remotely via the Internet or by telephone.
- Payments are made solely through credit cards or other means of electronic payments using on-line forms or platforms linked or integrated to the relative websites.
- Websites are the only means used to enter into a relationship with the enterprise; no physical stores or agencies exist for the performance of the core activities other than offices located in the parent company or operating company countries.
- All or the vast majority of profits are attributable to the provision of digital goods or services.
- The legal or tax residence and the physical location of the vendor are disregarded by the customer and do not influence its choices.
- The actual use of the digital good or the performance of the digital service do not require physical presence or the involvement of a physical product other than the use of a computer, mobile devices or other IT tools.[56]

According to this proposed option, a 'significant digital presence' would be deemed to exist in a country when:

[56] OECD (2014), above n 7, 144.

- A significant number of contracts for the provision of fully dematerialised digital goods or services are remotely signed between the enterprise and a customer that is resident for tax purposes in the country.

- Digital goods or services of the enterprise are widely used or consumed in the country.

- Substantial payments are made from clients in the country to the enterprise in connection with contractual obligations arising from the provision of digital goods or services as part of the enterprise's core business.

- An existing branch of the enterprise in the country offers secondary functions such as marketing and consulting functions targeted at clients resident in the country that are strongly related to the core business of the enterprise.[57]

To address administrative concerns under this option, businesses performing fully dematerialised digital activities would be deemed to have a PE only if they exceeded certain thresholds which would indicate a substantial ongoing interaction with the economy of the market country. According to the report, these thresholds could include:

- measures of total contracts for digital goods and services that are concluded remotely,

- the active engagement of substantial numbers of users (for example, the number of active accounts for social platforms,

- the number of visitors to websites, or the number of users of online tools) , or

- the overall level of consumption of the digital goods or services of the enterprise in the market country.

A variation of this option could exist to create a new tax nexus for enterprises engaged in fully dematerialised digital activity where the entity does a significant business in the country using personal data obtained by regular and systematic monitoring of Internet users in that country, generally through the use of multi-sided business models. This variation was proposed by the OECD in order to address concerns that the existing tax rules do not adequately address the challenges posed by increased reliance on data and users participation in the digital economy, particularly where users provide personal data that can then be used to attract revenue from other users through multi-sided business models.

Analysis of establishing a new nexus for determining PE status based on establishing a significant digital presence

This options looks at establishing an alternative nexus for determining PE status to address situations in which certain business activities may be conducted wholly digitally. The rationale for this option lies in the fact that since the modern business environment arguably allows many enterprises to conduct their business operations in other jurisdictions without the need for a fixed physical presence, a more appropriate indicator of sufficient participation in the economy of a jurisdiction to ground a finding of PE status may need to be developed.

[57] Ibid 145.

More specifically under this option, an enterprise engaged in a 'fully dematerialised digital activities' would be deemed to have a taxable presence in a country if it maintained a 'significant digital presence'. The OECD has noted that by canvassing this option it is not recommending the adoption of a virtual permanent establishment standard,[58] such as that advocated by Professor Luc Hinnekens.[59] Presumably this is intended then as an adjunct to the existing definition and or Commentaries relating to a PE as contained in the OECD Model Tax Convention to cover situations where business activities are conducted wholly digitally.

Self-evidently, immediate definitional issues arise with such an option. Not only does it rely on defining what a 'fully dematerialised digital activity' might include, it also relies on there being a 'significant digital presence' before PE status may be found. Also, arguably this approach may be seen as trying to ring-fence e-commerce activities from the rest of the economy for tax purposes which might not be consistent with the general approach taken by the OECD in addressing its BEPS Action Plan.

Neutrality

Careful consideration will need to be given to the scope of this option to ensure it is tailored to in order to address the tax challenges presented by the key features of the digital economy without creating substantial tax incentives for particular ways of doing businesses. It should not result in a more favourable tax treatment resulting conducting business digitially as opposed to via a traditional method, for example.

Efficiency

This option could involve significant compliance cost burdens for businesses would need to ascertain whether their activities were being conducted in a requisite sense – i.e., conducting 'fully dematerialised digital activities' in a country with a 'significant digital presence'. It is submitted that these will not be easy practical issues that could lead to many disputes between taxpayers and tax authorities.

Further, it could result in higher compliance cost burdens if businesses end up with a large number of PEs as a result of implementing this option. To address administrative concerns, the OECD has noted in its Action Plan 1 report that:

> …businesses performing such fully dematerialised digital activities would be deemed to have a PE only if they exceeded certain thresholds which would indicate a substantial ongoing interaction with the economy of the market country. These thresholds could include, for example, measures of total contracts for digital goods and services that are concluded remotely, the active engagement of substantial numbers of users (for example, the number of active accounts for social platforms, the number of visitors to websites, or the number of users of online tools) as well as the overall level of consumption of the digital goods or services of the enterprise in the market country.[60]

While this sounds good in theory, the practical application of the above rules could be very cumbersome and costly for both taxpayers and also tax administrators. Such threshold rules

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[58] See <http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm>, frequently asked question ('FAQ') 9.

[59] Luc Hinnekens, 'Looking for an Appropriate Jurisdictional Framework for Source-State Taxation of International Electronic Commerce in the Twenty-first Century' (1998) 26(6-7) *INTERTAX* 192.

[60] OECD (2014), above n 7, 144-145.

may also carry with them an in-built incentive to disaggregate activities to fall before the relevant thresholds.

This option also presents significant challenges for tax administrators, particularly where taxpayers have no or minimal presences in a jurisdiction which would be a typical situation if the definitions of ‘fully dematerialised digital activities’ and ‘significant digital presences’ are satisfied.

Further issues of tax administration arise in relation to how profits would be attributed to a PE under this option and whether doing so would require the current rules for attribution of profits to PEs to be substantially modified.

Certainty and Simplicity

This option turns on two critical definitions – what constitutes ‘fully dematerialised activities’ and what constitutes a ‘significant digital presence’. The OECD has included some guidance on the possible factors in its Action Plan 1 report which have been discussed earlier, but it is submitted that further work will be necessary in this area to ensure that an appropriate balance is achieved between the need for a combination of factors to be broad enough to effectively address the challenges of the digital economy (which is no mean feat in and of itself) with the need to provide clear and objective standards to taxpayers in order to minimise potential disputes, compliance costs and also to avoid possible double taxation.

Effectiveness and Fairness

Seeking to achieve parity in the tax treatment of a transaction notwithstanding how it is conducted is consistent with effectiveness and fairness. By focusing on activities conducted in a jurisdiction rather than on the existence of a fixed place may make the option more effective and harder to take advantage of than the current rules. A PE can currently be avoided in many situations by simply not setting up physical premises in a jurisdiction and accessing a market through a web site or through frequent but short-term presences and this might not be fair in the eyes of some.

However, the requirement of some domestic threshold under this option may facilitate avoidance of a tax liability in the source country. Enterprises might, for example, split their operations between a number of tax entities to ensure that the specified thresholds are not met by any one entity. Also, to the extent that services can be ‘performed’ in one jurisdiction, and delivered to the customer in another jurisdiction without creating an on-site presence, the potential for avoiding a tax liability arising in the source country remains.

Flexibility

Proponents of this option would likely argue that it would make the PE concept more robust and appropriate in the modern business environment, which does not require traditional human presence in order to perform what they see as the same functions that lead to the finding of a PE. Similarly, it is argued that this option depends on economic activity, whether performed by people, machinery or electronic means, and therefore should be sufficiently flexible to deal with different business models and emerging technologies. The critical factor in this option is an economic presence through the performance of significant business activities at the customer’s location. The technological or commercial method of performance may evolve without affecting the economic presence. Provided that amendments to the PE definition are drafted in terms of concept rather than specific examples (e.g. web site), they should remain relevant and flexible.

A major drawback of such an option, however, is that it is unclear how profits would be measured and attributed and also how taxes would be collected. This is a significant practical issue that would need to be resolved to make this option practically workable.

Equity

To the extent that this option seeks to allow source taxation in cases where an enterprise makes use of a country's infrastructure to generate profits, this would be consistent with one approach to the supply-based view as to where profits originate.

It could be argued that this option address situations where business functions are performed in a country without any physical presence of the business in that country. Conversely, it could also be argued that this option would clearly cover cases where no business functions are performed by the enterprise itself in the jurisdiction.

Proportionality and broader considerations

This option deals with establishing an alternative nexus to address situations in which certain business activities are conducted wholly digitally. In order to decide if the proposals are is proportionate to the tax challenges they are intended to address, a more detailed evaluation and understanding of the extent to which businesses in the digital economy are in fact able to achieve significant sales in a market country without maintaining physical presence will be necessary. Also, the participation of users and consumers in value creation in the digital economy will need to be comprehensively understood.

Conclusion

It is too early to conclude on the likelihood of success of this option until the additional issues noted above are more fully considered. The additional work on these topics which will be completed by 2015 along with an analysis of the outcomes of the BEPS Project will allow the OECD to make informed decisions as to the relevance, urgency, and scope of these challenges and on the potential options to address them.

The OECD has also observed that if further actions are necessary to address BEPS concerns with respect to the digital economy, one possible approach would be to limit the application of potential options to address the broader direct tax challenges referred to in is Action Plan 1 report to situations in which such BEPS concerns arise. Similarly, such options could be pursued as domestic law measures to address BEPS in situations where there is no relevant double tax treaty in place (e.g., in the case of a tax haven). In this way, the OECD has noted that:

> Limiting application of these measures to BEPS concerns could effectively address these concerns without changing the paradigm for the allocation of taxing rights between source and residence jurisdictions.[61]

[61] Ibid 155.

5.3.3 Replace the PE threshold concept with a 'significant presence' test

Like the previous option, this a more fundamental proposal that goes to the broader issue of establishing nexus. Under this option, the existing PE concept would be replaced with a 'significant presence' test intended to respond to the changing nature of customer relationships in the digital economy while continuing to rely in part on physical presence. According to the Action Plan 1 report, the criteria for this test should reflect the contribution to value of these closer, more interactive customer relationships and would include:

- Relationships with customers or users extending over six months, combined with some physical presence in the country, directly or via a dependent agent.

- Sale of goods or services by means involving a close relationship with customers in the country, including (i) through a website in the local language, (ii) offering delivery from suppliers in the jurisdiction, (iii) using banking and other facilities from suppliers in the country, or (iv) offering goods or services sourced from suppliers in the country.

- Supplying goods or services to customers in the country resulting from or involving systematic data-gathering or contributions of content from persons in the country.

Analysis of replacing the PE threshold concept with a 'significant presence' test

While the previous option looked at establishing a new nexus to address situations in which business activities were conducted in a wholly digital manner, this option seeks to replace the existing PE concept with a 'significant presence' test.

The rationale for this option is to try to respond to the changing nature of customer relationships in the digital economy which continuing to rely in part on physical presences. The criteria for this test is intended to reflect the contribution to value of the closer and more interactive customer relationships in a digital economy.

This option also raises an important issue in the context of electronic commerce which is where income should be regarded as being generated, if all the value of what is sold is created in the residence country but the customers that determine that value are in the source country.[62] In such cases, from an economic perspective, the only contribution of a source country would often only be its customer base or market. In this context, it could therefore be argued that source countries provide little or no benefits relevant to the production of income that would justify source-based taxation under the benefit principle.

This argument can, however, be challenged on two grounds. First, Skaar provides support for the view that even if a business does not have a physical presence in the source country it benefits substantially from its infrastructure and therefore should make a contribution to the source country, consistent with the benefit theory of taxation. According to him:

> **A [permanent establishment] is merely a piece of evidence of economic allegiance, not the reason for source-state taxation.** The circumstance that short-term business operations may accumulate

[62] This issue was explored by some detail in the author's PhD thesis – see Pinto, above n 11.

> substantial profits from domestic sources indicates on the contrary that the taxpayer benefits substantially from the infrastructure of the host country, even though no [permanent establishment] exists. It seems that an enterprise which does not need to invest in immovable facilities, or other fixed places of business, may still derive considerable advantages from the community in which its income sources are located. Today, the performance of a business activity in another country, the duration of the activity and the profits arising from it, are per se significant arguments …[that] requires **all enterprises which obtain such benefits from a country to render a corresponding contribution to this society, whether or not they have a [permanent establishment]**.[63] (emphasis added).

Vogel similarly notes that historically ‘states have claimed to tax income received from sales to their residents, reasoning that this income would not have been earned without the market they provide.’

Second, despite possible claims by non-resident businesses which have no physical presence in source countries that they therefore derive no benefits from these countries, it is argued that source jurisdictions do provide significant benefits to companies that carry on business activities with them, even in the absence of a physical presence. Apart from Skaar’s analysis noted earlier, non-resident companies that do not maintain a physical presence in source countries nevertheless benefit from the source country’s legal system inasmuch as they rely upon it to enforce payment for transactions, uphold intellectual property rights (e.g., trademarks), and maintain a pro-competitive and conducive business environment. Indeed, the protection of intellectual property rights (e.g., in the case of computer software) is critical to vendors of intangible products and digitised services and the protection of these rights arise independently of the need for any physical presence to be maintained in the source country. Likewise, vendors of digitised content (including music and computer games) would not have a market in source countries that did not have a suitable telecommunications infrastructure or whose population lacked competency in computers. The provision of these benefits therefore adds weight to the case for source-based taxation under the benefit principle, even in the absence of a physical presence in a source country.[64] Further, source countries would need to provide for the waste disposal for packaging materials, consumer protection laws and an infrastructure upon which delivery vehicles can travel (in the case of physically delivered electronic commerce products),[65] and the provision of these benefits strengthens the case for the source-based taxation of electronic commerce transactions.

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[63] Arvid A Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (1991) 559-60 (framing his concept of the benefit principle in what he refers to as the ‘equivalence principle’, which he argues requires all enterprises which obtain benefits from a country to render a corresponding contribution to that country, whether or not they have a physical presence in that country).

[64] Charles E McLure Jr, ‘Source-Based Taxation and Alternatives to the Concept of Permanent Establishment’ in Canadian Tax Foundation (ed), *2000 World Tax Conference Report* (2000) 6:13 (n 28). India released a report on electronic commerce, where it is asserted that value is not created only in the seller’s country, but also arises from demand in the buyer’s country: ‘The Committee is also unable to accept that value-addition takes place only where manufacturing or marketing is done and that the customer base does not create any value-addition. Customer base creates demand. Without demand, there will not be any value’: Ministry of Finance, *Report of the High Powered Committee on E-Commerce and Taxation* (2001), <http://www.laws4india.com/indiantaxlaws/notification/ecomcontent.asp> (‘Indian Electronic Commerce Report’), cited in David Hardesty, ‘India to Go Its Own Way?’ (13 February 2002), <http://www.ecommercetax.com/doc/021002.htm>.

[65] Ibid 6:6 (observing that ‘mail order sales of tangible products may [likewise] place demands on public services’).

Therefore, in an electronic commerce context, as benefits would be provided to non-resident vendors even though they may lack a physical presence in source countries, it is arguable that the costs of providing these benefits should justify the right for source countries to tax the resultant income (or at least part of it) under the benefit principle. In other words, it is arguable that the benefit principle continues to justify source-based tax even in an electronic commerce context, where business may be conducted in source countries by non-resident vendors without the need for these vendors to maintain a physical presence in the source country.

Neutrality

Like the previous option, careful consideration will need to be given to the scope of this option to ensure it is tailored to in order to address the tax challenges presented by the key features of the digital economy without creating substantial tax incentives for particular ways of doing businesses. It should not result in a more favourable tax treatment resulting conducting business digitially as opposed to via a traditional method, for example.

Efficiency

This option could involve significant compliance cost burdens for businesses would need to ascertain whether their activities were being conducted in a requisite sense – ie, satisfying the 'significant presence test'. Some issues under the criteria indicated by the OECD in its Action Plan 1 report include:

- How will relationships with customers or users be defined?
- How will a close relationship with a customer be effectively establishes? and
- What constitutes systematic data-gathering or contributions of content from persons in a country?

It is submitted that these will not be easy practical issues that could lead to many disputes between taxpayers and tax authorities. Further, it could result in higher compliance cost burdens if businesses end up with a large number of PEs as a result of implementing this option.

This option also presents significant challenges for tax administrators, particularly where taxpayers have no or minimal presences in a jurisdiction. Finally, issues of tax administration arise in relation to how profits would be attributed to a PE under this option and whether doing so would require the current rules for attribution of profits to PEs to be substantially modified.

Certainty and Simplicity

This option turns on satisfying a 'significant presence' test. While the OECD has included some guidance on the possible criteria for this test in its Action Plan 1 report which have been discussed earlier, it is submitted that further work will be necessary in this area to ensure that an appropriate balance is achieved between the need for a combination of factors to be broad enough to effectively address the challenges of the digital economy (which is no mean feat in and of itself) with the need to provide clear and objective standards to taxpayers in order to minimise potential disputes, compliance costs and also to avoid possible double taxation.

Effectiveness and Fairness

This option might be a more effective option than current rules as it seeks to reflect the contribution to value of the close more interactive customer relationships that exist in the digital economy.

However, to ensure it is effective, careful consideration will need to be given to how the 'significant presence' test is defined and practically applied to ensure that it applies fairly to the spectrum of possible business interactions in the modern economy.

Flexibility

Proponents of this option would likely argue that it would be a more robust test than the existing PE concept in the modern business environment as it responds to the changing nature of customer relationships in the digital economy and better reflects the contribution to value to these closer, more interactive customer relationships.

A possible drawback of such an option, however, is that it is unclear how profits would be measured and attributed and also how taxes would be collected. This is a significant practical issue that would need to be resolved to make this option practically workable.

Equity

To the extent that this option seeks to better reflects the contribution to value of the closer, more interactive customer relationships in a digital economy it might be seen to comport with equity considerations. On the other hand, to the extent it may potentially not be consistent with principles that might apply to non-digital transactions it might be considered inequitable. Whether this occurs is largely a moot point as this will ultimately depend on how the substantial presence test is defined and applied in practice.

Proportionality and broader considerations

This option deals with establishing an alternative to the well-established PE concept to respond to the changing nature of customer relationships in the digital economy while continuing to rely in part on physical presence. In order to decide if the proposals are is proportionate to the tax challenges they are intended to address, a thorough evaluation and understanding of the extent to which businesses in the digital economy are in fact able to achieve significant sales in a market country without maintaining physical presence will be necessary. Also, the participation of users and consumers in value creation in the digital economy will need to be comprehensively understood.

Also, it is conceded that as this approach is based on the supply-demand approach to the determination of the origin of business profits, many would argue it is more appropriate to justify a consumption tax approach than an income tax approach to tax the relevant operations. However, a consumption tax could not be applied to e-commerce imports only, as this would violate the World Trade Organisation (WTO) rules (e.g. Article III of the General Agreement on Tariffs and Trade (GATT) which deals with the National Treatment on Internal Taxation and Regulation)). Also, a general consumption tax on e-commerce only would put e-commerce at a disadvantage compared with traditional commerce thereby violating neutrality.

Conclusion

It is too early to conclude on the likelihood of success of this option until the additional issues noted above are more fully considered. The additional work on these topics which will be completed by 2015 along with an analysis of the outcomes of the BEPS Project will allow the OECD to make informed decisions as to the relevance, urgency, and scope of these challenges and on the potential options to address them.

The OECD has also observed that if further actions are necessary to address BEPS concerns with respect to the digital economy, one possible approach would be to limit the application of potential options to address the broader direct tax challenges referred to in is Action Plan 1 report to situations in which such BEPS concerns arise. Similarly, such options could be pursued as domestic law measures to address BEPS in situations where there is no relevant double tax treaty in place (e.g., in the case of a tax haven).

Finally, while both this option and the previous one both deal with alternate formulations of nexus for determining PE status, it is suggested that this option might be more difficult for many countries to accept as it involves replacing the PE concept, the history of which dates back to the second half of the 19th century where it was developed as a remedy to overcome double taxation in intermunicipal relations in Prussia by specifying the need for a *stehendes Gewerbe* ('a trade with a fixed place of business') before full source-tax jurisdiction could be exercised.

5.3.4 Create a withholding tax for digital transactions

Another option discussed in the Action Plan 1 report is to impose a final withholding tax on certain payments made by residents of a country for digital goods or services provided by a foreign provider. This may also be regarded as an option requiring more fundamental changes to the existing international tax order and before reaching firm conclusions on the feasibility of this option, further details relating to this option need to be considered more fully including:

- The scope of payments withholding will apply to. These are not defined in the Action Plan 1 report and could potentially encompass all payments or be confined only to some payments (e.g., base eroding payments in the source country).
- Whether it is intended for withholding to supplement, rather than replace, the traditional PE nexus rules.
- How will withholding payments be collected? To avoid requiring withholding by individual consumers, one potential option raised in the Action Plan 1 report would be to require withholding by the financial institutions involved with those payments.
- At what rate will withholding apply and will it operate on a final basis or will net filing be allowed? In relation to this issue, it is submitted that net filing will be necessary to overcome potential excessive tax burdens that may be associated with a gross basis of taxation. For example, a 40% withholding tax on 600 of gross income would be a 100% tax on net income if the expenses of earning the 600 amounted to 360. If the expenses are greater than 360, then the source country would effectively

collect a tax at greater than 100% of the net income, and if the expenses exceeded 600, then a tax could be imposed in the absence of any net income.

Analysis of seeking to create a withholding tax for digital transactions

In terms of the existing literature, an option such involving withholding to address the challenges presented by the digital economy is not necessarily a new one. A source-country low-rate withholding tax for base eroding payments was proposed by Professor Doernberg[66] ('base erosion approach') and the author put forward a refundable withholding approach in his PhD thesis on e-commerce and source-based taxation.[67]

The rationale for proposing a withholding tax for digital transactions would be to address concerns that it may be possible to maintain substantial economic activity in a market without being taxable in that market under current PE rules due to lack of physical presence in that market. Also, such a withholding tax could be used as a primary enforcement tool for one of the new nexus standards described in the previous two options.

Neutrality

The proposed withholding option would be neutral with respect to the type of product and form of commerce if it were applied to all cross-border transactions. However, if the option were applied only to a certain defined subset of international transactions, such as only applying to e-commerce transactions and then only to some of these transactions – for example, if it applied only to business-to-business transactions and not to sales or other transactions made directly with private consumers, then it would not achieve neutrality.

It will therefore be important to define the scope of payments covered by such a tax in a way that avoids creating different tax results for similar businesses and also avoids disputes as to the characterisation of payments.

Also, if it only applies to business-to-business transactions, then the approach may be criticised for not being conceptually pure, since withholding would only apply to payments

[66] Richard Doernberg and Luc Hinnekens, *Electronic Commerce and International Taxation* (1999) 315; Richard L Doernberg, 'Electronic Commerce and International Tax Sharing' (1998) 16 *Tax Notes International* 1013; Richard L Doernberg, 'International Tax Issues: The Taxation of Business Profits' (Paper presented at the International Fiscal Association Asia Regional Conference on E-Commerce and International Taxation, Mumbai, India, November 2000); Richard L Doernberg, 'Electronic Commerce: Changing Tax Treaty Principles Bit by Bit?' (2001) 3(3) *Tax Planning International e-Commerce* 7.

[67] Pinto, above n 11, 237 ff. The refundable withholding approach put forward in the thesis attempts to reconceptualise the way source is defined for active business income by putting forward an alternative to the permanent establishment threshold for determining source-country tax nexus. It also represents an attempt to simplify the way source is defined for passive income by seeking to apply withholding at a standard rate to all income covered by the proposal irrespective of the character of the income. Therefore, the approach seeks to simultaneously present a possible reconceptualisation of the way source is defined for both active and passive income. The refundable withholding approach draws upon elements from other proposals (eg, withholding), however, it also includes other elements to establish source-country tax nexus. It therefore represents a hybrid approach to reconceptualising the way source is currently defined for both active and passive income.

made by businesses and not consumers, as the criteria for applying withholding under this approach in such a way, presumably base erosion, would only occur in the case of a business that could deduct such a payment or include it in its cost of goods sold.

At the same time, from an administrative point of view, excluding consumers from withholding is desirable, as it would be practically difficult to successfully implement a system to collect a withholding tax on each transaction with consumers. The OECD Action Plan 1 report responds to this concern by noting that withholding in these cases could be undertaken by financial institutions involved with those payments. This would no doubt raise concerns from these institutions in terms of their cost structures and compliance obligations in having to verify transactions subject to withholding and collect the tax.

Further, if transactions with consumers were to be excluded from withholding this could confer a competitive advantage for out-of-state vendors, who could sell directly to consumers in source countries and not be subject to taxation in those countries in the absence of a PE.

To the extent that non-resident suppliers of goods and services to a domestic business would be subject to a withholding tax which could be final, the option would also appear non-neutral between foreign and domestic business suppliers.

Efficiency

The requirement to withhold under this option could impose significant compliance burdens on local businesses. Collection of tax and information reporting would be required on a vast number of individual transactions. Also, withholding would only be required with respect to payments for goods and services supplied from abroad but it could be practically difficult for the customer to verify the source of a particular purchase from online vendors. Also, as withholding would require enterprises to keep track of e-commerce payments and tax administrations would have the difficult task of verifying e-commerce payments made by enterprises in their country.

The option of filing a tax return as if the income were attributable to a PE would also have significant compliance and administrative consequences. A large number of enterprises that simply export to a country would now have tax filing obligations under such an option. Also, in most cases where the option would be chosen, all the relevant expenses would be incurred outside the country and the local authorities would not have access to accounting records or employees at a physical location in the country. The administrative burden of determining and verifying the tax would therefore be substantially increased.

Also, to the extent that enterprises would have to pay a withholding tax on business payments made to them from a particular country before having the possibility to recover that tax following the filing of a return, the base erosion option would impose a significant compliance burden on foreign enterprises. Such a system could also have significant effects on enterprises' cash flows, especially in the case of businesses that deal with high-value but low profit margin goods or services.

It is also arguable that a withholding tax such as that suggested by this option resembles an excise or expenditure tax. If this was the case, it could constitute an impediment to international trade and would therefore be an inefficient form of taxation, contrary to encouraging the growth of the digital economy. However, if the tax is intended to be creditable, it should not increase the overall liability of an electronic commerce business. Second, an electronic commerce business should have the option to file a return on a net basis in the source country if the gross tax levied would exceed the tax on its net income. In light of these two features, any efficiency concerns may be effectively allayed, though as noted, net filing in many countries may have the effect of imposing excessive compliance burdens for electronic commerce businesses.

One of the main concerns relating to a withholding approach is that it is inherently inefficient as it imposes withholding on a gross basis, which could result in excessive taxation, or even taxation being imposed in the absence of net income.

Both of these results could produce outcomes that are distortionary and the examples represent strong reasons why any withholding rate should be set at a very low level. The distorting effects of a gross-based withholding tax could also be ameliorated by allowing taxpayers to file on an assessment basis in the source country. The argument for a low rate is further supported by the fact that withholding would apply to a greater range of transactions than in a traditional withholding context. Also, international consensus is more likely to be reached if a lower rate is adopted.

Finally, countries will need to ensure that the tax is enforceable and this may involve additional rules to facilitate both the collection and enforcement of the tax. This may prove to be difficult, especially in a situation where a business may have no physical presence (or assets) in the source country.

Certainty and Simplicity

A withholding approach could be consistent with the principles of certainty and simplicity if it was applied in its purest form, i.e. a single withholding tax imposed on all base eroding payments (e.g., deductible cross-border transactions). However, the principles of certainty and simplicity would not be met to the same extent if distinctions began to be drawn among transactions.

A withholding system is also simple as it seeks to operate within the existing international tax regime by adopting a system based on withholding, which is a familiar system of taxation under current international tax rules. There is no need for a tax authority to identify the foreign recipient of the payment, as long as it is clear that the payment is made to a non-resident. The lack of physical presence is therefore not an obstacle to the collection of tax.

The approach can also be considered simple if it applies an objective standard, such as base erosion, to determine the right to withhold tax, rather than depending on the characterisation of income, which can be subject to differing interpretations by countries, thereby raising the risk of inconsistent characterisations of transactions between countries and the consequent risk for double taxation. This simplicity could furthered by not extending withholding to cases of consumption, because in most of these cases, no deduction is permitted for consumption, and hence no base erosion would occur. This position is also administratively sensible, as tax collection problems would exist with such a proposal if it extended to cases of private consumption; not to mention the political unpopularity of such a suggestion.

Apart from its simplicity, a base erosion approach would be enforceable due to the link that exists under the proposal between withholding and deduction. That is, in order for a taxpayer of a source country to be able to claim a deduction for a payment made to a residence country business, it would first need to substantiate that it properly withheld tax. If this could not be evidenced, then no deduction would be allowed under the proposal. In this way, the system creates a powerful incentive for payers to deduct the tax and could therefore create a self-enforceable system, which is an administratively desirable feature of the approach.

Finally, to determine whether a withholding approach would be certain and simple, the mechanics of how such a system would operate needs to be identified. As part of this inquiry, the following types of questions would have to be answered:

(i) Is it realistic to expect that a uniform withholding rate could be applied across-the-board to all transactions? Differential withholding rates might be appropriate to reflect different profit margins or political imperatives. If so, how will different rates be determined?

(ii) Will withholding apply on a transaction-by-transaction basis?

(iii) When, where, and to whom should the taxpayer turn over withheld amounts?

Effectiveness and Fairness

As discussed under the preceding option, the imposition of a withholding tax is an effective tax collection mechanism except in cases of business-to-consumer transactions. In light of this, business-to-consumer transactions could be excluded from withholding, which might be a serious limitation if the main justification for applying withholding tax to e-commerce transactions is the concern that a country may be unable to levy source tax in cases where foreign enterprises carry on substantial e-commerce operations in that country.

If they are included then a more effective collection mechanism needs to be considered. The OECD Action Plan 1 report seems to contemplate that in cases involving individual consumers, financial institutions could assume the withholding obligations. However, as these institutions would incur additional costs in reliably determining which payments were within the scope of the tax as well as having to collect withholding taxes under the proposed system, perhaps they could be compensated by being authorised to retain a portion of the tax withheld to help defray their costs. Paying these intermediaries would also have the additional advantage of creating an incentive for them to collect the tax.

If withholding only applies to business-to-business payments it could give rise to arbitrage opportunities (e.g., it could transactions where sales are made directly to consumers rather than to local distributors).

Also, while the option of filing a tax return on a net basis may be desirable for other policy reasons, as such a return would be produced by a non-resident enterprise with no physical presence in a country, it may be difficult to verify.

If the withholding tax applied without regard to profitability, it might be regarded as being unfair (e.g., for start-up enterprises) which might not generate profits for several years. The option of filing a tax return as if the income were attributable to a PE partly addresses this concern but this would be subject to the number of taxation years during which such an option would require an enterprise to file on a net basis. Also, the compliance costs associated with filing such returns should not be underestimated.

Flexibility

A withholding option would have some flexibility since a state could always adjust the withholding rate to be applied to different products and services or even exempt some of them. Such adjustments, however, would make the system less certain and increase tax planning opportunities. The option of filing on a net basis under a withholding options provides additional flexibility under this option.

Equity

As discussed earlier, the rationale for proposing a withholding tax for digital transactions would be to address concerns that it may be possible to maintain substantial economic activity in a market without being taxable in that market under current PE rules due to lack of physical presence in that market. Also, such a withholding tax could be used as a primary enforcement tool for one of the new nexus standards described in the previous two options.

The arguments to support levying a tax based on a market or customer base have also been discussed earlier and accordingly will not be repeated here, save to say if they are accepted then they would justify the taxation of such payments on grounds including the benefit theory as well as equity considerations, including the principal of inter-nation equity.

Proportionality and broader considerations

Similar to the 'substantial business presence' test discussed earlier, as this approach is based on the supply-demand approach to the determination of the origin of business profits, many would argue it is more appropriate to justify a consumption tax approach than an income tax approach to tax the relevant operations. However, as also noted earlier in the paper, a consumption tax could not be applied to e-commerce imports only, as this would violate the WTO rules as discussed earlier. Also, a general consumption tax on e-commerce only would put e-commerce at a disadvantage compared with traditional commerce thereby violating neutrality.

Conclusion

The option of withholding seeks to respond to the ability that electronic commerce offers for a business to earn profits in a country without it having to maintain a physical presence in that country which places pressure on source-country taxation based on the application of the existing PE threshold. This option requires further consideration of the issues identified in the preceding analysis. There are many practical, theoretical and also political considerations that need to be carefully analysed and considered before this option is likely to become a reality. Nevertheless, as discussed, withholding is an existing mechanism which is well-understood and offers certain advantages that could be useful in providing a more stable and appropriate basis for source-based taxation of international electronic commerce transactions than the current international tax system.

5.3.5 Introduce a bandwidth or 'Bit' tax[68]

A final option canvassed in the Action Plan 1 report involves taxing a websites' bandwidth use. Under the proposal described in the report, such a tax would be based on the number of bytes used by the website, although in order to introduce an element of progressivity, different tax levels could apply depending on the enterprise size or the turnover. For administrative purposes, such a tax would apply only to businesses that exceed minimum threshold of annual bandwidth used. In order to maintain equity between digital businesses and traditional businesses, the proposed bandwidth tax would be creditable against corporate income tax. This final option could also be considered as once which would require a more fundamental change to existing rules as compared with some of the other options contained in the Action Plan 1 report.

Analysis of seeking to introduce a bandwidth or 'Bit' tax

The idea of a bit tax was originally conceived by Arthur J Cordell and Thomas Ranald Ide and was first put forward in their paper, 'The New Wealth of Nations', which was presented at the Club of Rome in 1994.[69] Subsequently, in 1996 and then again in 1997, a High Level Expert Group ('HLEG') chaired by Professor Luc Soete, was appointed by the European Commission to advise on the social and societal aspects of the information society. This group recommended that further research should be conducted on the bit tax proposal to examine whether such a tax could be effectively designed to accommodate Internet communications and information flows.[70] Since being originally proposed, the idea of a bit

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[68] What follows in this section draws on previous research conducted by the author in this area: Dale Pinto, 'Finding solutions for taxing electronic commerce: A consideration of two polarised alternatives - part 1' 10 (2004) *New Zealand Journal of Taxation Law and Policy* 391-402; Dale Pinto, 'Finding solutions for taxing electronic commerce: A consideration of two polarised alternatives - part 2' 11 (2005) *New Zealand Journal of Taxation Law and Policy* 69-91.

[69] Arthur J Cordell and Thomas R Ide, 'The New Wealth of Nations' in Arthur J Cordell *et al*, *The New Wealth of Nations: Taxing Cyberspace* (1997) 20. Professor Luc Soete and Karin Kamp have also conducted research in this area: see, eg, Luc Soete and Karin Kamp, 'The Bit Tax: Taxing Value in the Emerging Information Society' in Arthur J Cordell *et al*, *The New Wealth of Nations: Taxing Cyberspace* (1997) 83. Aside from these works, the Maastricht Economic Research Institute on Innovation and Technology ('MERIT'), which is a research institute of the Maastricht University, has also conducted research in this area, which is available at their 'Cybertax Homepage', < http://meritbbs.unimaas.nl/cybertax/cybertax.html>.

[70] Luc Soete and Karin Kamp, 'The Bit Tax: Taxing Value in the Emerging Information Society' in Arthur J Cordell *et al*, *The New Wealth of Nations: Taxing Cyberspace* (1997) 83 (noting that the 1996 report, *Building the European Information Society for Us All* – an interim report of an independent group of experts established by the European Commission – contained a recommendation for the investigation of 'appropriate ways in which the benefits of the Information Society (IS) can be more equally distributed between those who benefit and those who lose. Such research should focus on practical, implementable policies at the European level, which do not jeopardize the emergence of the IS. More specifically, the expert group would like the Commission to undertake research to find out whether a "bit tax" might be a feasible tool in achieving such redistribution aims.'). The final report of the group of experts was finalised in April 1997 and contained a similar recommendation: see High Level Group of Experts, Luc Soete Chairman, *Building the European Information Society For Us All* (April 1997), available at <http://meritbbs.unimaas.nl/publications/2-hleg.pdf> 42-3 ('Recommendation 8. Maintaining national government revenues in a increasingly global environment … there is a need for more fundamental reflection and research on alternative taxation systems. The "bit tax" could be such an alternative, although its features and implementation aspects need more study.').

tax generated considerable reactions among the media, governments and users alike.[71] Subsequently, the bit tax proposal has been widely condemned and has almost been universally rejected by most governments and international bodies that have considered the proposal.[72]

Perhaps it is not surprising that although the digital economy is rapidly developing, any suggestion for a new tax is likely to be met with scepticism and to be quickly rejected.[73] On the other hand, proposals for alternate tax formulations in light of changing economic conditions, are nothing really new.[74] Ready examples in recent times can be found in

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[71] Ibid 84 ('Such reactions range from immediate adherence and even proposals for implementation to disbelief and disgust.'); Richard Krever, 'Electronic Commerce and Taxation - A Summary of the Emerging Issues' (2000) 6(6) *Asia-Pacific Tax Bulletin* 151, 157 ('The bit tax proposal has thus far been almost universally rejected by the governments and international bodies that might have imposed the tax. It should be recognized that much of the rhetoric against bit taxes … is offered by parties that are not entirely disinterested. For example, the US federal government has been one of the strongest advocates of tax-free Internet commerce.').

[72] See, eg, European Communities, *A European Initiative in Electronic Commerce* (COM(97)157), available at <http://www.cordis.lu/esprit/src/ecomcomx.htm> [57] ('While some commentators have suggested that there might be a need to look at alternative taxes such as a "bit tax", the Commission is of the opinion that this is not appropriate since VAT already applies to these transactions.'); William J Clinton and Albert Gore Jr, *A Framework for Global Electronic Commerce* (1997), available at <http://www.iitf.nist.gov/eleccomm/ecomm.htm> [I.1] ('US Framework Report') [I.1] (advocating that the taxation of Internet transactions should be developed under existing concepts and principles and no new taxes should be imposed on Internet commerce); Advisory Committee on Electronic Commerce, André Vallerand Chairman, *Electronic Commerce and Canada's Tax Administration: A Report to the Minister of National Revenue from the Minister's Advisory Committee on Electronic Commerce* (April 1998), available at <http://www.ccra-adrc.gc.ca/tax/business/ecomm/ecom0-e.html> [4.2.2.4] ('Canadian Report') [4.1.3.1] ('In the Committee's view, the concept of a bit tax is contrary to one of the Committee's fundamental principles - not imposing new taxes on electronic transactions.'); The Parliament of the Commonwealth of Australia, Joint Committee of Public Accounts and Audit ('JCPAA'), *Report 360: Internet Commerce - To Buy or Not to Buy?*(1998) 92 ('JCPAA Report') 67('The Australian Government has ruled out the use of a bit tax…'); Ibid 69 (' … and the Committee supports the Government's stated position on this matter.'); OECD, *ELECTRONIC COMMERCE: Opportunities and Challenges for Government* (1997) 1 ('As a matter of principle, the Group opposes proposals that are oriented to taxing the process of data exchange (the "bit tax"), as unworkable and potentially discriminatory to Electronic Commerce activities and to normal business communications.'). One of the few countries to express approval with the bit tax proposal is Italy: see Richard Doernberg and Luc Hinnekens, *Electronic Commerce and International Taxation* (1999) 378 ('For Italians, the bit tax on information and messages being electronically transmitted and the tax on PC's are to be recommended.').

[73] See Mike McCracken, 'Perspectives on a Bit Tax' in Arthur J Cordell *et al*, *The New Wealth of Nations: Taxing Cyberspace* (1997) 14 ('Partly this flows from the belief that everything to date has been "right" and therefore needs no changes, just patience.'); Soete and Kamp, above n 70, 84 ('on the side of the technical experts, the reaction has also been, by and large, negative: "bits" are, or soon will be, an irrelevant measure of transmission intensity; bits are difficult if not impossible to monitor; "broadband capacity is in effect infinite; etc.'); Ibid 88 ('the Internet [should be declared] a duty-free zone for goods and services that are bought and delivered electronically … to ensure that Internet commerce is not "encumbered" by customs duties or any forms of taxation such as a bit tax.').

[74] See, eg, Soete and Kamp, above n 70, 88 ('Just as one to two hundred years ago economic discussions were dominated by the "corn tax", reflecting the importance of grain for the national economy, today the dominant issue should be how governments can adjust their tax base in line with the changing economic structure

proposals including the Tobin Tax,[75] the United Nations proposals for a global email tax,[76] the carbon tax proposal[77] (which some countries have already implemented and others have since repealed, including Australia), as well as other transactional taxes including a telecommunications tax or PC tax.[78] More surprising however, in the case of the bit tax proposal, is the widespread and sustained rejection of the mere recommendation of the HLEG to conduct further research into the feasibility of a bit tax: rejecting a new tax proposal is one thing; but to reject the further exploration of it at the outset, is quite another, and in the author's view, very short-sighted. Less surprising, however, has been the outrage and

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towards an information society and the increasing importance of information transmission for economic production and consumption.').

[75] The Tobin tax was proposed by James Tobin, the 1981 Nobel Prize-winning economist from Yale University. Frequently referred to as a 'speculator's tax', Tobin proposed a tax on foreign exchange transactions which, he believed, would contribute to international policy coordination and needed autonomy on national and monetary policies: see James Tobin, 'Speculators Tax' in *New Economy* (1994); see also J A Frankel, 'How Well Do Foreign Exhange Markets Function: Might a Tobin Tax Help?' (NBER Working Paper Series, No 5422, NBER, Cambridge, MA, 1996) (arguing that a Tobin tax has been advocated for three purposes: 1) to restore monetary autonomy for national governments; 2) to reduce excess volatility in capital markets by making a short-term transaction relatively expensive; and 3) as an instrument to raise revenue for international projects or organisations.). Further information regarding the Tobin tax initiative may be found at <http://www.ceedweb.org/iirp/>. When examining the feasibility of a bit tax, much can be learned from the application of a Tobin tax on financial transactions, even though the purposes may be different - with a bit tax being designed primarily for revenue generation, while a Tobin tax is designed to reduce speculation. In this respect, McCracken notes that '[o]nly more recently has it [the Tobin tax] become a focal point for providing alternative financing for international development and institutions.': Mc Cracken, above n 73, 15. A tax which is similar in principle to a Tobin tax that has been discussed in the literature is a 'transaction tax', which 'would be levied on money flows on the internet and its on-line services. It would be automatically withheld by the banks involved in money transfers between accounts or in the issuance of electronic cash. Its proponents argue that a rate of 1%, for example, might suffice to replace all existing taxes, as the volume of payments is much greater than individual country's GDPs.': see Doernberg and Hinnekens, above n 72, 362.

[76] The United Nations, in its *1999 Human Development Report*, available at <http://www.undp.org/hdro/report.html>, proposed a tax of the equivalent of one US cent on every 100 emails that an individual might send. See also, Katie Dean, 'UN Proposes Global Email Tax' *Wired News*, 13 July 1999, available at <http://www.wired.com/news/print/0,1294,20705,00.html> (outlining the proposal for a global email tax); Declan McCullagh, 'UN Retreats from Email Tax' *Wired News*, 16 July1999, available at <http://www.wired.com/news/print/0,1294,20784,00.html> (noting that the UN email tax suggestion created much controversy and the UN subsequently retreated from its suggestion to impose such a tax).

[77] Barry Bracewell-Milnes, 'Summary of Proceedings of the Symposium "Visions of the Tax Systems of the XXI Century"' (Summary of Symposium at the 50th Congress of the International Fiscal Association, Geneva, 5 September 1996) 129 (arguing that an increased use of 'green taxes' and other charges imposed on those who pollute or otherwise degrade the environment could be considered likely in the future); Ibid 136 (also observing that '[t]here was acute political sensitivity to the introduction of an energy tax.').

[78] A telecommunications tax could be levied as a percentage of the gross revenue of telecommunication companies and other information intermediaries: see, eg, McCracken, above n 73, 16. A PC tax could be imposed on personal computers or other physical internet infrastructure located in the territory of a taxing country: see Doernberg and Hinnekens, above n 72, 363 (also observing that '[a]nother tax could be levied on automated teller machines (ATMs) and collected by their operators from customers using them for their financial transactions.').

negativity expressed toward the proposal by individual Internet users whenever it is raised as an option to deal with the challenges presented by the digital economy.[79]

Neutrality

The principle of neutrality can be used to advance arguments both in favour and against a bit tax. In support of a bit tax, it can be argued that by not adjusting a nations tax base for changes in the economy, this will result in a non-neutrality in the treatment of different distribution or communication systems, as new electronic distribution systems may allow for the avoidance of prevailing tax systems. In the European Union, for example, the issue of how to levy VAT on telecommunication services provided from outside the European Union has already generated concerns in this area.[80] Similar and ongoing concerns that relates to the digital downloading of products over the Internet also exist.[81] The concern is that businesses that supply such products (e.g., CDs, games, and software) within the European Union generally must charge VAT on such supplies, while non-European suppliers of digitised products do not have to charge VAT and therefore potentially enjoy a competitive advantage over suppliers based within the European Union.[82]

Non-neutralities like those evident in these examples will concern countries that are net importers of electronic commerce goods and services, as if they are unable to tax such transactions, they may suffer tax base erosion and additionally, their businesses may be at a

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[79] Soete and Kamp, above n 70, 98 (n 3) ('Since August 1996, when this paper was first circulated and made available on the WWW, we have received no less than 200 emails reacting to the bit tax proposal … We are grateful for the many comments, often by outraged individuals, that we have received so far.').

[80] The so-called 'American route', referring to the well-known case of US suppliers providing telecommunications services to European customers at lower rates than Europe's telecommunication operators could is a good example. Several reasons were offered to explain why US operators could provide cheaper access, but a main reason was that no VAT (or sales tax) was paid by their foreign customers. This led to changes in the telecommunications area on 17 June 1999, under which telecommunications services are now taxed at the place of establishment of the recipient of the services and no longer at the place of establishment of the service provider: see Council Directive 1999/59/EC amending Directive 77/388/EEC as regards the value added tax arrangements applicable to telecommunications services.

[81] This includes CDs, games and software.

[82] In June 2000, a working party of the European Commission proposed a new regime for VAT, which would impose VAT on the sales of downloaded goods and services: see David Hardesty, 'Europe Proposes New Taxes on Non-EU Sellers' (18 June 2000), available at <http://ecommercetax.com/doc/061800.htm>. The proposals were ultimately rejected by the Commission's Council of Economic and Finance Ministers ('ECOFIN') in November 2000: see David Hardesty, 'EU Withdraws Proposals for VAT on Digital Sales' (4 February 2001), available at <http://ecommercetax.com/doc/020401.htm>. This working party subsequently revised its proposals, which were considered again at a meeting in June 2001. However, this meeting once again saw the proposals fail as the United Kingdom did not agree to the proposed new rules. And since all fifteen European Union countries must agree for proposals such as this to be approved, the dissension of the United Kingdom stands in the way of such proposals being adopted: see David Hardesty, above n 64. The New Zealand Government is currently considering similar proposals to impose GST on software and other digital services provided over the Internet, which if passed by their parliament, will be effective toward the end of 2002: see Adam Creed, 'New Zealand Proposes Tax on E-Commerce' (28 June 2001), available at <http://www.newsbytes.com/news/01/167380.html>. A discussion document issued by the New Zealand Treasury on this matter is available at <http://www.treasury.govt.nz/tax/>.

competitive disadvantage compared with their foreign counterparts. This may support an argument to adjust the tax system for changes in the economy by imposing a bit tax to accommodate these transactions.

There are, however, many arguments against a bit tax that may be also be supported by the principle of neutrality. First, assuming that ISPs are given the responsibility of collecting and remitting a bit tax,[83] and if the tax is passed on to consumers (as would seem likely), then it is arguable that the tax will be passed on in a non-neutral way, as ISPs would be unlikely to be able (or willing) to separate electronic commerce transactions from other (non-electronic commerce) transactions. Indeed, because a bit tax would apply to all transactions, irrespective of their commerciality, this result is arguably non-neutral, as many of these transactions are currently untaxed (e.g., facsimile transmissions and data in private networks).[84] On the other hand, it may be argued on the grounds of simplicity, that it is desirable that the tax includes all users - private and commercial alike. Also, since the tax revenue which is collected from a bit tax would presumably be used for the welfare of all citizens, the tax should be comprehensive and apply to all users. In any event, as the majority of electronic commerce activity is currently dominated by the business-to-business sector, it follows that most of the bit tax burden would fall on commercial users.[85]

The principle of neutrality also suggests that taxes should be designed to minimise interference with the production process, which should be governed by economic and business considerations rather than tax one's. A bit tax would contravene this principle if it had the effect of discouraging a more efficient means of delivery – electronic rather than physical – for goods and services that are sold.[86] This could produce inefficiencies, in that consumers could prefer mail-order sales (which would not be taxed under a bit tax) over more efficient electronic commerce sales (which would be taxed under a bit tax). Also, a bit tax could cause valuable resources to be diverted from productive uses (production efficiency) to non-productive uses (how to minimise/avoid the bit tax).

In summary, by taxing business transactions in a different manner simply because they are conducted by electronic commerce means rather than physical means arguably violates the principle of neutrality and could produce the inefficiencies referred to above.

One of the other major criticisms of a bit tax is that it is indiscriminate in its application in that it seeks to tax all digital communications, from an e-mail through to a valuable business

[83] The most likely collectors of such a tax would either be ISPs or financial intermediaries.

[84] For the same reason, it could be argued that a bit tax constitutes a tax on freedom of speech: see, eg, Luc Soete and Bas Ter Weel, 'Cybertax' (1998) 30(9) *Futures* 869 (n 9). ('It penalises the private user as much as the commercial user, with no differentiation tax-wise between them.').

[85] See OECD, *The Economic and Social Impact of Electronic Commerce: Preliminary Findings and Research Agenda* (1999) 34 ('OECD Economic and Social Report').

[86] For example, instead of transmitting software electronically, companies may revert to selling and shipping disks.

transaction.[87] The universal application of a bit tax means that it is not related in any direct way to the value of a communication, but rather focuses on the volume of information transmitted. That is, it would be the number of bits transmitted that would count, irrespective of the underlying nature of what was being transmitted.

It is argued that by taxing on the basis of volume rather than value, distortions and economic anomalies will arise since valuable information that may be contained in a relatively small transmission would bear a smaller bit tax than less valuable information which may involve the transfer of large quantities of bits, thereby incurring a larger bit tax liability.[88] For example, valuable information (e.g., a commercial database) that may be contained in a small amount of digital information would, under a bit tax, be subject to a smaller level of tax than the transfer of a movie, which would involve the transmission of a large amount of digital information and would therefore be subject to a large bit tax. A commercial database would have relatively more value than a downloaded movie, but would be undertaxed by a bit tax in the example given. Also, the disproportionately high bit tax that would apply to a movie would likely constitute an impediment to it being traded electronically.

Outcomes such as that described above could lead to businesses modifying their behaviour to minimise or simply avoid the tax – for example, by compressing data before transmitting it and by keeping data in analogue form rather than converting it to a digital format. Moreover, much data that is currently exchanged between companies is not related to any function that is presently taxed. Under a bit tax, such transmissions would be taxed - that is, a bit tax could bring many data transmissions that are unrelated to the transactional aspects of electronic commerce into the tax net (e.g., e-mail messages).[89] Finally, as a bit tax does not differentiate

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[87] Any measure that would provide some indication of transmission intensity could be used as the base for a bit tax. The number of bits flowing over digital networks is considered more representative of such transmission intensity than time or distance would be: see, eg, Soete and Kamp, above n 70, 89 (arguing that '[o]nly in the case of communication systems using a constant number of bits per second, such as a telephone conversation, will there be a straightforward relation between time and transmission intensity.') In other words, a bit tax would apply to all bits and would treat all bits equally.

[88] On the other hand, it could be argued that just as existing petrol taxes, bridge tolls and licence fees for motor vehicles apply based on the weight of the vehicle, or the amount of petrol used rather than the value of the commodity carried by the vehicle, a bit tax similarly taxes all bits of information without regard it its inherent value. Further, Cordell argues that a bit tax does not seek to apply a tax in the absence of value; on the contrary, he argues that interactivity makes digital transactions valuable and therefore taxing the bits of information which represents such transactions is justified: see Arthur J Cordell, 'New Taxes for a New Economy' (1996) 2(4) *Government Information in Canada* 1, available at <http://www.usask.ca/library/gic/v2n4/cordell/cordell.html> 2 ('Interactivity makes the transaction valuable. A broadcast message may or may not add value, that is, if it is heard. An interactive transaction -- a conversation, data search, accessing an ATM -- is an activity you choose to do because it does something for you. You get something for doing it, you get something out of doing it -- otherwise you wouldn't be doing it. It is this new value, this new productivity that is creating so much new wealth in networks … [therefore] [a]ll interactive digital information would be subject to the new tax.').

[89] At the same time, one would question whether the imposition of a small usage fee for e-mail would act as a disincentive for businesses to use this as a form of communication given the advantages of its immediacy and convenience.

between commercial transactions and free information, it seeks to tax knowledge, which many ideologically believe, should be free.[90]

One way of accommodating these concerns would be to consider whether a lower rate should apply for high information items (e.g., movies) downloaded to consumers, due to their relatively low-value. Differential rates would, however, detract from the simplicity of a bit tax and may lead to taxpayers trying to artificially re-classify their transactions in order to attract the lower rate. Also, as originally formulated, a bit tax does not cater for lower rates or exemptions.[91]

Efficiency

The greater the extent of its automation, the easier should be the administration of the tax.[92]

The bit tax is easily identified, and its collection could be concentrated in a few hands, such as financial intermediaries or ISPs. Moreover, it is a tax that can be easily collected and one that would be difficult to avoid. Even if collected at an international level in conjunction with a supranational body, such a system would impinge less on national tax systems and national sovereignty than formulary approaches to determining the global income of entities. That is, a supranational institution would have a confined role in collecting and distributing the bit tax collected.[93] A bit tax could be integrated into the existing tax system, in a similar way that withholding taxes are. For example, if a company has a permanent establishment in a foreign country, it could receive a credit to be applied against tax assessed in that country, equal in amount to that country's share of bit tax paid by the company. In this way, the income of the company could still be based upon its presence in the foreign jurisdiction, and countries that grant a tax credit would not lose any money since they would have received recompense in the form of distributions of the bit tax. Importantly, a credit mechanism would also be a means of avoiding double taxation.

Similarly, payments made to acquire digital products or information, could be excluded from the treaty definition of a royalty thereby eliminating characterisation problems associated with electronic commerce transactions. This could also promote the simplicity of a bit tax and also assist in the avoidance of double tax, which could otherwise arise by countries characterising electronic commerce transactions differently.

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[90] See, eg, Krever, above n 71, 157 ('Critics of the bit tax point out the tax could not differentiate between purchases of products or services and downloading of free information. A bit tax, they assert, would therefore be a tax on knowledge, a somehow inherently undesirable outcome.').

[91] A bit tax does not seek to exempt transactions on the basis of the category of taxpayer either – eg, no exemptions would apply for educational, governmental or charitable organisations – despite arguments on the grounds of social equity (eg, ensuring broad access), and also in terms of ensuring that the bit tax does not represent an impediment to the growth of electronic commerce.

[92] Though appropriate integrity and security measures would need to be in place to ensure the correct amount of tax was collected and also to ensure it was not subverted electronically.

[93] Admittedly, distributing the bit tax would involve agreement on an appropriate revenue sharing mechanism, which may need to be formulary. Nevertheless, it is argued that the formula would be easier to agree upon and could utilise objective criteria like per capita usage of the Internet to distribute the bit tax to countries.

In any tax reform proposal, and especially in the case of a proposed new tax, an important consideration is to ensure that the possibility of double tax is avoided. In the case of a bit tax, this means that it must be clear which jurisdiction will tax transmissions – originating country or destination country – and mechanisms to avoid double tax must be in place. A familiar and relatively simple way of relieving potential double tax would be through one country granting a credit for tax paid in another country. In the context of a bit tax, taxpayers could be given a tax credit in countries in which they filed income tax returns, which could then be applied against income tax payable in those countries. The advantage of such a system would be that no additional tax burden would accrue to such companies, and less of an incentive to move a fixed place of business would exist. Compliance could be ensured if the availability of the tax credit was made contingent upon the filing of a return by a company. Such a system would also allow tax liability in foreign countries to be determined based upon the income that taxpayer's earn from permanent establishments within those countries. In other words, the bit tax and credit mechanisms could be integrated as part of the existing income tax system in the same way that withholding taxes currently are.

There are, however, other aspects of double tax concerns that need to be addressed. Many countries have universal service charges already included in the structure of their telecommunications tariffs, and additionally, telecommunications taxes already apply to data transmissions that are conducted over public switched networks. In this context, the imposition of a bit tax may be seen as being additive to these existing taxes. Similarly, concerns would be expressed that since tax is already paid when transmitting equipment is purchased, and tax may also be paid on the phone call to effect information transmissions, to impose a bit tax on top of this would be taxing that which is already taxed.

Against this, some have argued that a bit tax avoids double tax on the basis that it would only apply to the value added portions of interactive digital transmissions.[94] However, it is argued that in the case of electronic commerce transactions, it is difficult to refer in any meaningful way to a tax on 'value added.' For example, try to tax the valued added of a phone call by levying a bit tax on the call has little meaning to it.[95] Indeed, this very aspect prompted the proposed bit tax to be based on transmission intensity rather than any concept of value added, as it was believed this would be a more representative measure.[96]

While it is not within the scope of this paper to examine tax administration issues, brief mention must be made of the compliance and enforcement concerns of a bit tax, as they potentially constitute a major impediment to the successful implementation of such a tax.

[94] See, eg, Clayton W Chan, 'Taxation of Global E-Commerce on the Internet: The Underlying Issues and Proposed Plans' (2000) *Minnesota Journal of Global Trade* 233.

[95] Soete and Kamp, above n 70, 89 ('The cost of the communication will have no relationship to the possible value of the communication, but rather be a function of the distance (local/long distance) and time (seconds/minutes) of the communication.').

[96] Ibid ('We propose that the bit tax fits within a broader idea to replace value-added tax-based systems on immaterial goods and services with a transmission-based tax system.').

The first concern regards mechanisms to ensure that the collectors of a bit tax (ISPs or financial intermediaries) collect, account for, and remit the proper amount of the bit tax.[97] In the absence of a regulatory body, there would not seem to be an effective mechanism to ensure the integrity of this process. Even if such a body was created (e.g., a supranational body established by treaty), countries may be reluctant to agree to such a regime as it would allow for the operations of their telecommunications companies to be overseen by an centralised, international body.

As an alternative to a establishing a supranational body, another possibility would be to have the country where the collector is based to enforce the collection and accounting responsibilities. However, as many transactions would involve consumption that would occur in other countries, governments would be reluctant to devote resources to monitor the collector's tax and accounting activities in the host country of the collector. Certainly, there would be little economic incentive for them to do so if the revenues from such activities ultimately flow to the customer's country where a sale occurs.

Another concern is that a bit tax will not solve the tax administration issues that are raised by electronic commerce transactions, including tracing transactions and identifying in which jurisdictions they occur.[98] This is compounded in the case of transactions which may be conducted by using electronic cash, where a ready audit trail may not be created. And even though most current transactions are conducted using credit cards (which are traceable), they are not yet used to ensure that taxes (e.g., sales tax, and VAT/GST) are paid. Similar concerns would exist with a bit tax.

Finally, it is easy to dismiss the feasibility of a bit tax on technical grounds by arguing, for example, that bits cannot be monitored effectively (e.g., in the case of satellite communications) and that bits will eventually become an irrelevant measure of transmission intensity.[99] Coupled with encryption techniques, avoidance activities could emerge (e.g., the use of proxies and filters that can be employed to re-route bit flows), which would require the diversion of substantial resources to counter such activities. This, it is argued, would not make such a tax cost effective, as the costs of administration would outweigh the revenues generated by such a tax.

Certainty and Simplicity

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[97] Such remission could either be directly to national governments or alternatively to a supranational institution which would then divide the bit tax proceeds between member countries on an agreed basis.

[98] Several companies, including Quova, Digital Envoy, NetGeo and Akamai Technologies are working on the development of geographic targeting or mapping technology. One such product which has been developed by Akamai, called *EdgeScape*, is being used to pinpoint a person's location by city, state and country, with a claimed 98 percent accuracy rate: see Stefanie Olsen, 'Yahoo Ads Close in on Visitors' Locale' (27 June 2001), available at <http://news.cnet.com/news/0-1005-200-6397360.html>. See also the homepage of Akamai Technologies, which is available at <http://www.akamai.com/>.

[99] Against this, however, bits are an established and readily available unit of measure reflecting information or data transmission over computer networks and therefore represents an appropriate tax base for a bit tax. It is worth noting that already ISPs have the ability to measure such transmissions, and commonly base their pricing models as a function of bits downloaded.

The bit tax as proposed by Cordell and Ide is transparent to the user. It would be something that is openly and objectively measured, and the remission to governments would also be clear. Further, the tax proposal is a relatively simple one as it includes all transmissions. Simplicity would be enhance greatly if the tax is collected and distributed automatically; a possibility that was earlier seen to be technically feasible.[100]

Effectiveness and Fairness

If existing anti-avoidance regimes such as CFC legislation and transfer pricing rules do not prove effective mechanisms to combat tax avoidance activities, then a threat to the worldwide tax base could be experienced. This would be an undesirable outcome for all countries, importing and exporting alike, and it is unlikely that countries will agree to maintain existing rules if they discover that this is a likely possibility. A bit tax could be considered as a measure that seeks to respond to these issues in a way that integrates into the rapidly developing digital economy. Also, fairness considerations would dictate that if an increasing amount of value is generated digitally then the tax system should be able to appropriately capture where that value is created so as to identify a proper taxing point.

Also, a bit tax may be used to monetise some of the unaccounted or unappropriated productivity in the economy. If this were the case, then one outcome of this is that growth statistics will more accurately reflect productivity advances attributable to information technologies.

Flexibility

In the case of tangible goods or services, existing tax systems are satisfactory mechanisms to tax transactions involving the trade of such goods or services. For example, in the case of a VAT/GST, the value-added contributions of the various inputs through to final consumption can be easily tracked and quantified and the tax applied along the way. In the case of electronic commerce transactions involving intangible items, it becomes a difficult issue to ascertain the value added.[101]

Likewise, with an income tax, inputs and outputs are readily identified and measurable, making the levying and auditing of an income tax system relatively easy. Increasingly, goods that were traditionally delivered physically are becoming available electronically, reducing the ability of revenue authorities to audit assessments based on comparisons between inputs

[100] For a contrary position, see Chan, above n 94, 256-7 ('simplicity may be more apparent than real, for the bit tax presents vexing problems of how to accurately measure the volume of data flow and how to precisely separate which data is taxable and which is not.').

[101] For example, taxing the value added of a phone conversation by charging a percentage of the telephone bill is not a meaningful measure of value added. This is because the cost of communication will not bear a relationship to the value of the communication, but would be a function of distance and time of the call.

and outputs.[102] The taxation of the distribution of these goods could erode with the growth of the Internet.[103]

Therefore, with the sustained and inexorable move to an economy that increasingly produces and consumes intangibles, it could be argued that the tax base should be moved to reflect these changes, and after all, governments have historically adjusted the tax base to reflect changes in the economy[104] – so why not now?

Equity

If implemented on an international basis, a bit tax would allow all countries to participate in the revenues generated by electronic commerce. As all countries are stakeholders in electronic commerce and collectively provide the framework for electronic commerce to be conducted, it seems fair that they should all participate in the revenues generated from electronic commerce transactions. Indeed electronic commerce firms rely on the services and protection provided by all countries to be able to trade as well as protect their investment in goods and services provided. For example, providers of digital products will need to rely on the protection of countries of its intellectual property in products sold (e.g., software). The provision of a stable business environment involves a substantial amount of resources of the relevant country and therefore all countries that ensure the framework within which electronic commerce can occur should share in the revenues generated by electronic commerce.[105]

Also, if a bit tax was harmonised in terms of its rate, structure and application, it would represent a desirable system for all countries to implement. Moreover, if adopted multilaterally and implemented internationally, a bit tax would assist in the prevention tax

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[102] For example, consider a software company that distributes its programs on floppy disks. Currently, revenue authorities can check the number of blank disks the company purchases (ie, inputs) and can use that as an approximate guide as to how much software it sells (ie, outputs). As electronic commerce allows software to be downloaded over the Internet, this physical check on the scale of a business will no longer be available.

[103] The lack of traceability of sales of intangible goods sold via the Internet affords another reason for a potential tax base erosion. Coupled with electronic cash which may be anonymous and therefore untraceable, as well as encryption techniques, this may mean that many electronic transactions currently are untaxed. One estimate in the US predicted that through the use of the Internet by customers accessing mail-order companies, exempt from sales taxes, has led to a reduction in state sales tax revenues of over $3 billion in 1995: see N Newman, 'The Great Internet Tax Drain' (1996) *Technology Review*.

[104] Two examples are the corn tax, which reflected the importance of grain for the national economy, and taxes on motor highways (eg, tolls), reflecting the importance of motorised transport.

[105] Thomas S Adams, 'The Taxation of Business' 11 *National Tax Association Proc* 185, 187, cited in Michael J. Graetz and Michael M. O'Hear, 'The "Original Intent" of US International Taxation' (1997) 46 *Duke Law Journal* 1021, 1036 ('A large part of the cost of government is traceable to the necessity of maintaining a suitable business environment. . . . Business is responsible for much of the work which occupies the courts, the police, the fire department, the army and the navy. New business creates new tasks, entails further public expense. . . . The relationship between private business and the cost of government is a loose one . . . . The connection, however, is real. . . . [B]usiness ought to be taxed because it costs money to maintain a market and those costs should in some way be distributed over all the beneficiaries of that market.').

competition. This would allow for economic efficiency, as capital could be directed to its most optimal commercial use, rather than being diverted on the basis of tax advantage.

Proportionality and broader considerations

In a broader context, the imposition of a bit tax can assist with reducing the growing amount of irrelevant information which is transmitted over the Internet, as well as reducing congestion on the Internet and increasing worker productivity.[106] By introducing a costing element in Internet use, the bit tax could provide an incentive for more efficient use of electronic information, as currently there is no incentive to be economical or efficient with the transmission of information.

A bit tax could also have positive outcomes by increasing worker productivity. It is already evident that many employers are concerned about workers sending personal e-mail, playing games and surfing the Internet while at work. All of these activities carry a cost in terms of lower productivity, but no real cost or disincentive currently exists to prevent such activities. Again, by introducing a costing element, a bit tax can provide the incentive for more efficient use of the Internet at work.

On the other hand, it can be argued that the introduction of a bit tax may impede international trade for three main reasons. First, many businesses and consumers are wary of conducting extensive business electronically as they believe that the Internet does currently provide a predictable legal environment. Also, they are concerned that governments will impose taxes which will stifle the growth of electronic commerce. These concerns have been taken up by many, including the US Treasury, which has expressed the view that the Internet should be a global duty-free zone for goods and services that are delivered electronically.[107]

Second, many developing countries and regions (e.g., the European Union) have argued that as they are presently lagging behind some countries like the United States in terms of their Internet development, the prospect of a new tax would be inappropriate. However, this argument ignores that a bit tax would ideally be implemented internationally to avoid distortions and in this case would not favour one country or region over another.

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[106] Though a bit tax is not expressly or apparently related to any negative externality (such as environmental damage) but is simply a revenue-raising measure, it could be argued that it might reduce one negative externality of free information, namely the rapidly growing congestion and increasing amount of irrelevant information that is transmitted over the Internet. In this respect, it can be argued that as Internet resources are public goods, information pollution and congestion are potential negative externalities.

[107] US Framework Report, above n 72, [I.1] ('For over 50 years, nations have negotiated tariff reductions because they have recognized that the economies and citizens of all nations benefit from freer trade. Given this recognition, and because the Internet is truly a global medium, it makes little sense to introduce tariffs on goods and services delivered over the Internet… the United States will advocate in the World Trade Organization (WTO) and other appropriate international fora that the Internet be declared a tariff-free environment whenever it is used to deliver products or services … In addition, the United States believes that no new taxes should be imposed on Internet commerce.'). Efforts are continuing to extend for five years the existing moratorium on Internet access taxes that is due to expire in October 2001: see above n 6.

Finally, it is argued that a bit tax would produce negative environmental consequences since the Internet is environmentally friendly (e.g., as it reduces the use of paper) and by introducing a bit tax, this may discourage its use and thereby impede international trade.

Conclusion

There is no doubt that the bit tax proposal will remain a provocative and controversial issue, at least in the short-term, where there continues to be a determined resolve by countries and governments alike, to oppose the introduction of new taxes to cover electronic commerce transactions.[108] Despite the controversy presently surrounding the bit tax proposal, it is argued that it needs to be considered; if only to confirm that a new tax is not the appropriate policy response for the challenges that electronic commerce presents. Conversely, further research and analysis of the bit tax proposal may reveal that it represents a viable long-term solution to the challenges that electronic commerce presents, however, if such proposals are rejected outright without careful consideration, such opportunities will be missed. Accordingly, due consideration and analysis of the proposal is both necessary as well as desirable and therefore will be presently conducted.

The ultimate success of a bit tax depends on the ability to implement it on an international basis: if only implemented by some countries, it could drive businesses off-shore to jurisdictions that choose not to impose such a tax. Though it would not be essential to obtain agreement from all countries of the world for such a tax, no single country would be able to implement such an initiative unilaterally.[109] Therefore, broad agreement among the major trading partners of the world (e.g., OECD countries or G-8 group of nations[110]) would be needed, as well as consensus on common rates that would apply for the bit tax. Consensus on these matters in the context of the current debate regarding electronic commerce seems to be an extremely remote possibility and represents one of the major obstacles to the successful implementation of a bit tax.

6. Conclusion

This paper has sought to explain and undertake a preliminary analysis of possible options identified by the OECD to address the challenges presented by the digital economy to existing rules relating to direct taxation.

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[108] At the same time, Professor Soete has argued that 'a lack of tax appropriation systems for the Internet represents an opportunity for Internet development at the expense of the tax revenues that governments have greatly come to rely upon.': see Luc Soete, 'Reaction to European Commission, DG XIII Bit Tax Proposal Analysis', available at <http://meritbbs.unimaas.nl/cybertax/response.html>.

[109] See, eg, Krever, above n 71, 157 ('even if a suitable bit tax system were adopted, it could be bypassed by customers who acquire Internet accounts with providers outside the jurisdiction…').

[110] Alternatively, some have suggested that pilot projects run by small countries or regions may be useful groupings: see, eg, Arthur J Cordell, 'Taxing the Internet: The Proposal for a Bit Tax' (Speech delivered to the International Tax Program at the Harvard Law School on 14 February, 1997) 7 ('It has been suggested that the State of California, or the eleven Western States of the United States might serve as a possible pilot project.').

While some observations have been made in light of the tax policy principles which have formed the basis of evaluation for the analysis which was undertaken in the paper, it is difficult to reach definitive conclusions as to which of the possible options put forward would be best placed to address the challenges presented by the digital economy. This is due to the staggered time frame of the BEPS project as well as the interaction among the various BEPS Action items which made it difficult to conclude at this time how effective the work on the BEPS Action Plan will be in addressing BEPS concerns in the digital economy, including its efficacy in dealing with the broader challenges relating to nexus, data, and characterisation and potential options to address them.

Finally, it is submitted that the approach taken by the OECD in not ring-fencing the digital economy from the rest of the economy for tax purposes is a sound approach in seeking to address the challenges presented to direct taxation by the digital economy especially given that the digital economy is increasingly becoming the economy itself.

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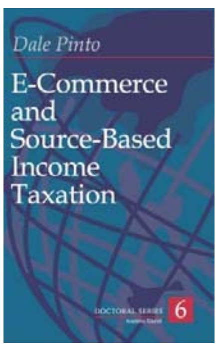
A Preliminary Analysis of Potential Options to Address the Tax Challenges Raised by the Digital Economy

Professor Dale Pinto
Curtin Law School
18 November 2014



BEPS Conference 18 November 2014

Action Plan

Coherence	Substance	Transparency
Neutralise hybrid mismatch arrangements (2) Strengthen CFC rules (3) Limit base erosion via interest deductions (4) Counter harmful tax practices (5)	Prevent treaty abuse (6) Prevent artificial avoidance of PE status (7) Ensure that TP outcomes are in line with value creation (8), (9), (10)	Establish methodologies to collect and analyse data on BEPS (11) Disclosure rules (12) TP documentation (13) Dispute resolution (14)

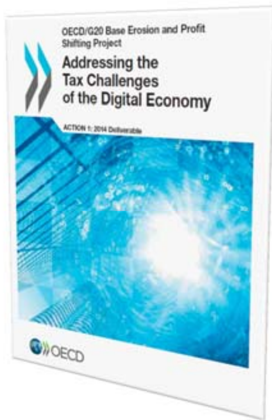
Digital economy (1)

Develop a multilateral instrument (15)

BEPS Action 1:

Tax Challenges of

the Digital Economy



Action 1 – Address the tax challenges of the digital economy

Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation.

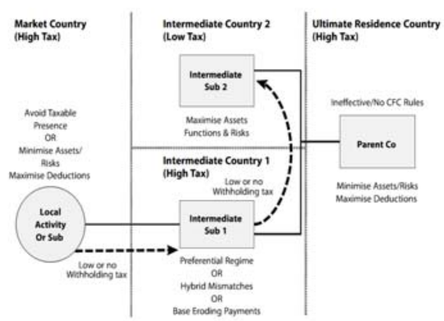
Key features of the digital economy from a tax perspective

- **Mobility**
  - intangibles
  - users
  - business functions
- **Reliance on data**
- **Network effects**
- **Use of multi-sided business models**
- **Tendency toward monopoly or oligopoly**
- **Volatility**
- **Greater integration (next slide)**

Greater integration

This integration has made it easier for business to adopt global business models that centralise functions at a regional or global level, rather than at a country-by-country level. Even for small and medium enterprises (SMEs), it has now become possible to be “micro-multinationals” that operate and have personnel in multiple countries and continents.

Tax issues raised by the digital economy



Tax issues raised by the digital economy

- **Broader issues**
  - Nexus
  - Data
  - Characterisation
- **Specific issues**
  - Ensuring that core activities cannot inappropriately benefit from the exception from PE status, and that artificial arrangements relating to sales of goods and services cannot be used to avoid PE status
  - The importance of intangibles, the use of data, and the spread of global value chains, and their impact on transfer pricing
  - The possible need to adapt CFC rules to the digital economy

Framework for Analysis

- Neutrality
- Efficiency
- Certainty and Simplicity
- Effectiveness and Fairness
- Flexibility
- Equity
- Proportionality

Approach

- The best way to address these risks in the view of the Action Plan 1 report is not by trying to 'ring-fence' the economy from the rest of the economy for tax purposes.

Instead:

- Analyse existing structures and new business models
- Focus on the key features of the digital economy and determine which of those features raise or exacerbate tax challenges or BEPS concerns

A 'preliminary' analysis

- Staggered time frame of the BEPS Project, and
- Interactions among the various BEPS outputs and their actual impact on BEPS

make it difficult to evaluate the ultimate scope of the broader tax challenges of the digital economy in the area of direct taxation.

The 5 options for addressing the direct tax challenges

1. Modify the exemptions from PE Status contained in Article 5(4) of the OECD Model Tax Convention
2. Establish a new nexus for determining PE status based on establishing a significant digital presence
3. Replace the PE threshold concept with a 'significant presence' test
4. Create a withholding tax for digital transactions
5. Introduce a bandwidth or 'Bit' tax

Option 1

Article 5(4): preparatory or auxiliary activities

Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

Rationale

As the economy has evolved, some of the activities described in subparagraphs (a) through (d) of paragraph 4 that were previously preparatory or auxiliary in the context of conventional business models (such as sales through a storefront) may have become core functions of certain businesses. Where the exceptions to the PE definition contained in paragraph 4 no longer serve their intended purpose as a result of that evolution, they should not be available.

Option 1 (cont'd)

- Eliminate Article 5(4) entirely
- Eliminate subparagraphs (a) through (d) or make them subject to an overall condition that they be 'preparatory or auxiliary'
- Eliminate 'delivery' in Articles 5(4)(a) and (b)

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Option 1 (cont'd)

- Eliminate Article 5(4) entirely
- Eliminate subparagraphs (a) through (d) or make them subject to an overall condition that they be 'preparatory or auxiliary'
- Eliminate 'delivery' in Articles 5(4)(a) and (b)

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Option 2

Establish a new nexus for determining PE status to address situations in which certain business activities are conducted wholly digitally.

The new nexus would be based on establishing a 'significant digital presence'.

An enterprise engaged in 'fully dematerialised digital activities' could be deemed to have a taxable presence in another country if it maintains a 'significant digital presence' in the economy of that country.

Rationale

Since the digital economy allows many enterprises to conduct their business operations in other jurisdictions without the need for a fixed physical presence, a more appropriate indicator of sufficient participation in the economy of a jurisdiction to ground a finding of PE status may need to be developed.

Option 3

Replace the PE threshold concept with a 'significant presence' test intended to respond to the changing nature of customer relationships in the digital economy

- **Relationships with customers or users extending over six months, combined with some physical presence in the country, directly or via a dependent agent.**
- **Sale of goods or services by means involving a close relationship with customers in the country**
- **Supplying goods or services to customers in the country resulting from or involving systematic data-gathering or contributions of content from persons in the country.**

Rationale

The rationale for this option is to try to respond to the changing nature of customer relationships in the digital economy which continuing to rely in part on physical presences. The criteria for this test is intended to reflect the contribution to value of the closer and more interactive customer relationships in a digital economy.

Option 4

- Impose a final withholding tax on certain digital transactions
- Require withholding by the financial institutions involved with those payments.
- Such a withholding tax could be used as a primary enforcement tool for one of the new nexus standards described above.
- If such an approach were taken, taxpayers could file returns in order to ensure that they were ultimately taxed on a net basis.

Rationale

The rationale for proposing a withholding tax for digital transactions would be to address concerns that it may be possible to maintain substantial economic activity in a market without being taxable in that market under current PE rules due to lack of physical presence in that market. Also, such a withholding tax could be used as a primary enforcement tool for one of the new nexus standards described in the previous two options.

Option 5

- Introduce a bandwidth or 'Bit' tax
- Based on the number of bytes used by a website, although different tax levels would apply depending on the enterprise size or turnover
- Would apply only to businesses that exceed minimum threshold of annual bandwidth used
- The tax would be creditable against corporate income tax to maintain equity between digital businesses and traditional businesses

Rationale

Alternate tax formulations may need to be considered in light of changing economic conditions. As the digital economy continues to grow rapidly, alternate tax formulations to deal with transactions which occur digitally may accordingly need to be considered.

Thank You !

TAX TREATY ISSUES RELATED TO THE BEPS ACTION PLAN

BEPS Actions dealing with tax treaties

1. The BEPS Action Plan[1] includes four Actions that are specifically focussed on tax treaties:

- Action 6 – Prevent Treaty Abuse
- Action 7 – Prevent the Artificial Avoidance of PE Status
- Action 14 – Make Dispute Resolution Mechanisms More Effective
- Action 15 – Develop a Multilateral Instrument

2. Since the work on Actions 7 and 14 will be addressed by other speakers, this note focusses on Actions 6 and 15. It is important to remember, however, that other parts of the work on the BEPS Action Plan could have a significant impact on tax treaties. Action 1 (Address the Tax Challenges of the Digital Economy) expressly calls for an examination of issues such as "the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules" and "the characterisation of income derived from new business models [and] the application of related source rules". The reference to treaties is even more specific in Action 2 (Neutralise the Effects of Hybrid Mismatch Arrangements):

> [d] evelop ***model treaty provisions*** and recommendations regarding the design of domestic rules to neutralise the effect (e.g., double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. This may include: (i) ***changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly***; .... ***Special attention should be given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention***. This work will be co-ordinated with the work on interest expense deduction limitations, the work on CFC rules, ***and the work on treaty shopping***. [emphasis added]

3. As was made clear in the Report on Action 2 delivered on 16 September 2014,[2] however:

- the main objective of that work, which is to neutralise the effect of hybrid instruments and entities (e.g. double non-taxation, double deduction, long-term deferral), is not really a treaty matter: as noted in the report, "[a]part from the rules of Articles 7 and 24, the provisions of

1 See http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/action-plan-on-base-erosion-and-profit-shifting_9789264202719-en#page1.

2 See http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/neutralising-the-effects-of-hybrid-mismatch-arrangements_9789264218819-en#page1

tax treaties do not govern whether payments are deductible or not and whether they are effectively taxed or not, these being matters of domestic law".[3]

– Although the change to the tie-breaker rule for treaty residence of legal persons[4] that is recommended in the report on Action 6 will address some of the BEPS concerns related to the issue of dual-resident entities, it cannot address all BEPS concerns related to dual-residence. That change will not, for instance, address avoidance strategies resulting from an entity being a resident of a given State under that State's domestic law whilst, at the same time, being a resident of another State under a tax treaty concluded by the first State. The solution to such avoidance strategies must be found in domestic law.[5]

4. Finally Actions 8, 9 and 10 (Assure that Transfer Pricing Outcomes are in Line with Value Creation), which all deal with transfer pricing, will have an impact on the interpretation of Article 9 (Associated Enterprises). As can be deduced from the case law on transfer pricing, however, the application of transfer pricing rules is primarily a matter of domestic law (except to the extent that Articles 7 and Article 9(2) are concerned).

Work on Action 6

5. Paragraph 5 of the report on Action 6 "Prevent the granting of treaty benefits in inappropriate circumstances"[6] refers to follow-up work that needs to be carried on in three different areas:

1. The implementation of the minimum standard.
2. The precise contents of the model provisions and related Commentary included in Section A of the report, in particular the LOB rule.
3. The policy considerations relevant to the treaty entitlement of collective investment vehicles (CIVs) and non-CIV funds.

Implementation of the minimum standard

6. Paragraph 14 of the report on Action 6 describes the minimum standard as follows:

> As long as the approach that countries adopt effectively addresses treaty abuses along the lines of this report, some flexibility is therefore possible. At a minimum, however, countries should agree to include in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements (see Section B); they should also implement that common intention through either the combined approach described in paragraph 11 (subject to the necessary adaptations referred to in paragraph 6 above), the inclusion of the PPT rule or the inclusion of the LOB rule supplemented by a mechanism (such as the alternative provision included in paragraph 15 of the Commentary on the PPT rule that appears in subsection A.1(a)(ii) below or domestic anti-abuse rules or judicial doctrines that would achieve a similar result) that would deal with conduit arrangements not already dealt with in tax treaties.

3 Paragraph 134 of the report on Action 2.

4 Art. 4(3) of the OECD Model Tax Convention.

5 Paragraphs 127-128 of report on Action 2.

6 See http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances_9789264219120-en#page1

7. Although the report describes the minimum standard and indicates that there is agreement that it should be adopted, it acknowledges that further work is needed with respect to the implementation of that minimum standard.[7] The following are examples of implementation issues that may need to be addressed as part of that work:

a) How would the minimum standard be reflected in the OECD Model Tax Convention? What types of reservations/observations/positions would be possible?

b) Whether and how should the minimum standard be reflected in the multilateral instrument envisaged under Action 15?

c) Should the minimum standard be purely prospective or should it also apply to existing treaties (*i.e*. should countries be required to modify existing treaties in order to implement the standard)?

d) Should there be some form of monitoring of compliance with the minimum standard?

e) What happens if, in the course of future bilateral negotiations, a country refuses to allow a treaty partner to incorporate provisions that are recognised as complying with the minimum standard?

Contents of the model provisions and related Commentary included in Section A of the report

8. As noted in paragraph 5 of the report, the model provisions and Commentary included in the first part of the report should be

> ...considered as drafts that are subject to improvement before their final version is released in September 2015. Some of the changes to be made will be necessary to take account of the results of other parts of the BEPS Action Plan. This is consistent with the holistic approach of the BEPS Action Plan. For example, one assumption in the drafting of the limitation-on-benefits rule found in Section A.1 below is that Action 5 (Counter harmful tax practices more effectively, taking into account transparency and substance) and Action 8 (Intangibles) will address BEPS concerns that may arise from a derivative benefits provision; that provision, or alternative means of addressing those BEPS concerns, may therefore need to be reviewed based on the outcome of the work on these Action items. Also, Section A.2, which addresses the relationship between domestic anti-abuse rules and tax treaty provisions, will need to take account of recommendations for the design of new domestic rules that may result from the work on various Action items, in particular Action 2 (Neutralise the effects of hybrid mismatch arrangements), Action 3 (Strengthen CFC rules), Action 4 (Limit base erosion via interest deductions and other financial payments) and Actions 8, 9 and 10 dealing with Transfer Pricing.

9. The specific issues on which that follow-up work will focus will be described in a discussion draft that will be released during the third week of November 2014. Given the length and complexity of the limitation-on-benefits (LOB) rule, it will not come as a surprise to anyone that the majority of these issues will deal with that rule. Apart from the specific issue of investment funds, which is discussed in the next section, the issues that will raise the most difficult questions are probably:

- The inclusion of alternative LOB provisions that EU countries would need to adopt in order to comply with EU law

7 Paragraph 5 of the Report.

– The drafting of the "broad" derivative benefits provision and of the equivalent beneficiary definition.

– Whether changes should be made to the alternative test of having its shares principally traded on a local stock exchange or having a local primary place of management and control, which is a test that has to be met for the LOB publicly-listed company provision to apply

– The design /drafting of a rule for PEs situated in third States

Policy considerations relevant to the treaty entitlement of CIV and non-CIV funds

Collective investment vehicles

10. One of the strongest criticisms that was received on the first version of the LOB rule that was included in the Discussion Draft released in March 2014 was that the rule, as drafted, would have resulted in a large number of investment funds losing (or not getting) treaty benefits. In many cases, these funds would have been denied treaty benefits under the draft LOB because they

a) would not qualify as publicly traded companies;

b) would not meet the 50% ownership requirement of subparagraph 2 *e*) if they are owned by persons that are not residents of the State in which these vehicles are established; and

c) would not qualify under the active business test of paragraph 3 to the extent that deriving investment income might not qualify as an "active business".

11. As part of the consultation process, the Working Party recognised that denying treaty benefits to collective investment vehicles (CIVs) under the draft LOB would seem to contradict the conclusions of the 2010 Report on the *Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles* (the "2010 Report"). Subparagraph 2 *e*) was subsequently added to the revised version of the LOB rule that appears in the report on Action 6. It provides for the inclusion, in the list of "qualified persons", of a provision dealing with CIVs. A footnote indicates that the subparagraph should be drafted, or omitted, based on how CIVs are treated in the Convention and are used and treated in each Contracting State; that footnote also refers to paragraphs 6.4 to 6.38 of the Commentary on Article 1. The Commentary on the LOB rule includes a discussion of how CIVs could be dealt with as well as a number of alternative provisions that correspond to the various approaches included in the 2010 Report.

12. As part of the follow-up work on the Report on Action 6, it is intended to review these alternative approaches and to examine whether it would be possible to suggest a single preferred approach not only with respect to the application of the LOB to CIVs but also with respect to the more general question of the treaty entitlement of CIVs, taking into account developments since 2010 and, in particular, the results of the work on the Treaty Relief and Compliance Enhancement (TRACE) project.

Non-CIV funds

13. Many comments that were received on the discussion draft (and in subsequent representations received by the Secretariat and by delegates) also raised LOB issues in relation to Sovereign Wealth Funds (SWFs), pension funds and alternative funds (including private equity funds).[8] Paragraph 6 of the report

8 Issues were also raised with respect to Real Estate Investment Trusts (REITs) but these issues are similar to those of CIVs in the case of REITs they are widely-held and regulated. Issues faced by REITs that are not CIVs are similar to those of private equity funds.

therefore indicated that further work was needed with respect to the policy considerations relevant to treaty entitlement of these "non-CIV funds."

i) Sovereign wealth funds

14. These funds are owned and operated by States themselves. The legal status and tax situation of sovereign wealth funds vary but in many countries, foreign sovereign wealth funds are entitled to an exemption from taxes on their portfolio investment income under the sovereign immunity doctrine. Paragraphs 6.35 to 6.39 of the Commentary on Article 1, which were added to the OECD Model Tax Convention in 2010, explain how treaties apply to sovereign wealth funds. These paragraphs discuss the application of the sovereign immunity doctrine to taxation, which is a matter of domestic law, and the application of the definition of "resident" in the light of the different views reflected in paragraphs 8.6 and 8.7 of the Commentary on Article 4.

15. It has been suggested that the LOB rule that is included in the Report on Action 6 may create difficulties for sovereign wealth funds. Where a sovereign wealth fund invests directly in a country, however, the definition of "qualified person" included in the LOB rule would apply to a resident who is "*a Contracting State, or a political subdivision or local authority thereof, or a person that is wholly-owned by such State, political subdivision or local authority*" (subparagraph 2 *b*) of the LOB rule), which would cover a sovereign wealth fund that qualifies as a resident of a Contracting State and that is wholly-owned by that State or its subdivisions. Similarly, investments that a sovereign wealth fund resident of one Contracting State makes through a subsidiary established in the same State would typically be covered by the "ownership / base erosion" provision (subparagraph 2 *e*) of the LOB rule). Problems could arise, however, in the case of investments made through an entity that is a resident of a third State (*e.g.* a sovereign wealth fund of State R uses a company in State T in order to invest in State S). Also, sovereign wealth funds are often among the institutional investors that invest in alternative funds and private equity funds and these may be established in other countries (see under subsection *iii)*).

ii) Pension funds

16. The LOB rule included in the Report on Action 6 does not restrict benefits in the case of a resident who "was constituted and is operated exclusively to administer or provide pension or other similar benefits, provided that more than 50 per cent of the beneficial interests in that person are owned by individuals resident in either Contracting State". The LOB rule also does not restrict benefits in the case of an entity that was constituted and is operated to invest for the benefit of such pension funds, "provided that substantially all the income of that entity is derived from investments made for the benefit of these pension funds." Similarly, investments that a pension fund that is a resident of one Contracting State makes through a subsidiary established in the same State would typically be covered by the "ownership / base erosion" provision (subparagraph 2 *e*) of the LOB rule).

17. As in the case of sovereign wealth funds, however, problems may arise where a third State entity is used, *e.g.* a pension fund of State R sets up an entity in State T in order to invest in State S: in that case, the LOB rule of the T-S treaty could deny benefits to the entity even if all participants in the fund are residents of State R (in such a case, however, the treaty entitlement and benefits of the pension fund under the R-S treaty may be different from those available under the T-S treaty, which could raise treaty-shopping concerns). In addition, pension funds, like sovereign wealth funds, are often among the institutional investors that invest in alternative funds and private equity funds and these may be established in third countries (see under subsection *iii)*).

18. Another specific issue for pension funds that arises in relation to the LOB rule relates to the requirement that more than 50% of the beneficial interests in a pension fund be owned by individual

residents in either Contracting State. This requirement may create difficulties for some EU pension funds (this issue is one of the issues that will be examined as part of the follow-up work on alternative LOB provisions for EU countries).

19. It has been suggested that, as part of the work on the treaty entitlement of non-CIV funds, the OECD should look at how the treaty definition of "resident" applies to pension funds in the light of the different views reflected in paragraphs 8.6 and 8.7 of the Commentary on Article 4. It has also been suggested that many of the above issues related to pension funds could be addressed by countries including in their treaties the alternative provision that is found in paragraph 69 of the Commentary on Article 18 of the OECD Model Tax Convention, which deals with the source taxation of income of foreign pension funds. As the preamble of that paragraph recognises, however, such a provision should be used where it will be mutually beneficial and there may therefore be valid policy reasons for not including that provision in a bilateral treaty.

iii) Alternative funds / private equity funds

20. For the purposes of the 2010 Report, "collective investment vehicles" are defined as "funds that are widely-held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established". Alternative funds / private equity funds generally do not meet these conditions because they typically have a limited number of institutional investors, may not hold a diverse portfolio and are not subject to the same investor-protection regulation.

21. The problems that the LOB rule creates for CIVs may also be encountered by private equity funds / alternative funds (*i.e.* since their investor base is not restricted to a single country, they would be denied benefits under the LOB rule and would probably not get the active business exception; any provisions dealing expressly with CIVs would not apply to them). Also, these funds face many of the treaty issues that were addressed in the 2010 OECD Report on CIVs (*e.g.* whether they qualify as residents).

22. As part of the follow-up work on Action 6, it is intended to examine how these issues related to the treaty entitlement of sovereign wealth funds, pension funds and alternative funds / private equity funds could be addressed in a way that would not create treaty-shopping opportunities.

Work on Action 15

23. Action 15 (Develop a Multilateral Instrument) envisaged a two-step process. The first step, which resulted in the report "Developing a Multilateral Instrument to Modify Bilateral Tax Treaties"[9] delivered on 16 September 2014, was to "[a]nalyse the tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties." That report concluded that a multilateral instrument is desirable and feasible, and that negotiations for such an instrument should be convened quickly.

24. The second step, which has a December 2015 deadline, will require moving from a feasibility analysis to the actual development of the multilateral instrument: "[o]n the basis of this analysis, interested Parties will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to

9 See http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/developing-a-multilateral-instrument-to-modify-bilateral-tax-treaties_9789264219250-en#page1.

this evolution.” A mandate for the development of that multilateral instrument is currently being drafted for consideration by the CFA in January 2015.

25. The objective of the multilateral instrument will be to expedite and streamline the implementation of the measures developed to address BEPS and amend tax treaties. It is envisaged that this multilateral instrument will coexist with the existing network of bilateral tax treaties. Flexibility, respect for bilateral relations, and a targeted scope are keys to the success of the negotiation of such an instrument. Flexibility could be provided through various mechanisms, such as excluding the application, in full or in part, of certain provisions; providing a choice between alternative measures set out in the instrument and providing the possibility for parties to take on additional commitments. The parties to the instrument could therefore commit to a core set of provisions in the multilateral instrument but could have the possibility to opt-out of certain measures (e.g. though reservations on non-core provisions), choose between alternative – clearly delineated – measures and/or opt-in to additional measures.

26. Based on the work done so far, the main candidates for inclusion in such a multilateral instrument would appear to be the treaty changes that will result from the work on Action 6 (Prevent Treaty Abuse), on Action 7 (Prevent the Artificial Avoidance of PE Status) and on the part of Action 2 that produced a treaty provision or transparent entities. Other possibilities that have been put forward relate to provisions for a multilateral MAP, for triangular PE cases and for a legal basis for safe exchanges of country-by-country reporting information. It is important to remember, however, that decisions as to what will be included in the multilateral instrument will ultimately be made during the negotiation by the interested parties.

Summary: Transparency, Disclosure and Developing Countries

Diane Ring, Boston College Law School

Introduction

Perhaps the most dominant topic in international tax today is the BEPS project (Base Erosion and Profit Shifting project) underway at the OECD with the support of the G20. Jurisdictions across the globe have expressed concern regarding their ability to preserve and capture their tax base. In the absence of a stable and adequate tax base, countries might forfeit their fiscal ability to support infrastructure, social services and development opportunities vital to their citizens. The BEPS project, with its Action Items, constitutes the G20's and the OECD's response to this taxing challenge. The majority of the Action Items and their implementation proposals concern substantive tax law—the underlying taxing rules and practices that can enable taxpayers to erode a country's tax base and shift profits out of the jurisdiction. But even the most carefully designed tax code is powerless without adequate transparency and disclosure of tax information to the taxing authorities. As a result, the BEPS project includes significant attention to the more administrative issues of transparency and disclosure. The goal is to put in place systems and mechanisms designed to ensure that tax authorities have appropriate access to information necessary for the effective administration of the tax law. The most notable transparency and disclosure Action Item proposal emerging from the BEPS project is the articulation of standards for information reporting by multinational enterprises—"country-by-country reporting" (CbC). Along with the proposed "Master File" and "Local File," CbC reporting has the potential to greatly impact many jurisdictions' access to timely and global information regarding multinationals engaged in business in their jurisdictions.

The problem of base erosion and profit shifting, and the desire for solutions, impacts both developed and developing countries. Despite the fundamental universality of many aspects of the BEPS problem, analyses of the transparency and disclosure proposals have illuminated the distinctive challenges faced by developing countries in trying to implement these "solutions." This paper suggests that the effort to consider transparency and disclosure from a "developing country" perspective forces us to more directly confront: (1) developing countries' need for significant support in building technical capacity, much of which must precede the fruits of transparency and disclosure; (2) the significant variability of circumstances (including technical, legal, economic, social and political) among developing countries; (3) the potential limits of tax base protection through transparency and disclosure even when those mechanisms are successfully in place; and (4) how developing country challenges may reflect in a more magnified way issues that might plague developed countries who are anticipating that implementation of transparency and disclosure will revolutionize their ability to protect their tax base.

By identifying and examining potential constraints on the ability of transparency and disclosure reforms to be transformative, this paper does not intend to argue that such efforts should abandoned. Rather the goal is to encourage attention to these issues at the outset in order to: (1) facilitate remedies through changes in resources, design details, and implementation plans; and (2) acknowledge which "failures" lay at the doorstep of transparency and disclosure efforts, and which are due to other facets of the international tax system.

I. Transparency and Disclosure: An Overview

Contemporary efforts to guarantee that countries can access necessary tax-related information have emphasized the goals of "transparency" and "disclosure." Both terms appear in the July 2013 BEPS Action Plan[1] and related materials. The term "transparency" captures the idea that a country must understand a taxpayer's transactions, business operations, structure, and in-country investments. To achieve a level of understanding adequate to implement the tax system, it may be necessary for the country to have a firm picture of taxpayer's activities, transactions and business structure *beyond* the borders of that specific taxing jurisdiction. The term "disclosure" reflects the idea that a country will need access to certain types of information in order to achieve an appropriate level of transparency and understanding of taxpayer activities.

Regardless of the specific mechanism employed for providing information to tax administrators, certain universal questions arise:[2] (1) what type of information must be provided, (2) how difficult will it be for the taxpayer to provide that information, (3) how will the information be provided, (4) what kind of technology and infrastructure will be needed by the taxpayers and the countries to implement this system, (5) to whom will the information be distributed, (6) what are the permissible uses of the information, (7) does the country have the capacity to meaningfully use the information, and (8) how will data protection and taxpayer privacy be ensured? There may be significant agreement among nations regarding the importance of transparency and disclosure conceptually. But the effort to translate those principals into specific transparency and disclosure practices and regimes reveals challenges and concerns. Countries will likely arrive at different assessments of the right balance among these risks, trade-offs and benefits, as a reflection their own domestic infrastructure, economic position, existing tax agreements, and substantive tax system.

Given that income taxation of cross border business originated in the early 20th century, the increased attention directed now to transparency and disclosure may warrant some explanation. The demand for taxpayer information by taxing authorities certainly is not new. However, the current lack of transparency that many countries face (due in part to insufficient disclosure), has

[1] OECD, BEPS Action Plan (July 2013) available at http://www.oecd.org/ctp/BEPSActionPlan.pdf.

[2] Some of this of this discussion is drawn from prior work, see *Protecting the Tax Base of Developing Countries: Transparency and Disclosure*, available at http://www.un.org/esa/ffd/tax/2014TBP2/Paper_TransparencyDisclosure.pdf.

become a significant problem. Specifically, the volume of cross border activity, including inbound investment into developing countries and outbound investment by developing country multinationals, combined with taxpayers' ability to engage in sophisticated tax planning all point to the importance in a well-functioning tax system of transparency and disclosure. The cost from lack of adequate information may be particularly severe for developing countries. If MNEs successfully pursue base eroding and profit shifting transactions, developing countries typically have fewer alternative tax bases upon which to draw (e.g., individual taxes, consumptions taxes).[3] Not only are the costs of BEPS to developing countries potentially more severe, the barriers to solving and curbing base erosion may be less readily available. These impediments can roughly be grouped into three categories: (1) domestic law, (2) domestic enforcement, and (3) international support.[4] A more extensive discussion of these constraints provides further basis for evaluating and developing the four observations offered at the beginning of the paper regarding the capacity building problems of developing countries, their nontechnical constraints, and their connections to developed countries.

II. Tax Information Beyond BEPS

The BEPS work on transparency and disclosure is not occurring in a regulatory vacuum. Currently tax administrators can rely on a range of tools to enhance their enforcement capabilities including: bilateral tax treaties (based on the UN and/or OECD Model Treaties), TIEAs (tax exchange information agreements often based on the OECD Model), regional agreements, and the work of the Global Forum on Transparency and Exchange of Information. Other new initiatives outside the formal BEPS project have been undertaken by individual countries, regional networks, and other international bodies. The efforts include: IGAs (intergovernmental agreements), automatic exchange of information agreements, the common reporting standards (CRS) for automatic exchange, and increased attention to the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.

III. Transparency and Disclosure in the BEPS Project

The BEPS recommendation regarding transfer pricing and disclosure that has received the most attention has been Action Item 13, including the proposal for country-by-country reporting (ranked as of "high" relevance to developing countries).[5] At its core, Action Item 13 seeks to establish rules that would require an MNE to "provide all relevant governments with needed

[3] See, e.g., OECD, Part I of a Report to G20 Development Working Group on the Impact of BEPS on Low Income Countries (July 2014) at 11.

[4] Some of this of this discussion is drawn from prior work, see *Protecting the Tax Base of Developing Countries: Transparency and Disclosure*, available at http://www.un.org/esa/ffd/tax/2014TBP2/Paper_TransparencyDisclosure.pdf.

[5] OECD, Part 1 of A Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries, (July 2014) at 31 (Annex A).

information on their global allocation of the income, economic activity and taxes paid among countries according to a common template."[6] This reporting template concept, known as "country-by-country reporting," has raised a number of issues: (1) the kind of information required, (2) the burden on taxpayers, (3) permitted recipients of the information and permitted uses of the information, (4) countries' ability to use the information, (5) protection of taxpayer data, and (6) delivery mechanism.[7] Overall, the reporting recommendations under Action Item 13 envision a tripartite system: (1) the Master file,[8] (2) the Country-by-Country template,[9] and (3) the Local File.[10]

Although many specific questions have been raised over the past year regarding each component in the Action Item 13 proposal, four major issues have dominated the discussion. First, taxpayers have been quick to object to Action Item 13 on the grounds that its reporting requirements would place enormous burdens on taxpayers because existing reporting systems in multinationals do not necessarily align with the information required in the master file, CbC template and local file. Moreover they contend that information can be difficult to secure in a timely and uniform manner, and that there remains uncertainty surrounding precisely what information is being requested. Second, taxpayers have questioned how (and to whom) the three items will be delivered? Taxpayers urge that the filings (at least of the master file and the CbC report) be made to the country of the multinational's parent. From there, information could be shared with other jurisdictions through treaty exchange of information mechanisms. Third, taxpayers object to the possibility that tax administrators may use information to "skip" the audit phase an immediately impose an adjustment, or to shift to formulary apportionment for transfer pricing. Finally, taxpayers have registered concern that the information provided in these Action Item 13 materials may not be adequately protected. In addition to the general questions about countries' data protection mechanisms, procedures and laws, taxpayers remain concerned that there may be a growing groundswell of support for *public* disclosure of some or all information in order to

[6] OECD, *Action Plan on Base Erosion and Profit Shifting* (July 2013) at 23.

[7] See, e.g., OECD, *Memorandum on Transfer Pricing Documentation and Country by Country Reporting* (3 October 2013).

[8] A master file would contain "standardized information for all MNE group members." The goal of this information would be to provide a "reasonably complete picture of the global business, financial reporting, debt structure, tax situation and the allocation of the MNE's income." OECD, *Public Consultation: Discussion Draft on Transfer Pricing Documentation and CbC Reporting* (30 January 2014). The file would contain information in five categories: (1) group organizational structure, (2) description of business or businesses, (3) the intangibles held by the group, (4) intercompany financial activities, and (5) the MNE's financial and tax positions.

[9] The CbC template would report seven items on a country by country basis: (1) revenue, (2) earnings before taxes, (3) cash tax, (4) current year tax accruals, (5) stated capital and accumulated earnings, (6) number of employees, and (7) tangible assets.

[10] The local file would be capture more jurisdiction-specific information. Together with the master file, it could help ensure that the taxpayer complied with the arm's length principle and transfer pricing rules in its major transactions connected to that jurisdiction. The local file would include more detailed information regarding transactions between the MNE's entity in the local jurisdiction and its related entities in other countries. OECD, *Public Consultation: Discussion Draft on Transfer Pricing Documentation and CbC Reporting* (30 January 2014) at 6.

facilitate a more informed public discussion of tax policy, tax administration, multinationals and effective tax burdens.

IV. Developing Countries and Transparency and Disclosure

Despite many shared concerns, questions, and goals among nations regarding the reporting recommendations under Action Item 13, developing countries may have a distinct perspective. [11] First, to the extent developing countries must decide where to direct their most sophisticated audit resources, they would want to identify their most serious base erosion and profit shifting problems. A high-level assessment tool (master file and template) delivered by each MNE operating in the jurisdiction would provide the country with a solid basis for making that preliminary risk assessment and assigning audit resources. Second, if the Action Item 13 proposals become the standard reporting format, the resulting uniformity further reduces administrative burdens on developing country tax administrations. Third, if the tripartite reporting package emerges as the global reporting *expectation*, then developing countries may be able to obtain this information without having to expend resources establishing their own reporting mechanism and then enforcing it in the absence of global practice.

Among the specific issues raised in examining the Action Item 13 proposals, the delivery mechanism may be the most relevant question.[12] Action Item 13 will play little meaningful role if countries cannot predictably and effectively access the information in the master file, template, and local file. Given that many of the key advantages of this information package for developing countries derive from the resource-savings opportunities provided, it is important that countries have easy access to the information in a timely fashion. To the extent that the delivery mechanism imposes costs, the value of the entire process for developing countries is diminished.

But assuming that the final delivery mechanism (anticipated in January 2015) enables developing countries adequate access to the information, there remains the question of the countries' ability to use the information now in its possession. For resource-constrained developing countries, targeted capacity building might enhance their ability to use the information received from all three formats (master file, CbC template, and local file) in a strategic manner. Training for developing country tax auditors could focus on the information included in these files and how to use that information to make overall risk assessments, and where appropriate to pursue taxpayer level audits.[13] "Case studies" of hypothetical taxpayers with corresponding master files,

[11] Some of this of this discussion is drawn from prior work, see *Protecting the Tax Base of Developing Countries: Transparency and Disclosure*, available at http://www.un.org/esa/ffd/tax/2014TBP2/Paper_TransparencyDisclosure.pdf.
[12] Some of this of this discussion is drawn from prior work, see *Protecting the Tax Base of Developing Countries: Transparency and Disclosure*, available at http://www.un.org/esa/ffd/tax/2014TBP2/Paper_TransparencyDisclosure.pdf.
[13] Some of this of this discussion is drawn from prior work, see *Protecting the Tax Base of Developing Countries: Transparency and Disclosure*, available at http://www.un.org/esa/ffd/tax/2014TBP2/Paper_TransparencyDisclosure.pdf.

templates and local files would help developing countries not only receive the information but begin to use it effectively and more immediately to tackle base erosion and profit shifting.[14] Real-time technical assistance and capacity building could also be pursued through the "Tax Inspectors Without Borders" program[15] currently being piloted by the OECD, which provides expertise to developing country tax administrations during the course of real-time audit and enforcement.[16] The G20 has noted its support for this program.[17]

Just as developing countries would likely experience challenges in accessing and using the Action Item 13 tax information materials, so too might they anticipate challenges in benefitting from the new work on automatic exchange of information. The G20 gave the OECD a mandate to prepare standards and guidance on automatic exchange of information. In February 2014, the OECD released the first part of this project, the "Standard for Automatic Exchange of Financial Account Information: The Common Reporting Standard,"[18] which the G20 approved: "We endorse the Common Reporting Standard for automatic exchange of tax information on a reciprocal basis and will work with all relevant parties, including our financial institutions, to detail our implementation plan at our September meeting."[19] The OECD released its more comprehensive "Standard for Automatic Exchange of Financial Account Information in Tax Matters" in July 2014.[20] This July OECD report includes: (1) the text of a Model Competent Authority Agreement ("CCA") for automatic exchange of certain tax information, (2) the Common Reporting Standard ("CRS"), and (3) Commentary intended to facilitate uniform

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[14] See, e.g., African Tax Administration Forum, A Practical Guide on Information Exchange for Developing Countries (2013) at 46-47 (outlining an abbreviated version of the case study concept in the context of requesting information).

[15] See generally, OECD website at http://www.oecd.org/tax/taxinspectors.htm.

[16] OECD Task Force on Tax and Development, Final Report on the Feasibility Study into the Tax Inspectors Without Borders Imitative (5 June 2013) at 1 ("Experts would be deployed to work directly with local tax officials on current audits and audit-related issues concerning international tax matters, and to share general audit practices. In addition to improvements in the quality and consistency of audits and the transfer of knowledge to recipient administrations (tax administrations seeking assistance), broader benefits are also anticipated including the potential for more revenues, greater certainty for taxpayers and encouraging a culture of compliance through more effective enforcement.), available at http://www.oecd.org/ctp/tax-global/TIWB_feasibility_study.pdf. The G20 has noted its support for this program. G20 Leaders' Declaration (St. Petersburg, September, 2013) at 13 ("we welcome the OECD Tax Inspectors without Borders initiative, which aims to share knowledge and increase domestic capacities in developing countries in the tax area.").

[17] G20 Leaders' Declaration (St. Petersburg, September, 2013) at 13 ("we welcome the OECD Tax Inspectors without Borders initiative, which aims to share knowledge and increase domestic capacities in developing countries in the tax area.").

[18] OECD, Standard for Automatic Exchange of Financial Account Information (February 2014), available at http://www.oecd.org/ctp/exchange-of-tax-information/automatic-exchange-financial-account-information-common-reporting-standard.pdf.

[19] Communiqué Meeting of Finance Ministers and Central Bank Governors Washington, 18-19 April 2013, available at https://www.g20.org/sites/default/files/g20_resources/library/Communique%20Meeting%20of%20G20%20Finance%20Ministers%20and%20Central%20Bank%20Governors%20Sydney%2022-23%20February%202014_0.pdf.

[20] OECD, Standard for Automatic Exchange of Financial Account Information in Tax Matters (21 July 2014), available at http://www.oecd.org/ctp/exchange-of-tax-information/standard-for-automatic-exchange-of-financial-information-in-tax-matters.htm.

implementation of the agreement and standard. Exchange of information under this system requires that each country take two basic steps. First, countries must implement any domestic law changes necessary to (1) require financial entities to gather and report the designated information, and (2) ensure appropriate protection of taxpayer data. Second, countries (through their competent authorities) must agree to exchange on an automatic basis and must set the terms of that exchange (e.g., the Model Competent Authority Agreement).

Developing countries have expressed interest in automatic exchange of information, particularly given that current methods for obtaining information located outside the jurisdiction can be costly or unavailable, and treaties generally permit exchange of information only on request (a process that can be burdensome in time, money and expertise).[21] Automatic, bulk provision of the enumerated information in the CRS would significantly reduce the costs of acquiring that information compared to existing mechanisms. Additionally, the automatic nature of the delivery reduces the opportunity for pressure, leverage, and corruption in tax administration. These advantages, though, essentially reflect the reduced costs and difficulties of acquiring information *as compared* to obtaining it via an existing bilateral treaty. But the ability to participate in the CRS and CAA is currently contingent on meeting the standards necessary to commit to providing, not just receiving information (required reciprocity). The only option for non-reciprocal participation in the CRS and CAA is provided for countries which do "not need to be reciprocal" (e.g., because one of the jurisdictions does not have an income tax).[22] This has been characterized by some commentators as intended to facilitate automatic exchange of information *from* tax havens. There is no current model or provision allowing for non-reciprocal automatic exchange of information with (or more precisely, *to* a developing country (i.e. providing information to that developing country without receiving information in return). If non-reciprocity with developing countries were permitted, it could be managed in a gradual manner. The country could commit to meeting established benchmarks for domestic information collection and processing.

V. Reflections on Transparency and Disclosure

A comprehensive review of the transparency and disclosure practices from a developing country perspective will first provide a serious reminder that many developing countries will require significant capacity building support if they are to fully participate in the benefits that transparency and disclosure can bring to the BEPS problem. Some of the objections offered by taxpayers require that we direct attention to the ways in which resource limitations might, for

[21] Some of this of this discussion is drawn from prior work, see *Protecting the Tax Base of Developing Countries: Transparency and Disclosure*, available at http://www.un.org/esa/ffd/tax/2014TBP2/Paper_TransparencyDisclosure.pdf.

[22] See Nonreciprocal Model Competent Authority Agreement, in OECD, Standard for Automatic Exchange of Financial Account Information in Tax Matters (21 July 2014) Annex 2 at 223, available at http://www.oecd.org/ctp/exchange-of-tax-information/standard-for-automatic-exchange-of-financial-information-in-tax-matters.htm.

example, impact a country's audit practices (using the Action Item 13 reporting to by-pass audit) and its data protection infrastructure. Detailed analysis of these issues will reveal the wide variety of "developing countries" with vastly differing limitations, resources, and concerns. However, even if many of the technical and capacity building constraints faced by developing countries are resolved, we likely will face the next serious question triggered by transparency and disclosure: Do countries really want to use that information to more effectively tax multinationals and others engaged in cross-border transactions? There are at least two reasons that countries might not fully embrace the power of new information --- (1) political pressure not to pursue domestic taxpayers with cross border income, and (2) tax competition. In the past decade, a dominant refrain in international tax has been the importance of information to preventing cross border tax abuse. Reflecting a turn away from an explicit focus on tax competition in the late 1990s, the OECD (and others) directed more attention to information exchange and transparency as keys to meaningful cross-border tax enforcement. If, through the work of the BEPS project and the others discussed above, developing countries find they have adequate information to implement their tax systems, will they face pressure *not* to do so in the name of competition? This possibility has been tentatively raised. Moreover, the recent attention in the EU to the possibility that certain tax rulings issued by member states may constitute state aid, reminds us that the power and lure of competition remains a constant and ever-present force whose face may be more readily visible in the clear light provided by transparency and disclosure.

Transparency, Disclosure and Developing Countries

18 November 2014

Diane Ring

BEPS and Transparency and Disclosure

- BEPS attention to transparency and disclosure in several Action Items
- Connection to recent efforts in other contexts by OECD, Global Forum, EU, and other groups and countries
- Goal to protect countries' tax bases through ensuring tax authorities have adequate access to taxpayer information
- BEPS problems and desire for solutions cut across developed and developing countries

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- Developing countries have distinct perspective and concerns
- Examination of these concerns results in three observations:
  - Inclusion of developing countries may be only nominal if not adequately supported in very specific ways, and developed countries may need to offer more than technical support
  - Failure to provide sufficient support here would be inconsistent with broad message and commitments of G20 and other organizations and countries
  - Even if there is notable success in the implementation phase we may "re-discover" the lure of tax competition and need to consider potential remedies for non-enforcement

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Context of Transparency and Disclosure

New Sources for Information

- BEPS Project (especially Country-by-Country Reporting Template and Master File)
- Automatic Exchange of Information
  - OECD's "Common Reporting Standard" and Related Material
- Industry-Specific Reporting Requirements
- Intergovernmental Agreements ("IGAs")
- Expanded Use of Multilateral Convention on Mutual Administrative Assistance in Tax Matters

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Context of Transparency and Disclosure

Existing Sources of Information

- Article 26 in Bilateral Treaties (based on UN and OECD Models)
- Tax Information Exchange Agreements ("TIEAs")
- Regional Agreements
- Global Forum on Transparency and Exchange of Information

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BEPS and Transparency and Disclosure

- Three Action Items: 11, 12, 13
- Action Item 12: Disclosure of Aggressive Tax Planning (Delivery Date September 2015)
- Action Item 11: Project to Collect and Analyze BEPS Data and Assess Impact of Reforms (Delivery Date September 2015)
- Action Item 13: Transfer Pricing Related Documentation (Major Focus)

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BEPS Action Item 13

- Re-examine transfer pricing documentation
- MNE's provide all relevant governments with the needed information on their global allocation of income, economic activity, and taxes paid among countries according to common template.
- Country-by-Country Reporting Template
  - Relevant beyond transfer pricing to assist country efforts to evaluate BEPS situation and to make risk assessments
  - Risk assessment particularly valuable to developing countries: help to maximize allocation of audit and investigative resources

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BEPS Action Item 13 continued

Three Components:

- Master File: "standardized information for all MNE group members"

  Information would cover five topics:

  (1) Group's organizational structure
  (2) Description of business or businesses
  (3) Intangibles held by the Group
  (4) Intercompany financial activities
  (5) MNE's financial and tax positions

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BEPS Action Item 13 continued

- Country-by-Country Reporting Template ("CbC")

  Template includes information on seven topics:

  (1) Revenue
  (2) Earnings before taxes
  (3) Cash taxes
  (4) Current year tax accruals
  (5) Stated capital and accumulated earnings
  (6) Number of employees
  (7) Tangible assets

- Information provided on a Country-by-Country basis (as opposed to Entity-by-Entity)
- Template accompanied by a list of all group entities and permanent establishments operating in each jurisdiction along with business activity codes identifying major activities

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BEPS Action Item 13 continued

- Local File: Jurisdiction-specific information complements master file in helping country ensure that the taxpayer complied with the arm's length principle and with transfer pricing rules in its major transactions connected to that jurisdiction
  - File includes: detailed information regarding relevant transactions between the MNE's local entity and its related entities in other countries, including (1) financial details of the transactions; (2) comparability analysis for pricing; and (3) "selection and application of the most appropriate transfer pricing method for the fiscal year"
  - See Annex to OECD Discussion Draft—information in local file expected to cover details on Local Entity (structure, organization, operations), Financial Accounts, and Controlled Transactions (details and analysis)

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BEPS Action Item 13 continued

- Key Issues:
  - Burden on taxpayer
  - Mechanism for reporting and sharing information required under Action Item 13
  - Access to information
  - Permitted uses of information by countries
  - Capacity of countries to use information
  - Public disclosure, data protection, and privacy

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BEPS Action Item 13 continued

Developing Country Perspectives

Advantages

- Risk Assessment: Master file and CBC template assist in assessing greatest tax base risks and directing resources accordingly
- Uniformity: Standardized MNE reporting facilitates cross-taxpayer risk assessments and facilitates training of new staff
- Meaningful Documentation: Widespread adoption and enforcement of documentation requirements increases the availability and quality of information for developing countries (regardless of the country's leverage or enforcement influence)

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BEPS Action Item 13 continued

Developing Country Perspectives

Concerns

- Access: Implications of proposed delivery mechanisms for jurisdictions with many foreign MNEs and a limited treaty network
- Language: Importance of local language materials for resource-constrained countries
- Domestic legislation: Need for domestic legislation to implement
- Transfer pricing regime and penalties: Impact of a country's transfer pricing rules and penalties on an MNE's conduct and planning
- Capacity building: Types of resources and capacity building that would be valuable in or necessary to using the proposed documentation

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Automatic Exchange of Information

- Overview
- Current Practices (Model Treaties, EU, other)
- Challenges in Implementing Automatic Exchange of Information
  (1) Common standard for reporting information
  (2) Due diligence by financial institutions
  (3) Exchange process
  (4) Legal framework for exchange
  (5) Compatible technical systems
- OECD and G2O

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Automatic Exchange of Information continued

OECD Release July 2014:

(1) Common Reporting Standard ("CRS")
(2) Model Competent Authority Agreement ("CAA")
(3) Commentary

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Automatic Exchange of Information continued

October 29, 2014:

(1) Approximately 50 countries signed multilateral competent authority agreement to implement OECD standard for global information exchange

(2) Early adopter jurisdictions commit to exchanges in 2017

(3) U.S. not a current signatory

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Automatic Exchange of Information continued

- CRS Specifics:
  - Reporting Entities: Custodial institutions, depository institutions, investment entities, and specified insurance companies
  - Information Provided: Includes interest, dividends, account balance or value, income from certain insurance products, sales proceeds from financial assets, other income generated by assets held in the account, and payments made with respect to the account
  - Covered Accounts: Include those held by individuals and entities (including trusts and foundations). Identifying information required includes, "name, address, jurisdiction(s) of residences, TIN(s) and date and place of birth (in the case of an individual)
  - Due Diligence: Required by reporting financial entities (level of due diligence required varies, depending on when account was created, its contents, its value, and other information known to the financial entity)

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Automatic Exchange of Information Continued

CAA:

- Pursuant to agreement, countries agree to:

  (1) have domestic rules requiring financial institutions to report accounts and follow appropriate due diligence standards

  (2) have appropriate safeguards to protect confidentiality of taxpayer data

  (3) infrastructure necessary for effective exchange

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Automatic Exchange of Information Continued

Developing Country Perspectives

Advantages

- Global approach: More global approach to automatic exchange facilitates implementation for developing countries – many of which are interested
- Reduced Burden: Receipt of information "automatically" imposes less burden on country than receipt through "on request" approach
- Message to Taxpayers: Widespread implementation of automatic exchange sends message to taxpayers about countries' ability to enforce tax rules and risks of evasion
- Uniform Treatment of Taxpayers: Automatic access to information on all of the country's taxpayers increases uniformity of enforcement
- Individuals and Entities Covered: Inclusion of entities (such as trusts) in automatic exchange of information enhances effectiveness and helps curb tax base erosion

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Automatic Exchange of Information Continued

Developing Country Perspectives

Concerns

- Reciprocity: Current reciprocity requirement for CAA may limit availability for developing countries
- Need for Existing Legal Mechanism: If based on bilateral treaties, then value to developing countries depends on treaty network
- Multilateral Mechanism: Basing agreement on the Multilateral Convention on Mutual Assistance in Administrative Tax Matters eliminates treaty network concern, *but* still need to get relevant countries to participate, and reciprocity issue
- Domestic Reforms Needed: CRS data reporting, due diligence standards, and data protection must be implemented in domestic law
- Infrastructure: Financial entities and government need infrastructure adequate to meet their obligations under automatic exchange

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Industry-Specific Reporting Requirements

- Overview
- Examples:

1) Extractive Industries Transparency Initiative ("EITI")
- Seeks to promote 2-pronged reporting approach for transparency in extractive industries
  - Businesses report what they pay to each jurisdiction
  - Governments report what they receive

2) European Union's Capital Requirements Directive (CRD IV)
- Seeks disclosure by covered financial institutions of information on Country-by-Country basis (profit or loss before tax, tax paid, subsidies received, average number of employees)
- EU member states must domestically enact rules to require reporting

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Other New Developments

- Intergovernmental Agreements ("IGAs"):
  - Prompted by United States' introduction of "Foreign Account Tax Compliance Act" ("FATCA") in 2010, which requires foreign and domestic financial institutions to provide data to the United States on U.S. taxpayers, or face penalties
  - Role of IGAs
  - Expanded interest in IGAs beyond United States
- Increased Attention to Multilateral Convention on Mutual Administrative Assistance in Tax Matters:
  - As independent source of heightened exchange of information
  - As a possible legal framework for sharing, receiving and providing information under Action Item 13 reporting
  - As a legal framework for CRS and Automatic Exchange of Information

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Existing Mechanisms Supporting Transparency and Disclosure

- Article 26 (based on UN and/or OECD Model Treaties)
- Tax Information Exchange Agreements (TIEAs)
- Regional Agreements
- Global Forum on Transparency and Exchange of Information

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Implications of a Close Look at Transparency and Disclosure from a Developing Country Perspective

(1) "Meaningful" Participation will Require Technical Support and Capacity Building Which Includes Basic Regime *Design* Choices:
- Access to Action Item 13 Reports
- Using and Interpreting Information in Action Item 13
  - Language
  - General Transfer Pricing Expertise
  - How to Make Risk Assessment from the Files
  - Case Study Training Using Action Item 13 Reports

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Implications of a Close Look at Transparency and Disclosure from a Developing Country Perspective

(1) Meaningful Participation: ***continued***

- **Participation in Information Exchange and Delivery (All Mechanisms)**
  - **Domestic legislation**
- **Additional Supports for Use of Information under Exchanges and Delivery**
  - **Increased compliance**
  - **Improved enforcement**
  - **Domestic transparency and governance issues**
  - **Domestic Political Buy-in**

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Implications of a Close Look at Transparency and Disclosure from a Developing Country Perspective

(1) Meaningful Participation: ***continued***

Current responses:

- **Range of projects and pilots**
- **Variety of international actors and organizations**
- **Combination of core technical tax assistance and capacity building, plus specific cross border issues**
- **Examples**
- **Concerns**

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Implications of a Close Look at Transparency and Disclosure from a Developing Country Perspective

(2) Inadequate Support is Inconsistent with Commitments and Goals of G20, OECD, and others

- **Tenor and framing of BEPS problem and project**
- **G20 Development Working Group (DWG) request to OECD to report on main challenges of BEPS for developing countries**
- **OECD two part report to DWG**
- **IMF study of spillover effects in corporate taxation**
- **UN commitment to facilitate meaningful participation in the design of the BEPS project and its outputs**
- **Recent (September 2014) request from the Finance Ministers of the G20 to the OECD to enhance developing country role in BEPS project**

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Implications of a Close Look at Transparency and Disclosure from a Developing Country Perspective

(3) Even if Significant Technical and Administrative Issues are Addressed, Will some Countries still not see expected BEPS gains due to:

- Tax competition incentives to ignore new information
- Corruption/and or lack of political buy-in (relevant efforts to tackle both individual tax evasion and multinational corporation base erosion activities)

- Note variation by developing country, even by issue
- Domestic political structure and allocation of different financing powers relevant
- Recent scrutiny of Ireland, Luxembourg and others on potential illegal state aid is good reminder of this issue

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Implications of a Close Look at Transparency and Disclosure from a Developing Country Perspective

(3) Will Some Countries still not see Expected BEPS Gains: *continued*

- Recommendation:
  - In addition to providing technical support, international and regional organizations can provide political support for tax administrators in developing countries
  - Revisit issue of public disclosure of some multinational tax information to public– provide a counterbalance to indifference, corruption, and unstated deals with multinationals
    - See context, concerns and limits of such an approach

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Improving Tax Treaty Dispute Resolution – lessons from Australia

Dr. Jonathon Spencer[1]

SUMMARY

In recent months, the rather specialist world of Base Erosion and Profit Shifting (BEPS) has reached out into public consciousness, with a plethora of media reports profiling alleged corporate tax avoidance of some very large and popular international corporations. This increasing public focus has been fuelled by the 'perfect storm' with:

- the release of OECD recommendations to the G20 of seven elements of the BEPS Action Plan (16 September 2014)
- the BEPS focus at the G20 Finance Ministers meeting in Cairns (20-21 September 2014)
- the so called 'Lux leaks' from the International Consortium of Investigative Journalists - ICIJ (6 November 2014), and
- the G20 Leaders Summit in Brisbane (15-16 November 2014).

[1] Disclaimer: The views expressed in this presentation are those of the author, and do not necessarily represent the view of the Australian Taxation Office or the Australian Government.

During our 2014 presidency of the G20, Australia has been in the spotlight promoting issues surrounding BEPS. Discussions have centered on the notion of taxing profits in the location where the economic activity takes place, the exchange of information, and the use of a multilateral instrument.

Delivering the keynote address at the 2014 CPA Congress in October, the Australian Taxation Commissioner, Chris Jordan, observed that "In a globalised world, multinationals operate seamlessly across borders and take a global, top-down view to structure their operations across countries for maximum economic advantage. As tax administrators, we need to do the same. We will remain at a disadvantage unless we move from taking an isolated, single country view and replace it with a global, bigger picture view"[2].

In promoting a more unified and collaborative approach amongst tax administrations, an effective and transparent policy framework for the resolution of international tax disputes needs to be further developed. In this regard, recent developments in Australian *domestic* taxation dispute resolution may provide some guidance and viable options.

This presentation seeks to briefly address some current issues relating to the arbitration provision of Article 25 in the OECD Model Tax Convention on Income and on Capital 2010-2012, and recent Australian taxation dispute developments. The first part outlines some of the context behind the development of the

[2] https://www.ato.gov.au/Media-centre/Speeches/Commissioner/Commissioner-s-keynote-address-to-the-2014-CPA-Congress/ [accessed 09 November 2014]

provision and highlights a need to improve its effectiveness, as demonstrated in OECD BEPS Action Plan 14.

The second part describes recent domestic policy enhancements to the resolution of taxation disputes by the Australian Taxation Office (ATO). Attention is drawn to a number of relevant domestic dispute documents, such as the ATO Disputes Policy, the ATO Dispute Management Plan 2013-14, and ATO dispute resolution strategies.

The final part extrapolates this experience to the international setting, and suggests some future options which could be considered for the promotion of more effective international taxation dispute resolution frameworks. Notions around Alternative Dispute Resolution (ADR), arbitration, MEMAP, Mutual Independent Review, and a global tax authority will be explored.

Australian Government
Australian Taxation Office

BEPS 14 - Improving Tax Treaty Dispute Resolution

Lessons from Australia

Presented by
Jonathon Spencer
Australian Taxation Office

Sydney Law School BEPS Conference
17-18 November 2014

Outline

1/ OECD Model Convention Article 25 & BEPS Action Item 14

2/ Australian Domestic Dispute Resolution Practices

3/ Future Options

1. OECD Model Convention – Article 25 MAP

- Paragraph 1:

irrespective

Domestic law

Competent authority

Three years

OECD Model Convention – Article 25 MAP

- Paragraph 1:
- Paragraph 2:

shall endeavour

Mutual agreement

Tax not in accord with treaty

Notwithstanding any time limits in the domestic law

OECD Model Convention – Article 25 MAP

- Paragraph 1:
- Paragraph 2:
- Paragraph 3:

shall endeavour

Mutual agreement

difficulties or doubts

OECD Model Convention – Article 25 MAP

- Paragraph 1:
- Paragraph 2:
- Paragraph 3:
- Paragraph 4:

communication

direct

joint commission

OECD Model Convention – Article 25 MAP

- Paragraph 1:
- Paragraph 2:
- Paragraph 3:
- Paragraph 4:
- Paragraph 5:

unable to reach agreement

two years

arbitration

binding

An insight into likely directions for 2015 deliverables 7

MEMAP

An insight into likely directions for 2015 deliverables 8

BEPS Action 14

- Measures to improve MAP
- Encourage arbitration
- Multilateral approaches
- Forum on Tax Administration support

An insight into likely directions for 2015 deliverables 9

2. Australian Domestic Dispute Resolution

- In-house Facilitation
- Independent Review
- Alternative Dispute Resolution
  - mediation
  - early assessment and resolution
  - arbitration
- Settlement
- Litigation & test case

3. Future Options for MAP

- Statistics
- MEMAP
- Mandatory Arbitration
- ADR options
- Extending APAs
- Mutual Independent Review
- Global Tax Authority
- Other ?

ATO Commissioner Chris Jordan:

> Business does not want unilateral solutions that could be a nightmare and … I don't want that either. Because as an administrator that means I'll be arguing with all other people in all other countries about who's got what share. We're going to go right back to the old problems, of double taxation. Who's got what right to tax people.

Chris Jordan, 'Closing Remarks'
(Paper presented at G20 International Tax Symposium, Tokyo, Japan 9-10 May 2014)

The BEPS Project and Developing Countries: from Consultation to Participation

Base Erosion and Profit Shifting (BEPS) is a global problem which requires global solutions. BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid. BEPS is of major significance for developing countries due to their heavy reliance on corporate income tax, particularly from multinational enterprises (MNEs).

DEVELOPING COUNTRIES AND BEPS

Taxation plays a central role in promoting sustainable development, and developing countries face significant challenges in developing their tax capacities and mobilising domestic resources. Engagement of developing countries in the international tax agenda, including on BEPS, is therefore important, in particular to ensure they receive appropriate support to address the specific challenges they face.

In the first year of the Project, more than 80 developing countries and other non-OECD/non-G20 economies have been consulted through four in-depth regional consultations and five thematic global fora. The input received from developing countries has been fed directly into the development of the BEPS Action Plan through the technical groups carrying out the work on BEPS (for example on the template for Country-by-Country reporting, or the work on treaty abuse and the considerations for entering into tax treaty relationships).

This engagement has also been crucial in identifying the specific challenges and priorities of low-income countries. These priorities, and how the G20 can provide support to address them, was the subject of a dedicated two-part Report prepared by the OECD under a mandate from the G20 Development Working Group, and it was welcomed by the G20 Finance Ministers at their meeting in Cairns in September 2014.

The BEPS Project priority areas identified by developing countries include limiting base erosion via interest deductions and other financial payments (Action 4 of the BEPS Action Plan), preventing tax treaty abuse and the artificial avoidance of Permanent Establishment status (Actions 6 and 7), transfer pricing, in particular base eroding payments (Actions 8, 9 and 10), and transfer pricing documentation and country-by-country reporting (Action 13). Political support and capacity building to address BEPS issues have been identified as key cross cutting challenges for developing countries, particularly as the implementation of the BEPS measures begins.

The lack of transfer pricing comparables data and the granting of wasteful tax incentives have also been identified as areas of particular concern for developing countries. These issues are not part of the BEPS Project itself and are the subject of specific mandates for further analysis from the G20 and ongoing work through the Task Force on Tax and Development.

The BEPS Project in a nutshell

In an increasingly interconnected world, national tax laws have not always kept pace with how global corporations have developed nor with the rise of the digital economy, leaving gaps that can be exploited to generate double non-taxation. This undermines the fairness and integrity of tax systems. The first set of BEPS measures and reports were released in September 2014. Combined with the work to be completed in 2015, these measures will give countries the tools they need to ensure that profits are taxed where economic activities generating the profits are performed and where value is created, while at the same time give business greater certainty by reducing disputes over the application of international tax rules, and standardising requirements. The OECD/G20 BEPS Project is leading to concrete change and is now strengthening the engagement and participation of developing countries.

STRENGTHENING THE INVOLVEMENT OF DEVELOPING COUNTRIES IN THE BEPS PROJECT

In September 2014, the G20 Finance Ministers asked the OECD to build on its current engagement with developing countries and develop a new structured dialogue process, with clear avenues for developing countries to work together and directly input into the G20/OECD BEPS Project. The OECD, working with other International Organisations and regional tax organisations, has also been mandated to develop tools to translate the BEPS Action Plan into practical support for lower capacity developing countries, to be delivered in 2016. The new structured dialogue process on the BEPS Project is based on three pillars.

1. Direct participation in the Committee on Fiscal Affairs and its subsidiary bodies

2. Regional Networks of tax policy and administration officials

3. Capacity building support

1

Developing countries from a cross-section of regions and per capita income-levels, will be invited to participate in the Project by attending the meetings of the Committee on Fiscal Affairs (CFA, the key decision-making body of the BEPS Project) and of its subsidiary bodies (the working groups responsible for carrying out the technical work). Regional tax organisations ATAF (African Tax Administration Forum) and CIAT (Inter-American Centre for Tax Administration) have also been invited to participate in the CFA and all technical working groups. IMF, the WBG and the UN already participate in these meetings.

Through this direct participation, developing countries will be able to provide input at the working and decision-making levels of the BEPS Project, and to ensure that the specific concerns and context of developing countries are taken into account in the development of solutions to counter BEPS. Not only will developing countries be able to directly input and gain an improved understanding of the BEPS process, but OECD members and BEPS Associates will also be exposed first-hand to accounts of the specific perspectives of, and challenges faced by, developing countries.

2

Leveraging on the success of the regional consultations in 2014, regionally-based networks of tax policy and administration officials are being set up for an ongoing and more structured dialogue process with a broader group of developing countries. Countries participating in the BEPS Project will play a key role in these networks acting as a direct conduit to the BEPS Project on the issues and comments raised by their colleagues through the regional networks.

The networks are to be organised based on 5 regional/linguistic groupings, in close co-operation with other international organisations and relevant regional tax organisations:

- ***Africa***, with ATAF (African Tax Administration Forum)
- ***Latin America and the Caribbean***, with CIAT (Inter-American Centre of Tax Administration)
- ***Asia***, in co-operation with SGATAR (Study Group on Asian Tax Administration Research)
- ***French-speaking countries***, in co-operation with CREDAF (*Centre de rencontre des administrations fiscales*)
- ***Central Europe and Middle East***, in co-operation with IOTA (Intra-European Organisation of Tax Administrations)

Supporting capacity building in developing countries on BEPS issues is a priority. The regional networks will play an important role in the development of toolkits needed to support the practical implementation of the BEPS measures and the other priority issues for developing countries (tax incentives and comparables) which are outside the BEPS Project. Each will be a forum for interested developing countries to discuss participation in the work on the multilateral instrument under Action 15 of the BEPS Project.

In addition to the regional networks, the OECD Global Relations Tax Programme and the Tax and Development Programme provide additional platforms for engagement and dialogue on BEPS issues – through demand-led training events and bilateral country programmes which help put in place stronger international tax rules and administrative processes. All these initiatives will be coordinated with the IMF, the WBG and the UN to ensure effective and efficient support to developing countries.

Countries Views

"Jamaica is pleased to be a participant in the BEPS project. It is our hope that the work of the OECD's Committee of Fiscal Affairs and the various technical working groups will allow for meaningful participation of developing countries and that the outcome of this project will be workable and applicable solutions, which can lead to the stimulation of sustainable economic growth worldwide, underpinned by the pillars of greater levels of tax compliance within states and the creation of a global economic environment which will allow for increased economic viability of developing states."

"Kenya is committed to getting directly engaged in the BEPS process. As an initial step, we have joined the ATAF working Group on BEPS and are building capacity in this area. We are convinced that by being engaging in BEPS processes, we shall be able to address the real issues that have been exposed by the various TP audits we have conducted that have made it evident that BEPS is not a perception but a reality. In the circumstances we shall be more than happy to be quoted in the press about our joining BEPS."

NEXT STEPS

A **workshop for developing countries representatives is planned for 10-11 December 2014 in Paris** to discuss the content of the BEPS Project, how it is organised and structured, as well as the human and technical resources available to support the participation of developing countries, such as dedicated contact persons in the Secretariat and the use of secure websites to share relevant materials. A number of developing countries are then expected to participate in the CFA meeting of January 2015, alongside the IMF, the WBG and the UN, as well as CIAT and ATAF.

From January 2015, **developing countries representatives will attend the meetings of the relevant subsidiary bodies**, such as Working Party 1 on tax treaties, Working Party 2 on Tax Policy and Statistics, Working Party 6 on transfer pricing, Working Party 9 on consumption taxes, Working Party 11 on aggressive tax planning, the Forum on Harmful Tax Practices and the Task Force on the Digital Economy.

Regional network meetings are planned for February-May 2015, including the Global Forum on Transfer Pricing in Paris on 16-18 March, followed by a the plenary of the Task Force on Tax and Development entirely dedicated to BEPS issues in the developing country context.

By participating directly in the BEPS Project, developing countries will be able to present their perspectives, participate in the decision-making process, play a leading role in the regional networks and in the development of toolkits needed for the practical implementation of the BEPS outputs.

Further information

www.oecd.org/tax/developing-countries-and-beps.htm

PART 2 OF A REPORT TO G20 DEVELOPMENT WORKING GROUP ON THE IMPACT OF BEPS IN LOW INCOME COUNTRIES

13 AUGUST 2014

OECD
BETTER POLICIES FOR BETTER LIVES

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EXECUTIVE SUMMARY

This paper constitutes Part 2 of a two-part report to the G20 Development Working Group (DWG) on the impact of BEPS in low income countries. It builds on Part 1 of the report, which was presented to the DWG at its meeting in Hobart in May 2014[1].

The DWG has invited the Organisation for Economic Co-operation and Development (OECD) to write a report on the main challenges of BEPS in developing countries, how these are related to the Action Plan, and how the DWG might assist developing countries to meet those challenges. This report draws on the experiences of developing countries and the report reflects comments from the International Monetary Fund (IMF), given its body of work on international tax issues, with a particular focus on the special concerns and experiences of developing countries, and from the World Bank Group (WBG), United Nations (UN) and regional organisations[2].

The report is not intended to provide, and does not represent, a consensus view shared by these organisations.

The report identifies the highest priority BEPS issues faced by developing countries and sets out how the DWG could help. This means that the report is restricted to a discussion of issues, including capacity development concerns, that arise from the interaction between different tax rules or from arrangements that lead to no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place. It should be recognised that this is only one of many challenges faced by developing countries as evidenced by the work of international organisations.

The 2011 report from the international organisations to the DWG (OECD, 2011) noted that a series of broader problems plague the revenue raising efforts of developing countries including corruption, the informal sector and various tax policy and administration concerns. This diagnosis remains true today and BEPS must be seen in the context of a range of priorities that each country faces. Nevertheless, for many developing countries, addressing BEPS is not a luxury item – one that can be delayed to when more advanced levels of development are reached. Reliance on corporation tax means addressing BEPS is an urgent domestic resource mobilisation matter – a bridge that must be crossed in lower and middle income countries, in combination with other pressing problems – and a strengthened capacity to address BEPS issues in turn strengthens effectiveness in other areas, including domestic tax avoidance.

The report outlines a number of recommendations on how the DWG can assist developing countries meet the challenges posed by BEPS, particularly the priorities identified in the Action Plan. The key messages and recommendations are as follows:

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[1] The report is prepared under the responsibility of the OECD Secretariat. It does not represent the views of member states.

[2] The DWG's Terms of Reference state: "the report will be led by the OECD Tax and Development Secretariat, drawing on the views and expertise of the OECD Centre for Tax Policy and Administration (CTPA). … The OECD Tax and Development Secretariat will work closely with and coordinate its work with the IMF, in order to benefit from the IMF's near-universal membership and expertise in domestic resource mobilisation in developing countries. … The Tax and Development Secretariat will also work with other international and regional organisations to elicit the views of LICs."

- BEPS is an issue which harms developed and developing countries, arising from deficiencies of current international tax rules and standards. As a standard setter, the OECD is engaged in fixing these deficiencies involving all G20 countries on an equal footing. While it is recognised that no one size fits all, global solutions are needed to resolve global problems. It is essential that the OECD take the views and perspectives of developing countries into account when developing a new international tax framework.

- The OECD/G20 BEPS Project, which is responsible for the Action Plan, needs to ensure that BEPS solutions are relevant to, and effective for, developing countries. This means that developing countries must be fully engaged to ensure the solutions take into account the information and capacity gaps they frequently face. Some key concerns of developing countries have already shaped the Action Plan, such as revised transfer pricing rules that includes a template for country-by-country reporting to tax administrations, but the engagement of developing countries in the design of solutions needs to be stepped up. There are opportunities to put in place a more structured dialogue process, with clear avenues for developing countries to work together and directly input on the OECD/G20 BEPS Project. The OECD will strengthen the way it engages with developing countries over the coming months.

- Political level engagement on BEPS issues in many developing countries is at an early stage. G20 members, international and regional organisations, NGOs and other stakeholders can facilitate increased awareness of the importance of BEPS issues at developing country political levels, while recognising that BEPS may not be the highest priority issue in each case.

- G20 countries should analyse the spillover effects of changes to the design of their own tax systems on those of developing countries.

- The OECD, IMF, UN, WBG and regional organisations, where appropriate and they are in a position to do so, should assess how practical toolkits can be produced to help developing countries implement key BEPS actions regarding: for example, interest, services and royalties payments; the pricing of exported commodities; issues raised by business restructuring and accessing the information needed to assess and address BEPS. The toolkits will assist developing countries to address the highest priority BEPS issues. They will not create separate or alternative norms or standards.

- Part 1 of the report to the DWG shows that some of the key base erosion challenges faced by developing countries are not addressed in the OECD/G20 BEPS Project. The international and regional organisations can help the G20 to undertake further analyses on the lack of comparability data for transfer pricing, and on structures that indirectly transfer the ownership of an asset situated in a country in a way that avoids taxation by that country of profits arising from an increase in the value of that asset.

- Tax incentives, a major focus of work by the IMF, WBG and others for many years, are still a top priority concern for developing countries. Although outside the Action Plan, the DWG has already suggested further effort and recommendations will be required in 2015.

- The development of the Multilateral Instrument (Action 15) is still in its early stages but has the potential to be an important tool for developing countries that have a tax treaty network. This instrument has the potential to be cost efficient to governments, while providing more certainty to foreign investors.

- The report recognises that capacity development on BEPS issues is critical. There has been extensive work by the international organisations in this area for many years, and the IMF, WBG and others have considerable experience. G20 members are active partners in this field. Some further recent international experience gathered under the auspices of the OECD's Task Force on Tax and Development suggests capacity building on BEPS issues achieves significant results, providing grounds for optimism as the Action Plan rolls out. The report proposes the DWG promotes and endorses the long-standing efforts of the international and regional organisations on BEPS issues, as well as some promising new initiatives such as the OECD's Tax Inspectors Without Borders (TIWB) through which G20 countries are gearing up support to developing country tax administrations.

- To guide their actions to address BEPS, DWG members can note some of the capacity development experiences from developing countries and international organisations. Lessons include the importance of approaching BEPS issues in the context of broader reform plans and development strategies; the role of regional organisations, civil society and business; and the importance of retaining skilled staff.

SECTION 1: INTRODUCTION AND BACKGROUND

At the 2013 St. Petersburg Summit, Group of Twenty (G20) leaders endorsed the St. Petersburg Development Outlook (G20, 2013), which committed the DWG to “review relevant work on base erosion and profit shifting (BEPS) during 2014 in order to identify issues relevant to low income countries (LICs) and consider actions to address them”.

In response to this commitment the DWG requested the OECD, working with other international and regional organisations, in particular with the IMF, to report on the main sources of BEPS for LICs and other low capacity countries (‘developing countries’), how those sources relate to the Action Plan and how the DWG might assist developing countries to meet those challenges.

Part 1 of this report was based on extensive dialogue and consultations with developing countries, and, in accordance with the DWG’s Terms of Reference, drew on the findings of the transfer pricing pilots undertaken by the OECD Task Force on Tax and Development, which featured in the DWG’s 2010 Multi-Year Action Plan. A key objective of the OECD’s participation in these pilots, undertaken in partnership between the European Union (EU), OECD and WBG, is for the OECD to gain a better understanding of the issues faced by developing countries in implementing internationally developed norms and standards. This is achieved by working directly with developing countries, and the EU and WBG.

Part 1 was discussed at the meeting of the DWG in May 2014. It reported that BEPS is a major concern for developing countries, and found that:

- While BEPS is a global issue, developing countries face specific policy issues and implementation challenges that are not always shared with developed countries;
- Some BEPS Actions are of more immediate relevance and concern to developing countries than others. Over the longer term, however, all BEPS Actions are likely to become important to developing countries as they work through their priority list and strengthen their tax systems accordingly;
- There are other base erosion issues, not covered in the OECD/G20 BEPS Project, which developing countries report are of immediate concern and which are already the subject of considerable technical assistance.

This paper constitutes Part 2 of the report, for discussion at the meeting of DWG in September 2014 in Perth, Australia. It builds on Part 1 and takes account of further consultations with developing countries and the comments received from the DWG meeting in May 2014.

This report proposes recommendations for the DWG to:

- Call on the OECD to ensure engagement with developing countries is stepped up so that BEPS solutions take account of specific capacity and political challenges faced by developing countries (in Section 2 below).

- Call on the OECD, IMF, UN, WBG and regional organisations, where appropriate and they are in a position to do so, to assess how they can assist developing countries address the challenges they face in relation to action items in the Action Plan (in Section 3 below).

- Call on the OECD, IMF, UN, WBG and regional organisations, where appropriate and they are in a position to do so, to assess how they can assist developing countries address the challenges they face from other BEPS related issues outside of the Action Plan (in Section 4 below).

- Welcome the work being carried out by international organisations in response to capacity development issues (in Section 5 below).

These recommendations are summarised in Section 6.

SECTION 2: STEPPING UP ENGAGEMENT WITH DEVELOPING COUNTRIES TO ADDRESS BEPS CHALLENGES AT TECHNICAL AND POLITICAL LEVELS

Part 1 of this report concluded that developing countries face challenges not always shared by developed countries. In particular it identified information and capacity gaps exacerbated by a lack of political awareness of these challenges. These have a number of implications that are discussed in this Section.

a) Engagement with developing countries to ensure the specific challenges they face are taken into account in designing BEPS solutions

BEPS is a global issue requiring solutions that are relevant for developing countries and effective in addressing their specific capacity and resource constraints. The design of BEPS solutions cannot ignore these constraints, and developing country views and perspectives must impact on BEPS solutions.

There has already been significant engagement between the OECD/G20 BEPS Project and developing countries which has already shaped the OECD/G20 BEPS agenda (see Box 1 below).

Box 1. Shaping the OECD/G20 BEPS agenda

Dialogue with developing countries has shaped the OECD/G20 BEPS agenda in several key areas:

- Work has begun in response to **concerns expressed by developing countries about the lack of quality comparability data** in their countries that can be used for transfer pricing purposes. Further details of this work are set out in Section 5 b) below.
- Revision of the Transfer Pricing Guidelines on documentation (Action 13) in response to developing country concerns that they face significant challenges in **obtaining the information they need to apply their transfer pricing rules.** This includes a **template for country-by-country reporting** to tax administrations of income, taxes and economic activity to meet the demands from many developing countries for the introduction of some form of country-by-country reporting. This will assist developing country tax administrations that have faced significant challenges in building a "big picture" view of a taxpayer's global operations.
- New **guidance on safe harbours** for transfer pricing purposes have been produced in response to the concerns expressed by many developing countries that they face significant capacity issues in implementing highly complex transfer pricing rules and need some simplification measures. The guidance provides a basis for countries, especially developing countries, to design a transfer pricing compliance environment that makes optimal use of the limited resources available.
- In the context of the OECD/G20 BEPS Project, work is underway to develop transfer pricing rules to provide **protection against common types of base eroding payments**, such as service fees which were identified as a significant BEPS issue by developing countries during the BEPS consultation process.
- The **model anti-abuse provisions** that countries can include in treaties have been designed under the OECD/G20 BEPS Project to make it possible for tax administrations with limited capacity to administer them.

As the evidence base grows, indicating the importance of BEPS to the developing world, the time is right for the dialogue to be taken to a new level. There are opportunities to put in place a more structured dialogue process, with clear avenues for developing countries to work together and directly input into the work under the Action Plan. The OECD will strengthen the way it engages with developing countries over the coming months.

Recommendations

The DWG calls on:

1. The OECD/G20 BEPS Project to ensure that the outcomes of the Project take into account the specific challenges faced by developing countries, in particular in the highest priority Actions for developing countries (Actions 4, 6, 7, 10, 11, and 13).

2. The OECD to put in place a new structured dialogue process, with clear avenues for developing countries to work together and directly input into the OECD/G20 BEPS Project.

b) Need for stronger political awareness within both developing and developed countries

i) Political awareness in developing countries of the potential impact of BEPS on their country's tax base

The IMF regularly engages with its members on international tax issues, most intensely in its technical assistance work. Yet countries in the consultation process frequently reported the need to achieve political buy-in as a prerequisite to making the legislative changes and resource commitment required to counter BEPS. Many developing countries report that there is a lack of awareness at a political level on the need for action and reform. Box 2 below reports, as an example, the conclusions of Australia and New Zealand regarding the profile of BEPS in Pacific Island countries.

Box 2. Pacific Island countries have limited awareness of BEPS

In Australia and New Zealand's bi-lateral consultations with Pacific Island countries (PICs) most reported very little awareness of BEPS issues. Based on these consultations Australia and New Zealand see a need to engage further with PICs to build awareness of how BEPS affects broader domestic resource mobilisation efforts.

All stakeholders — G20 countries, international and regional organisations, civil society and donors — that have access to political levels in developing countries have a role to play in explaining BEPS risks and in bringing these issues to the attention of Ministers in government departments other than tax administrations, in particular Ministries of Finance.

Recommendations

The DWG calls on:

3. All stakeholders – G20 countries, international and regional organisations, civil society and donors – to raise awareness of the significance of BEPS issues at political levels in developing countries by holding high-level political dialogue on BEPS issues with developing country Ministers from Ministries of Finance and other relevant Ministries.

ii) Political awareness in developed countries of the potential spillover effects of changes to their tax systems on BEPS related issues in developing countries

The 2011 report from the international organisations to the DWG (OECD, 2011) recommended that developed countries undertake spillover analysis of the impact of any significant changes to their own tax systems on those of developing countries. The issue is further highlighted in Action 11 of the Action Plan, which includes the development of an economic analysis of the scale and impact of BEPS (including spillover effects across countries). In light of these developments, and the recent work undertaken by the IMF (IMF, 2014) on this topic, G20 countries should analyse the spillover effects of revisions made to their own tax systems on those of developing countries.

Recommendations

The DWG suggests:

4. G20 countries should analyse the spillover effects of revisions made to their own tax systems on those of developing countries.

SECTION 3: POTENTIAL ACTIONS TO ASSIST DEVELOPING COUNTRIES ON HIGH PRIORITY BEPS ISSUES

Section 3 and section 4 of this paper recommend that the DWG calls on international and regional organisations, where appropriate and in a position to do so, to assess how practical toolkits can be produced to assist developing countries implement key BEPS outcomes and to address the difficulties caused by a lack of comparability data. There is a clear need for this work but further discussion is required on how such toolkits should be developed, what they should cover, how the different international and regional organisations can assist in their development and the timelines going forward.

a) Base eroding payments between Multinational Enterprise (MNE) related parties

The profit-shifting risk of payments between related companies is one of the most frequently reported concerns of developing countries. Many consider that excessive or unwarranted payments by MNE taxpayers to foreign related companies represent a significant risk to their tax bases. They similarly report concerns about profit shifting through under-priced export sales to foreign related parties.

Risks arising from excessive or unwarranted payments are frequently reported in relation to payments of interest and royalties, or to fees paid for management or other services. Countries often find it difficult to apply the criteria contained in the current international tax rules to assess whether such payments are excessive or unwarranted.

Risks arising from under-pricing of exports to related parties occur in all industries, but are especially significant for some mineral and commodity products, where, again, international tax rules may be difficult to apply. This has led some resource rich countries to introduce rules intended to counter these specific risks. Box 3 below describes the rule introduced by Zambia, which is an example of rules sometimes described as the "Sixth Method".

Box 3. Pragmatic adaptation: Zambia's special rule on metals pricing

Zambia has introduced rules that apply to the sale of base metals or any substance containing base metals or precious metals between related parties. In such transactions the sale price for tax purposes will be broadly the monthly average quoted price on metal exchange markets.

The Action Plan addresses these types of risks under Actions 4 and 10. It is important that the design of BEPS solutions under these Actions takes account of the challenges that developing countries report in applying current international rules to these risks. The Zambian case illustrates the type of adaptation potentially of value and interest to many other countries together with tools that enable them to effectively implement BEPS solutions associated with these risks.

Recommendations

The DWG calls on:

5. The OECD/G20 BEPS Project to ensure that Actions 4 and 10 take into account developing country issues.

6. The OECD, IMF, UN, WBG and regional organisations, where appropriate and they are in a position to do so, to assess how practical toolkits can be produced to assist them implement rules to address BEPS issues relating to base eroding payments between MNE affiliates.

A toolkit might, for example, consist of:

- An explanatory note, describing how risks from base eroding payments between MNE affiliates arise.
- A paper on policy considerations and implications related to measures to counter tax loss arising from such payments.
- A description and analysis of regulatory options available, such as transfer pricing, thin capitalisation, anti-avoidance rules, BEPS special measures, as well as treaty measures, outlining potential advantages and disadvantages of each, in the light of country experiences to date.
- Model legislation and explanatory notes.
- Guidance on the administration of regulatory options (including governance), and practical auditing techniques.
- Supporting training materials.

b) Challenges created by new ways of doing business

As set out in Part 1 of the report the increasing mobility of capital and people, and the rapid adoption of technology to improve communications, has resulted in restructuring of MNE business models and operations.

Such restructurings offer the opportunity to contractually shift risk and valuable intellectual property from, for example, local distributors to a central entrepreneurial company (the principal) in a low tax jurisdiction. This ability to contractually shift risk and intellectual property between the members of an MNE (but not outside the MNE group as a whole) allows MNEs to plan where profits are reported, and thus tax paid.

Developing country tax administrations are seeing many such restructurings and challenging them frequently involves the interaction of a number of international tax rules—transfer pricing rules, tax treaties, the taxation of non-residents, and rules concerning the transfer of intangible assets.

The Action Plan recognises these rules have weaknesses that create opportunities for BEPS and these are being addressed by Actions 7, 8 and 9. It is important that the design of BEPS solutions through these actions takes account of developing country concerns and they are provided with the tools to enable them to implement the solutions. The box below proposes recommendations to address these issues.

Recommendations

The DWG calls on:

7. The OECD/G20 BEPS Project to ensure that BEPS Actions concerning the rules to counter artificial profit shifting through supply chain restructuring, for example the definition of a Permanent Establishment (Action 7), risk allocation and intangibles (Action 8 and 9), take into account developing country capacity limitations and information gaps.

8. The OECD, IMF, UN, WBG and regional organisations, where appropriate and they are in a position to do so, to assess how practical toolkits can be produced to assist developing countries implement rules to counter artificial profit shifting through supply chain restructuring.

A toolkit might, for example, consist of:

- An explanatory note, explaining how and why businesses restructure their supply chains, and the tax implications. This will include a description of the different supply chain models MNEs typically employ and guidance on how to identify a business restructuring has taken place.
- A paper on policy considerations in designing measures to ensure that MNEs that undergo, or have undergone, business restructuring pay the right amount of tax in each of the locations in which they operate.
- A description and analysis of the regulatory tools available to counter BEPS arising from business restructuring. These include transfer pricing, permanent establishment issues, residency issues, treaty measures, anti – avoidance rules and BEPS special measures.
- Guidance on the administration of regulatory measures, including how to assess the BEPS risks from the restructuring on risk assessment and practical auditing techniques.
- Supporting training materials.

c) Information needed to assess and address BEPS issues

A major issue for developing countries is the ability to obtain information needed to assess the scale and impact of cross-border tax avoidance, and to take effective action to counter such avoidance. Developing countries need data to adequately quantify tax loss from cross-border tax avoidance, and to pinpoint the sources and nature of such losses, as well as the effectiveness of measures introduced to counter them. This issue is being addressed by Action 11.

Again, it is important that the design of BEPS solutions through Action 11 takes account of developing country constraints and such countries are provided with the tools to enable them to implement the solutions.

In addition, despite many developing countries introducing transfer pricing documentation rules they still often face significant challenges in obtaining the information they require to select the most appropriate taxpayers for audit, and then to effectively check or challenge their transfer pricing and other cross-border practices.

These countries see significant value in the revised guidance on transfer pricing documentation rules and the country-by-country template being developed under Action 13 but have reported they will require supplementary tools and instruments to implement the guidance.

The box below proposes recommendations to address these issues.

Recommendations

The DWG calls on:

9. The OECD/G20 BEPS Project to ensure that Action 11 takes into account developing country issues.

10. International and regional organisations, where appropriate and in a position to do so, to assess how tools and materials can be developed to assist developing countries assess the risks they face from BEPS.

11. The OECD, IMF, UN, WBG and regional organisations, where appropriate and they are in a position to do so, to assess how practical toolkits can be produced to support the successful implementation by developing countries of a) assessment of BEPS risks, and b) effective transfer pricing documentation requirements that balance compliance imperatives with compliance costs. The toolkit might, for example, consist of:

- Model legislation and explanatory notes.
- Reviews of country information requirements, procedures and practices.
- Supporting training materials.

d) Challenges deriving from the abuse of treaties

Whilst developing countries generally agree that bilateral tax treaties have been effective in preventing double taxation, and support a predictable investment landscape, they are deeply concerned about their misuse.

The main concern is focused on the use of techniques (sometimes called "treaty shopping'') to obtain treaty benefits (typically the reduction of withholding taxes) in situations in which such benefits were not intended.

Action 6 addresses such misuse by designing model anti-abuse provisions that countries can include in treaties. The design of these provisions ensures the provisions are capable of being effectively administered by tax administrations with limited capacity.

Developing countries are also concerned that the interpretation of the treaty rules on Permanent Establishments allow contracts for the sale of goods belonging to a foreign company to be negotiated and concluded in the country by the sales force of a local subsidiary on behalf of that foreign company. This can lead to the profits from these sales not being taxable to the same extent as they would have been if the sales were made by the local subsidiary. Action 7 will develop changes to the definition of Permanent Establishments to address challenges posed by what is technically referred to as "commissionaire structures".

A wider concern expressed by developing countries, and highlighted by NGOs in particular (McGauran, 2013), concerns the relative costs and benefits of entering into treaties. This raises both practical issues, such as the capacity of developing countries to ensure the treaty terms they negotiate are beneficial to the country, as well as policy considerations that countries should analyse before deciding to enter into a tax treaty with another country.

The box below proposes recommendations by the DWG to address these issues.

Recommendations

The DWG calls on :

12. The OECD/G20 BEPS Project to ensure that Actions 6 and 7 take into account developing country issues.

13. The OECD, IMF, UN, WBG and regional organisations, where appropriate and they are in a position to do so, to assess how to strengthen capacity development on treaty negotiation.

e) Use of the multilateral instrument developed under Action 15

Although the development of a multilateral instrument has not been identified as high priority by developing countries, the work by the OECD under Action 15 of the Action Plan to develop a multilateral instrument will minimize the cost and time required to modify bilateral tax treaty provisions. The multilateral instrument will be open to all countries and has the potential to be an important tool for developing countries to assist them counter BEPS issues and to provide more certainty to foreign investors.

Recommendations

The DWG calls on:

14. G20 countries to engage in dialogue with developing countries on the design and potential benefits of the Multilateral Instrument.

SECTION 4: POTENTIAL ACTIONS ON OTHER BASE EROSION ISSUES OF HIGH PRIORITY TO DEVELOPING COUNTRIES

a) Tax loss on indirect transfer of assets

Developing countries report that the profit made by the owner of an asset when selling it (for example, the sale of a mineral licence) is often not taxed in the country in which the asset is situated. Artificial structures are being used in some cases to make an 'indirect transfer'; for example through the sale of the shares in the company that owns the asset rather than the sale of the asset itself.

The IMF reports some recent cases in developing countries of significant gains on indirect transfers of assets being untaxed (or with tax disputed) by the country where the underlying assets are located (see Box 4 below).

Box 4. Examples of indirect transfers

Mauritania: A Canadian company effectively acquired an interest in a large gold mining project [in Mauritania] from another Canadian company via a transaction in the Bahamas in 2010, with a potential capital gain of US$4 billion. No tax was collected on the transaction in Mauritania.

Mozambique: In 2011 a change in ownership of mining projects in Mozambique was achieved through the sale, on the Australian stock market, of shares in the mining company holding interests in the projects. The value of the transaction was around US$4 billion. No tax was collected on the transaction in Mozambique. In the case of the sales of shares in the exploration concessions in the Rovuma basin, the authorities have collected US$1.1 billion in capital gains taxes in 2013-14. Changes were made to the tax code, on January 1, 2014, to ensure taxation of capital gains resulting from a direct or indirect transfer between non-residents of assets located in Mozambique (International Monetary Fund, 2014).

The UN Committee of Experts on International Cooperation in Tax Matters is also currently considering some of these issues in the context of tax treaties, as well as domestic law issues in the extractive industries.

Further work needs to be carried out on how domestic and international tax rules could be designed to address the indirect transfers of assets, in the developing country context.

Recommendations

The DWG calls on:

15. The OECD, in consultation with the IMF, to report on whether further analysis on this issue is needed to identify policy options to tackle abusive cases, with particular reference to developing countries.

b) Lack of data for transfer pricing comparability analyses

The international standard in transfer pricing, which is usually incorporated in domestic transfer pricing rules, requires MNEs to price their related-party transactions in line with the pricing they would have used if they were conducting the same transactions with unrelated parties. Financial data about transactions between unrelated parties (referred to as "comparable transactions") is thus important for countries to be able to effectively enforce their transfer pricing rules.

Developing countries often lack financial data on comparable transactions[3] effecting the application of transfer pricing rules to MNEs in all industries, but the lack of data on the pricing of certain natural resources is often particularly detrimental for developing countries. Some countries are starting to take measures to increase the data that might be used for transfer pricing purposes. Box 5 describes the approach taken by Kenya.

Box 5. Kenya expands data sources for transfer pricing analyses

Kenya has concerns regarding the availability and quality of financial data that might be used for transfer pricing purposes. To improve the data available it has introduced a requirement in its Companies Bill for statutory accounts to be filed with the central registry and to be made publicly available.

Developing countries recognise that measures such as those taken by Kenya above will assist, but they have also expressed an interest in:

- The development of additional tools (e.g. a template for carrying out searches for comparables), materials and training programmes on the use of available databases;
- The development of a toolkit to assist developing countries make appropriate use of foreign comparables (i.e. data on entities in a foreign country); and
- Work on alternative approaches to applying internationally agreed principles in the absence of reliable data on comparables, including work on safe harbours and approaches that operate in ways similar to the "Sixth Method" referred to in Section 3 a) above.

[3] Measures to address this issue are discussed in the OECD document *Transfer Pricing Comparability Data and Developing Countries* (OECD, 2014).

Recommendations

The DWG:

16. Welcomes further work by the OECD and WBG to assess how practical toolkits can be produced to a) assist developing countries address difficulties in accessing comparables data and b) use approaches to apply internationally accepted principles in the absence of comparables (for example, safe harbour provisions).

A. Improving access to comparability data and the effectiveness of its use

A toolkit might, for example, consist of:

- An explanatory note, describing the role of comparables data in transfer pricing and implications of the inability to access such data.
- A description and analysis of measures developing countries might take to improve access to comparables data (such as expanding the scope and use of databases and the use of foreign comparables) or to reduce reliance on comparability data (including the use of measures and approaches such as the 'sixth method' that do not rely on the availability of such data).
- Model legislation and explanatory notes, where needed.
- Supporting training materials.

B. Safe harbours

A toolkit might, for example, consist of:

- An explanatory note, describing the key features of safe harbours and country approaches.
- A paper on policy considerations and implications of introducing a safe harbour regime.
- A description and analysis of regulatory options available, including developing country experience to date.
- Model legislation and explanatory notes.
- Guidance on the administration of safe harbours.
- Supporting training materials.

17. Calls on the OECD to commence a study on the feasibility of addressing the information gap on prices of some natural minerals sold in an intermediate form, e.g. mineral concentrate.

c) Wasteful tax incentives

Although outside of the Action Plan, Part 1 of this report raised concerns from developing countries about potentially wasteful tax incentives that erode the tax base with little demonstrable impact on investment. Many efforts are underway by governments, international and regional organisations and civil society to address these concerns. The IMF and WBG have analysed the problem and provided support to developing countries for decades.[4] Recently, the OECD's Task Force on Tax and Development has proposed a set of *draft principles to enhance the transparency and governance of tax incentives for investment in developing countries* (OECD, 2013), that can be used as a diagnostic framework to analyse the problem in developing countries (see Annex 1). The G20 now has an opportunity to bring much of the existing knowledge together and to raise the profile. Using country-studies and focusing on governance and transparency, guidance could be developed for developing countries to better balance investment and tax revenue priorities.

Recommendations

The DWG welcomes:

18. A report (in 2015) on good practice in transparency and governance on tax incentives in developing countries from the IMF, OECD, UN and the WBG, using case studies, to better guide the developing countries in:

- Balancing investment and public revenue priorities.
- Estimating the cost of tax incentives, including revenue leakages due to unintended tax planning opportunities.

[4] See for example, James (2013), Klemm and Van Parys (2009).

SECTION 5: CURRENT BEPS CAPACITY DEVELOPMENT ISSUES INVOLVING INTERNATIONAL ASSISTANCE PROVIDERS

Part 1 of this report relayed a clear message from developing countries that capacity development is critical to the successful implementation of measures to counter BEPS. The IMF, WBG and others have provided extensive support, including on international tax issues and tax incentives, and including through investment lending support, on strengthening tax policy and administration in developing countries for many years, with many positive results (OECD, 2011). More recently, International organisations have gathered specific evidence to show capacity development on BEPS issues can make a significant difference, including impacting on domestic resource mobilisation (see Box 6 below). This provides some grounds for optimism that BEPS solutions, with the right support, can be successfully implemented in developing countries as the BEPS Action Plan rolls out.

Box 6. Capacity development makes a difference

In 2011 the OECD, WBG and EU, began a programme of support for developing countries seeking to strengthen their transfer pricing rules and their implementation. Support initiatives are now in place in Colombia, Ethiopia, Ghana, Kenya, Peru, Rwanda, Vietnam and Zambia. Other country and regional projects are in the formative stages, including in Cambodia, the East African Community (EAC) and the Economic Community of West African States (ECOWAS) region. Key impacts of the programme include:

- Improved transfer pricing legislation and a new a transfer pricing decree in **Colombia**, aligned to international standards. Following transfer pricing adjustments made as a result of audits of MNEs, the Colombian tax administration has increased revenues from US$3.3 million in 2011 to US$5.83 million in 2012 (a 76% increase).
- Increased revenue collection in **Kenya**, from US$52 million for year ended 30 June 2012 to US$85 million for year ended 30 June 2013, following a training programme on advanced transfer pricing issues.
- New transfer pricing regulations in **Ghana** together with supporting guidance and a transfer pricing return schedule, complemented by a comprehensive skills-building programme with a newly established team of specialist transfer pricing auditors leading to the first transfer pricing audits in Ghana being started in 2014.
- Significantly improved capacity in **Vietnam** to enforce its transfer pricing rules, resulting in an increase in the number of audits conducted by the tax administration from one audit in 2012 to 40 audits in 2013, giving rise to transfer pricing adjustments of US$110 million by the end of 2013.

With globalisation and a greater focus on BEPS, demand for capacity development assistance is increasing rapidly. G20 countries are already active in the tax and development cooperation area, including in addressing BEPS. Examples gathered by the G20 Presidency include: Australia, China, Germany, Japan, Korea, and Russia providing assistance to Timor-Leste, Democratic Republic of Congo, Ghana, Malaysia, African Tax Administration Forum (ATAF) member countries, and Europe and Central Asia (ECA) countries respectively. In addition, the UK is supporting the OECD and World Bank Group to deliver their transfer pricing programmes. As further resources for support are deployed towards this area, the G20 can draw on some of the lessons learned from experience, described in the paragraphs below.

a) Setting BEPS issues in the context of country-led reform plans and priorities

The 2011 report from the international organisations to the DWG (OECD, 2011) noted that a series of problems plague the poorest countries including corruption, the informal sector and various tax policy and administration concerns. This diagnosis remains true today and is a useful reminder that, as the focus on international tax matters intensifies, BEPS issues must be seen as an issue that needs to be addressed in step with a broader range of reforms that each country undertakes, and in accordance with each country's policy agenda. For international assistance providers, Box 7 below provides some examples of tools and approaches developed to ensure that international support targets the most pressing needs.

Box 7. Approaching BEPS in context

The IMF's Tax Administration Diagnostic Assessment Tool (TADAT) is a diagnostic tool to help developing countries and international assistance providers see priorities in a comprehensive and strategic manner. In turn, this will help to set out how BEPS issues fit into wider reform contexts.

The WBG's IAMTAX is a benchmarking, diagnostic and monitoring tool which allows for a comprehensive assessment of tax administration performance. It is used for diagnosing a broad range of issues in a country and monitoring those over time.

Germany's Gesellschaft für Internationale Zusammenarbeit (GIZ) Good Financial Governance programme in Ghana supports a range of public financial management concerns. In this case, the support from OECD/WBG/EU on transfer pricing provides a contribution, and is designed and sequenced according to a broader set of related public financial management reforms and priorities.

b) Regional organisations and BEPS capacity development issues

Regional organisations have extensive membership and are increasingly influential in and beyond their regions. For example, ATAF now has 38 member countries, and has established a BEPS Working Group to lead an African approach to BEPS and give input into the OECD/G20 BEPS process.

Box 8 below describes steps already taken in Africa to increase collective action and co-operation, illustrating that regional organisations can act as powerful platforms to address BEPS capacity development issues.

Box 8. Acting regionally: mutual assistance among African countries

ATAF has developed the ATAF Agreement on Mutual Assistance in Tax Matters (AMATM). This multilateral instrument allows for the exchange of information, sharing of expertise, joint audits and investigations, and mutual administrative assistance among African countries. The AMATM has the potential to be a key instrument in the fight against BEPS in Africa.

In Latin America, the Inter-American Center of Tax Administrations (CIAT) is actively supporting the BEPS initiative. A BEPS workshop was co-sponsored in February 2014 in Colombia with a large number of Latin American and Caribbean (LAC) tax officials present. In October 2014 a follow-up to that event will be hosted in Spain during CIAT's Technical Conference. CIAT is also co-sponsoring seminars on transfer pricing in LAC, most recently in Trinidad and Tobago and Uruguay.

The Pacific Islands Tax Administration Association (PITAA) meeting in July 2014 provided an opportunity for senior tax officials to discuss BEPS issues relating to PICs.

c) Engaging with all stakeholders

Business and civil society both have key roles to play in the design and delivery of capacity development, and both stakeholders increasingly have a regular place in the dialogue on BEPS issues with governments in developing countries. They also have a role in complementing the efforts of international assistance providers. Business insights into the investment climate implications of BEPS, for example, can be important. Business can provide a unique source of highly valued industry knowledge to support actions to address BEPS.

Civil society has an equally important role to play in raising awareness of the significance of BEPS issues amongst developing country governments, international organisations and donors, and engagement by providers of support and local NGOs is to be encouraged.

Examples of promising partnerships are highlighted in Box 9 below.

Box 9. Working with business and civil society on BEPS issues in Zambia and Colombia

Colombia and Zambia are working with business and civil society, supported by the OECD/WBG/EU programme on transfer pricing.

Unilever is working with the Colombian Tax Administration (DIAN) and OECD/WBG to provide training on the consumer goods industry and its supply chain in 2014.

With the OECD, the mining industry is providing experts to help Colombia and Zambia to analyse the coal, copper and gold industry supply chains – all key BEPS risk areas.

The OECD and WBG are working closely with the Zambia Extractive Industries Transparency Initiative Secretariat on issues to improve transparency in financial reporting in Zambia.

d) Setting objectives and measuring results

Governments in developing countries are paying greater attention to setting out clear and measurable objectives for their own reform strategies on BEPS issues and from the support provided by international development partners. To support these efforts, the OECD and WBG have developed a results framework as a tool to discuss and define objectives with developing countries. For example, the programme with Ethiopia has a key objective of assessing the impact the introduction of safe harbour regulations has on creating a more certain investment climate and assisting the tax administration in ensuring its limited resources are used in the most effective way.

e) Addressing institutional, organisational and individual needs

The 2011 report to the G20 noted international assistance on tax matters should encompass institutional, organisational and individual issues in order to make a difference. This observation remains valid as international providers of assistance engage with more intensity on BEPS issues. New transfer pricing legislation, for example, will have little or no impact if an administrative structure for enforcing them does not exist. Similarly, the effectiveness of such rules will be severely impaired if auditors responsible for enforcing them lack the requisite skills. Capacity building thus needs to encompass a full spectrum of issues including: policy development; legislation and guidance; administrative structure and governance; risk assessment and practical auditing skills.

f) Assessing and addressing BEPS issues holistically

The BEPS Action Plan has highlighted the interactions between the various international tax rules that relate to BEPS and Part 1 of this report noted that capacity development on BEPS actions needs to encompass all BEPS issues of priority to developing countries.

The scope of capacity building programmes to assist developing countries on BEPS Actions should be designed to build effective regimes able to address all issues relating to BEPS. Each country context will vary, but where relevant may include transfer pricing, treaty issues, Permanent Establishment issues and thin capitalisation issues. Box 10 illustrates the point in the case of Nigeria.

Box 10. A holistic approach to addressing BEPS risks in Nigeria

Following a risk and needs assessment, Nigeria's Federal Inland Revenue Service (FIRS) identified that it faces significant risk to its tax base from i) abusive and inappropriate transfer pricing, ii) excessive interest payments out of Nigeria, iii) abuse of some of Nigeria's tax treaties, and iv) abuse of the definition of permanent establishments. Based on these findings the OECD/WBG/EU capacity development programme has been designed to address these concerns and to sequence different actions accordingly.

g) Hands-on and focused support

Many developing countries report that much of the training they have received over a number of years has focused on theory and principles. Such training has been useful as an initial step to raise awareness of the type of rules needed to counter base erosion and profit shifting, but there is high demand for a focus on the practical implementation of rules, skills building and peer-learning, centred on practical case studies and issues encountered by the tax administration. The IMF, WBG and others have, of course long recognised this and have extensive programmes of support in place. The transmission of skills and knowledge through hands-on support on real issues and cases is proving effective. The OECD's Tax Inspectors Without Borders (TIWB) described in Box 11 below is designed to respond to demand for such support by mobilising specialist audit skills.

Box 11. The OECD's "Tax Inspectors Without Borders" (TIWB) Initiative

The OECD's TIWB is a new project which deploys tax audit experts to work directly under the management and supervision of local officials in developing country tax administrations on audits, with a particular emphasis on international tax matters, including those covered in the Action Plan. TIWB programmes complement existing initiatives that focus on putting in place the regulatory and administrative building-blocks needed to counter base erosion and profit shifting, through a real-time, "learning by doing" approach to solve current audit issues while transferring knowledge and skills. TIWB assistance can cover direct and indirect tax audit issues including pre-audit risk assessment and case selection, audit investigatory techniques, audit cases involving transfer pricing issues, anti-avoidance rules, or sector-specific issues, relating for example to e-commerce, natural resources, financial services or telecommunications. TIWB programmes can be full-time, or involve periodic assistance, and there is no minimum or maximum period.

Most importantly, TIWB can assist with improving the quality and consistency of tax audits, achieving sustained improvements in tax audit skills, and a resulting rise in the level of voluntary compliance by taxpayers who see a strengthening of tax administrations' ability to carry out their mandate. The project is in a pilot phase in 2014, with requests for experts from Albania, Ghana, Malawi, Papua New Guinea, Senegal and Vietnam currently being met by France, India, Italy, the Netherlands, South Africa and the United Kingdom.

h) Sustaining practical skills and knowledge

Competitive terms and conditions of employment are needed in tax administrations to ensure that officials with practical skills and knowledge are not lost to the private sector. For their part, providers of international assistance should be alert to the risks of building the practical skills of officials if they are only to be lost to the private sector. Box 12 below illustrates the measures Kenya has taken to ensure staff with specialist international tax knowledge and experience are retained.

Box 12. Retaining specialist skills in Kenya's tax authority

The Kenyan Revenue Authority (KRA) has been successful in retaining the staff in its transfer pricing team. The KRA considers it has been able to achieve this through a combination of factors including providing market rate remuneration packages, strong leadership and a strong team ethic. The stability and experience developed within the team has assisted the KRA to build an effective transfer pricing regime to address BEPS related issues and achieve substantial year on year revenue increases from transfer pricing adjustments. The KRA reports that the IMF noted recently that the Kenyan tax administration was now well equipped to handle complex issues such as transfer pricing.

Recommendations concerning capacity development

The issues set out in this section align to the five actions set out in the G20 DWG guiding framework for response to capacity issues arising from the G20 agenda that was agreed at the G20 DWG meeting in Hobart on 8th to 9th May 2014.

Recommendations

The DWG promotes and endorses:

19. Capacity development programmes from international organisations on BEPS issues.

20. The OECD/WBG/business partnership to build industry knowledge in developing country tax administrations.

21. The OECD's 'Tax Inspectors Without Borders' initiative as a tool to build developing country capacity to implement BEPS solutions.

22. The proposed initiatives of regional organisations, and regional programmes, to assist developing countries on BEPS issues.

SECTION 6: CONCLUSION AND SUMMARY OF RECOMMENDATIONS

This report has set out how the DWG might assist developing countries meet the challenges of the most relevant BEPS issues they face, both the most relevant action items in the Action Plan and the most relevant other BEPS-related issues. However, this report comes in the mid-point of the OECD/G20 BEPS project and is by no means the final word on the impact of BEPS on developing countries. As BEPS solutions are finalised the recommendations and findings of this report will need to be reviewed and updated to reflect these solutions. Developing countries should be engaged throughout this process.

The table below summarises proposed recommendations for the DWG to address the BEPS issues of highest concern to developing countries, identified in Part 1 of this report.

Issue	Recommendation
Continuing dialogue with developing countries to ensure developing country issues are taken into account	The DWG calls on: **1.** The OECD/G20 BEPS Project to ensure that the outcomes of the project take into account the specific challenges faced by developing countries, in particular in the highest priority Actions for developing countries (Actions 4, 6, 7, 10, 11, and 13). **2.** The OECD to put in place a new structured dialogue process, with clear avenues for developing countries to work together and directly input into the OECD/G20 BEPS Project. **3.** All stakeholders – G20 countries, international and regional organisations, civil society and donors – to raise awareness of the significance of BEPS issues at political levels in developing countries by holding high-level political dialogue on BEPS issues with developing country Ministers of Ministries of Finance and other relevant Ministries. **4.** G20 countries should analyse the spillover effects of revisions made to their own tax systems on those of developing countries.
Development of toolkits to assist developing countries implement BEPS solutions	The DWG calls on: **5.** The OECD/G20 BEPS Project to ensure that Actions 4 and 10 take into account developing country issues. **6.** The OECD, IMF, UN, WBG and regional organisations, where appropriate and they are in a position to do so, to assess how practical toolkits can be produced to assist developing countries **a**ddress base eroding payments

	between MNE affiliates. **7.** The OECD/G20 BEPS Project to ensure that BEPS Actions concerning the rules to counter artificial profit shifting through supply chain restructuring. **8.** The OECD, IMF, UN, WBG and regional organisations, where appropriate and they are in a position to do so, to assess how practical toolkits can be produced to assist developing countries implement rules to counter artificial profit shifting through supply chain restructuring. **9.** The OECD/G20 BEPS Project to ensure that Action 11 takes into account developing country issues. **10.** International and regional organisations, where appropriate and in a position to do so, to assess how tools and materials can be developed to assist developing countries assess the risks they face from BEPS. **11.** The OECD, IMF, UN, WBG and regional organisations, where appropriate and they are in a position to do so, to assess how practical toolkits can be produced to support the successful implementation by developing countries of a) assessment of BEPS risks, and b) effective transfer pricing documentation requirements.
Challenges deriving from the abuse of treaties	The DWG calls on : **12.** The OECD/G20 BEPS Project to ensure that Actions 6 and 7 take into account developing country issues. **13.** The OECD, IMF, UN, WBG and regional organisations, where appropriate and they are in a position to do so, to assess how to strengthen capacity development on treaty negotiation.
Use of the Multilateral Instrument	The DWG calls on: **14.** G20 countries to engage in dialogue with developing countries on the design and potential benefits of the Multilateral Instrument.
Addressing tax loss on indirect transfer of assets	The DWG calls on: **15.** The OECD, in consultation with the IMF, to report on whether further analysis on this issue is needed to identify policy options to tackle abusive cases, with particular reference to developing countries.
Addressing lack of transfer pricing comparability data	The DWG: **16.** Welcomes further work by the OECD and WBG to assess how practical toolkits can be produced to a) assist

	developing countries address difficulties in accessing comparables data and b) use approaches to apply internationally accepted principles in the absence of comparables (for example, safe harbour provisions). **17.** Calls on the OECD to commence a study on the feasibility of addressing the information gap on prices of some natural minerals sold in an intermediate form, e.g. mineral concentrate.
Addressing wasteful tax incentives	The DWG welcomes: **18.** A report in 2015 on good practice in transparency and governance on tax incentives in developing countries from the IMF, OECD, UN and the WBG to better guide the developing countries in: • balancing investment and public revenue priorities. • estimating the cost of tax incentives, including revenue leakages due to unintended tax planning opportunities.
Capacity development	The DWG promotes and endorses: **19.** Capacity development programmes from international organisations on BEPS issues. **20.** The OECD/WBG/business partnership to build industry knowledge in developing country tax administrations. **21.** The 'Tax Inspectors Without Borders' initiative as a tool to build developing country capacity to implement BEPS solutions. **22.** The proposed initiatives of regional organisations, and regional programmes, to assist developing countries on BEPS issues.

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ANNEX 1:

SELECTED DEVELOPING COUNTRIES EXPERIENCES SET OUT AGAINST THE OECD TASK FORCE ON TAX AND DEVELOPMENT PRINCIPLES TO ENHANCE THE TRANSPARENCY AND GOVERNANCE OF TAX INCENTIVES FOR INVESTMENT IN DEVELOPING COUNTRIES

Principle 1. Make public a statement of all tax incentives for investment and their objectives within a governing framework.

A public statement of the full extent of tax incentives in Nigeria is hard to achieve due to the complexity of the tax incentives framework. Tax incentives can also be introduced through laws (currently including as many as 15 acts and provisions), budget speeches, government notices, executed agreements, as well as Memoranda of Understanding between the government and businesses.

Principle 2. Provide tax incentives for investment through tax laws only.

In 2009, the Code of Fiscal Benefits harmonised most investment incentives in Mozambique. In 2013, as many as 17 laws and legislative acts were consolidated into the General Tax Code in Senegal, significantly improving transparency of the tax system.

Principle 3. Consolidate all tax incentives for investment under the authority of one government body, where possible.

In Ghana, as many as 10 organizations/agencies have the authority to recommend or grant tax incentives and exemptions.

Principle 4. Ensure tax incentives for investment are ratified through the law making body or parliament.

Proposed tax incentives measures in Zambia are announced through a budget speech delivered in Parliament by the Minister of Finance; and are debated, voted, and passed by Parliament.

Principle 5. Administer tax incentives for investment in a transparent manner.

The administration process for the Swaziland's Development Approval Order is opaque and includes discretionary eligibility criteria such as "beneficial to the development of the economy." The application process is long and time-consuming; it doesn't follow a set timeline.

Principle 6. Calculate the amount of revenue forgone attributable to tax incentives for investment and publicly release a statement of tax expenditures.

> In Tanzania, in the 2013-2014 Budget Speech, the Government voiced a commitment to rationalise the existing investment incentives, in particular, to reduce tax exemptions from 4.3% of GDP in 2011-12 to a maximum of 1% by 2014, based on systematic analysis of revenues foregone.

Principle 7. Carry out periodic review of the continuance of existing tax incentives by assessing the extent to which they meet the stated objectives.

> Impact evaluation of investment incentives in Mauritius prompted a move away from an investment regime of numerous and overlapping tax incentives towards the current simplified tax system.

Principle 8. Highlight the largest beneficiaries of tax incentives for investment by specific tax provision in a regular statement of tax expenditures, where possible.

> The analysis of Ghana's tax expenditure landscape reveals that 15 largest "beneficiaries" take the vast majority, 93.2 %, of all VAT tax expenditures.

Principle 9. Collect data systematically to underpin the statement of tax expenditures for investment and to monitor the overall effects and effectiveness of individual tax incentives.

> Not enough data is collected in Tunisia to allow for systematic cost-benefit analyses and simulation modelling of tax incentives. Integration and leverage of common inter-agency data is challenging due differences in the classification systems, which lack common definitions and structure.

Principle 10. Enhance regional cooperation to avoid harmful tax competition.

> OECD is working with the SADC to strengthen investment policy framework at the regional level by defining common guidance across member states, including related to tax incentives. The project builds a SADC-wide mechanism to satisfactorily address the harmful tax competition.

RESPONSE

> *We ask the OECD, IMF, UN, and World Bank Group to build on its current engagement with developing countries and develop a new structured dialogue process, with clear avenues for developing countries to work together and directly input in the G20/OECD Base Erosion and Profit Shifting project by the Leaders' Summit in November.*

Context

This note sets out how the IMF, OECD, World Bank Group and United Nations (the IOs) plan to contribute to addressing the need for a more structured dialogue with and among developing countries in response to the G20 Finance Ministers' mandate. This would include the priority issues highlighted by the two-part Report to the Development Working Group on the Impact of BEPS in Low Income Countries, which stresses the need for developing countries to provide meaningful input into the development of BEPS measures. The proposed structured dialogue would cover BEPS issues most relevant to developing countries, in particular the BEPS Action Plan, tax incentives and comparables pricing.

The proposal builds on the differing comparative advantages that the IOs bring to the table: clear development mandates and global memberships, networks of trust built up over many years, real world experience in dealing with the full range of tax and related challenges in developing countries and recognized standard-setting roles in international taxation. It complements the enhanced engagement of developing countries in the OECD/G20 BEPS project, as decribed in the OECD's report to G20 Leaders,[1] which provides for developing countries to be directly involved in the BEPS standard setting process, and the establishment of regional networks to provide further avenues for input as well as for the development of toolkits to support practical implementation of the BEPS measures, in partnership with the other IOs and the regional tax organisations.

The IOs recognize that we can do more to provide a structured, robust and inclusive framework to link more effectively to international processes. We also recognize the need for strong coordination to avoid duplication of efforts but rather join forces in our different areas of expertise. To this end, and to respect the many pressures on developing country tax officials, the IOs will coordinate closely in all the various BEPS-related events for developing countries that they will take the lead in organizing.

[1] OECD Secretary-General Report to the G20 Leaders, November 2014.

The aim is to ensure the wide and diverse sense of ownership that is essential to any truly global and truly globally effective and sustainable tax cooperation outcomes, and to give developing countries confidence that international agreements will both reinforce their efforts to build transparent and effective national systems and take due account of the specific challenges they face. The call by G20 Finance Ministers for IOs to build engagement with developing countries and develop a new structured dialogue process, with clear avenues for developing countries to work together and directly input in the OECD/G20 BEPS Project, is a critical step. The OECD's plan for direct developing country engagement in the BEPS project and regional networks of tax policy and administration officials, to develop input on BEPS as well as practical tools to support implementation of BEPS measures, in conjunction with this proposal, are essential elements to achieve that objective.

Proposals

Actions proposed (all subject to resourcing and scheduling constraints, and avoiding duplication) are:

Leveraging the Spring/Annual meetings of the IMF and World Bank.

These meetings provide a unique opportunity to assemble ministers of finance, and as appropriate, for a longer period—perhaps a full day—senior technical officials. This could serve to both raise awareness and explore technical matters on BEPS issues.

These meetings would be hosted by the World Bank and IMF in close coordination with the other IOs, but in substance would be country-led with the engagement of Regional Tax Organisations and participation of all IOs. This grouping would select the BEPS related topic and speakers, with the IOs providing support and helping to shape and inform the discussion as a response to developing country needs and priorities.

IOs would make sure that these meetings and those mentioned above complement and feed each other, facilitating the engagement of developing countries in the standard setting mechanism, to structure the dialogue with them on BEPS issues, and to support the G-20 mandated process by which the OECD, with the other IOs, will develop toolkits for effective implementation of the BEPS measures in developing countries.

Promoting dialogue by leveraging the IMF and World Bank's regional centers, OECD Regional consultations and the UN structure

To facilitate the continuing dialogue with and between developing countries, the IOs have a substantial infrastructure to build on:

- The IMF has nine regional technical assistance centers (RTACs),[2] now covering close to 100 countries.

- The OECD, building on its engagement with developing countries in the first phase of the BEPS Project, is establishing regional networks of tax policy and administration officials in conjunction with the regional tax organisations such as ATAF and CIAT, which will be key avenues to develop broader input into the BEPS project and to support them in addressing their international tax priorities. These networks would substantially reinforce the ongoing global dialogue on these issue in the OECD's various global fora on tax treaties, transfer pricing and VAT, as well as the capacity building events held at the OECD's five multilateral tax centres.

- The World Bank Group has country offices in nearly all developing countries, as well as regional centers in Amman, Bangkok, Nairobi, Panama City and Vienna. These play a key role in the delivery of tax-related technical assistance, have well-established networks of tax officials and already routinely convene meetings and workshops on topics of interest.

- The UN now has an annual one-day meeting of the Economic and Social Council (ECOSOC) on tax matters, often linked to special high-level Meetings of ECOSOC with the BWIs, WTO and UNCTAD. This meeting of ECOSOC and the annual five day meeting of the UN Committee of Experts on International Cooperation in Tax Matters also could be leveraged more to engage with key developing country policy and administration experts.

The BEPS issues which developing countries identify as their priorities would be natural topics around which to organize discussion and formation of views, with the aim of feeding such views into the process as outlined in the OECD's report to G20 Leaders. We would see these too as routes by which the IOs could help to develop toolkits for the implementation of the BEPS measures, as requested by the G20 to the OECD with IO support.

[2] Including five that together cover all of Sub-Saharan Africa; and one each in the Caribbean, Central America, the Pacific Islands, and the Middle East.

G20 Leaders' Communiqué
Brisbane Summit, 15-16 November 2014

1. Raising global growth to deliver better living standards and quality jobs for people across the world is our highest priority. We welcome stronger growth in some key economies. But the global recovery is slow, uneven and not delivering the jobs needed. The global economy is being held back by a shortfall in demand, while addressing supply constraints is key to lifting potential growth. Risks persist, including in financial markets and from geopolitical tensions. We commit to work in partnership to lift growth, boost economic resilience and strengthen global institutions.

2. We are determined to overcome these challenges and step up our efforts to achieve strong, sustainable and balanced growth, and to create jobs. We are implementing structural reforms to lift growth and private sector activity, recognising that well-functioning markets underpin prosperity. We will ensure our macroeconomic policies are appropriate to support growth, strengthen demand and promote global rebalancing. We will continue to implement fiscal strategies flexibly, taking into account near-term economic conditions, while putting debt as a share of GDP on a sustainable path. Our monetary authorities have committed to support the recovery and address deflationary pressures when needed, consistent with their mandates. We will be mindful of the global impacts of our policies and cooperate to manage spillovers. We stand ready to use all policy levers to underpin confidence and the recovery.

3. This year we set an ambitious goal to lift the G20's GDP by at least an additional two per cent by 2018. Analysis by the IMF-OECD indicates that our commitments, if fully implemented, will deliver 2.1 per cent. This will add more than US$2 trillion to the global economy and create millions of jobs. Our measures to lift investment, increase trade and competition, and boost employment, along with our macroeconomic policies, will support development and inclusive growth, and help to reduce inequality and poverty.

4. Our actions to boost growth and create quality jobs are set out in the Brisbane Action Plan and in our comprehensive growth strategies. We will monitor and hold each other to account for implementing our commitments, and actual progress towards our growth ambition, informed by analysis from international organisations. We will ensure our growth strategies continue to deliver and will review progress at our next meeting.

Acting together to lift growth and create jobs

5. Tackling global investment and infrastructure shortfalls is crucial to lifting growth, job creation and productivity. We endorse the Global Infrastructure Initiative, a multi-year work programme to lift quality public and private infrastructure investment. Our growth strategies contain major investment initiatives, including actions to strengthen public investment and improve our domestic investment and financing climate, which is essential to attract new private sector finance for investment. We have agreed on a set of voluntary leading practices to promote and prioritise quality investment, particularly in infrastructure. To help match investors with projects, we will address data gaps and improve information on project pipelines. We are working to facilitate long-term financing from institutional investors and to encourage market sources of finance, including transparent securitisation, particularly for small and medium-sized enterprises. We will continue to work with multilateral development banks, and encourage national development banks, to optimise use of their balance sheets to provide additional lending and ensure our work on infrastructure benefits low-income countries.

6. To support implementation of the Initiative, we agree to establish a Global Infrastructure Hub with a four-year mandate. The Hub will contribute to developing a knowledge-sharing platform and network between governments, the private sector, development banks and other international organisations. The Hub will foster collaboration among these groups to improve the functioning and financing of infrastructure markets.

7. To strengthen infrastructure and attract more private sector investment in developing countries, we welcome the launch of the World Bank Group's Global Infrastructure Facility, which will complement our work. We support similar initiatives by other development banks and continued cooperation amongst them.

8. Trade and competition are powerful drivers of growth, increased living standards and job creation. In today's world we don't just trade final products. We work together to make things by importing and exporting components and services. We need policies that take full advantage of global value chains and

encourage greater participation and value addition by developing countries. Our growth strategies include reforms to facilitate trade by lowering costs, streamlining customs procedures, reducing regulatory burdens and strengthening trade-enabling services. We are promoting competition, entrepreneurship and innovation, including by lowering barriers to new business entrants and investment. We reaffirm our longstanding standstill and rollback commitments to resist protectionism.

9. Our actions to increase investment, trade and competition will deliver quality jobs. But we must do more to address unemployment, raise participation and create quality jobs. We agree to the goal of reducing the gap in participation rates between men and women in our countries by 25 per cent by 2025, taking into account national circumstances, to bring more than 100 million women into the labour force, significantly increase global growth and reduce poverty and inequality.

10. We are strongly committed to reducing youth unemployment, which is unacceptably high, by acting to ensure young people are in education, training or employment. Our Employment Plans include investments in apprenticeships, education and training, and incentives for hiring young people and encouraging entrepreneurship. We remain focussed on addressing informality, as well as structural and long-term unemployment, by strengthening labour markets and having appropriate social protection systems. Improving workplace safety and health is a priority. We ask our labour and employment ministers, supported by an Employment Working Group, to report to us in 2015.

11. We are committed to poverty eradication and development, and to ensure our actions contribute to inclusive and sustainable growth in low-income and developing countries. We commit to take strong practical measures to reduce the global average cost of transferring remittances to five per cent and to enhance financial inclusion as a priority. The G20 Food Security and Nutrition Framework will strengthen growth by lifting investment in food systems, raising productivity to expand food supply, and increasing incomes and quality jobs. We support efforts in the United Nations to agree an ambitious post-2015 development agenda. The G20 will contribute by strengthening economic growth and resilience.

Building a stronger, more resilient global economy

12. Strengthening the resilience of the global economy and stability of the financial system are crucial to sustaining growth and development. We have delivered key aspects of the core commitments we made in response to the financial crisis. Our reforms to improve banks' capital and liquidity positions and to make derivatives markets safer will reduce risks in the financial system. We welcome the Financial Stability Board (FSB) proposal as set out in the Annex requiring global systemically important banks to hold additional loss absorbing capacity that would further protect taxpayers if these banks fail. Progress has been made in delivering the shadow banking framework and we endorse an updated roadmap for further work. We have agreed to measures to dampen risk channels between banks and non-banks. But critical work remains to build a stronger, more resilient financial system. The task now is to finalise remaining elements of our policy framework and fully implement agreed financial regulatory reforms, while remaining alert to new risks. We call on regulatory authorities to make further concrete progress in swiftly implementing the agreed G20 derivatives reforms. We encourage jurisdictions to defer to each other when it is justified, in line with the St Petersburg Declaration. We welcome the FSB's plans to report on the implementation and effects of these reforms, and the FSB's future priorities. We welcome the progress made to strengthen the orderliness and predictability of the sovereign debt restructuring process.

13. We are taking actions to ensure the fairness of the international tax system and to secure countries' revenue bases. Profits should be taxed where economic activities deriving the profits are performed and where value is created. We welcome the significant progress on the G20/OECD Base Erosion and Profit Shifting (BEPS) Action Plan to modernise international tax rules. We are committed to finalising this work in 2015, including transparency of taxpayer-specific rulings found to constitute harmful tax practices. We welcome progress being made on taxation of patent boxes. To prevent cross-border tax evasion, we endorse the global Common Reporting Standard for the automatic exchange of tax information (AEOI) on a reciprocal basis. We will begin to exchange information automatically with each other and with other countries by 2017 or end-2018, subject to completing necessary legislative procedures. We welcome financial centres' commitments to do the same and call on all to join us. We welcome deeper engagement of developing countries in the BEPS project to address their concerns. We will work with them to build their tax administration capacity and implement AEOI. We welcome further collaboration by our tax authorities on cross-border compliance activities.

14. We endorse the 2015-16 G20 Anti-Corruption Action Plan that will support growth and resilience. Our actions are building cooperation and networks, including to enhance mutual legal assistance, recovery of

the proceeds of corruption and denial of safe haven to corrupt officials. We commit to improve the transparency of the public and private sectors, and of beneficial ownership by implementing the G20 High-Level Principles on Beneficial Ownership Transparency.

Strengthening global institutions

15. The G20 must be at the forefront in helping to address key global economic challenges. Global economic institutions need to be effective and representative, and to reflect the changing world economy. We welcome the increased representation of emerging economies on the FSB and other actions to maintain its effectiveness. We are committed to maintaining a strong, quota-based and adequately resourced International Monetary Fund (IMF). We reaffirm our commitment in St Petersburg and in this light we are deeply disappointed with the continued delay in progressing the IMF quota and governance reforms agreed in 2010 and the 15th General Review of Quotas, including a new quota formula. The implementation of the 2010 reforms remains our highest priority for the IMF and we urge the United States to ratify them. If this does not happen by year-end, we ask the IMF to build on its existing work and stand ready with options for next steps.

16. We need a strong trading system in an open global economy to drive growth and generate jobs. To help business make best use of trade agreements, we will work to ensure our bilateral, regional and plurilateral agreements complement one another, are transparent and contribute to a stronger multilateral trading system under World Trade Organization (WTO) rules. These rules remain the backbone of the global trading system that has delivered economic prosperity. A robust and effective WTO that responds to current and future challenges is essential. We welcome the breakthrough between the United States and India that will help the full and prompt implementation of the Trade Facilitation Agreement and includes provisions on food security. We commit to implement all elements of the Bali package and to swiftly define a WTO work programme on the remaining issues of the Doha Development Agenda to get negotiations back on track. This will be important to restore trust and confidence in the multilateral trading system. We agreed to discuss ways to make the system work better when we meet next year. We will continue to provide aid-for-trade to developing countries in need of assistance.

17. Increased collaboration on energy is a priority. Global energy markets are undergoing significant transformation. Strong and resilient energy markets are critical to economic growth. Today we endorse the G20 Principles on Energy Collaboration. We ask our energy ministers to meet and report to us in 2015 on options to take this work forward. Gas is an increasingly important energy source and we will work to improve the functioning of gas markets.

18. Improving energy efficiency is a cost-effective way to help address the rising demands of sustainable growth and development, as well as energy access and security. It reduces costs for businesses and households. We have agreed an Action Plan for Voluntary Collaboration on Energy Efficiency, including new work on the efficiency and emissions performance of vehicles, particularly heavy duty vehicles; networked devices; buildings; industrial processes; and electricity generation; as well as work on financing for energy efficiency. We reaffirm our commitment to rationalise and phase out inefficient fossil fuel subsidies that encourage wasteful consumption, recognising the need to support the poor.

19. We support strong and effective action to address climate change. Consistent with the United Nations Framework Convention on Climate Change (UNFCCC) and its agreed outcomes, our actions will support sustainable development, economic growth, and certainty for business and investment. We will work together to adopt successfully a protocol, another legal instrument or an agreed outcome with legal force under the UNFCCC that is applicable to all parties at the 21st Conference of the Parties (COP21) in Paris in 2015. We encourage parties that are ready to communicate their intended nationally determined contributions well in advance of COP21 (by the first quarter of 2015 for those parties ready to do so). We reaffirm our support for mobilising finance for adaptation and mitigation, such as the Green Climate Fund.

20. We are deeply concerned with the humanitarian and economic impact of the Ebola outbreak in Guinea, Liberia and Sierra Leone. We support the urgent coordinated international response and have committed to do all we can to contain and respond to this crisis. We call on international financial institutions to assist affected countries in dealing with the economic impacts of this and other humanitarian crises, including in the Middle East.

21. We remain resolute in our commitment to lift economic growth, support job creation, promote development and build global confidence. We thank Australia for its leadership this year. We look forward to working together in 2015 under Turkey's presidency and to discussing progress at our next meeting in Antalya on 15-16 November 2015. We also look forward to meeting in China in 2016.

Annex

Agreed documents

The following documents agreed by the G20 support our communiqué:

- Brisbane Action Plan, November 2014
- G20 Note on the Global Infrastructure Initiative and Hub, November 2014
- 2014 Financial Inclusion Action Plan, November 2014
- G20 Plan to Facilitate Remittance Flows, November 2014
- G20 Food Security and Nutrition Framework, November 2014
- Development Working Group Accountability Framework, November 2014
- 2015-16 G20 Anti-Corruption Action Plan, November 2014
- G20 High-Level Principles on Beneficial Ownership Transparency, November 2014
- G20 Principles on Energy Collaboration, November 2014
- G20 Energy Efficiency Action Plan, November 2014
- The 2015 G20 Accountability Assessment Process, November 2014
- 2014 Accountability Assessment Report, November 2014

Ministerial statements

- Communiqué, Meeting of G20 Finance Ministers and Central Bank Governors, Cairns, 20-21 September 2014
- G20 Labour and Employment Ministerial Declaration, Melbourne, 10-11 September 2014, including G20 Statement on Safer and Healthier Workplaces
- Chairman's Summary, Meeting of G20 Trade Ministers, Sydney, 29 July 2014
- Communiqué, Meeting of G20 Finance Ministers and Central Bank Governors, Washington DC, 10-11 April 2014
- Communiqué, Meeting of G20 Finance Ministers and Central Bank Governors, Sydney, 22-23 February 2014

Supporting documents

We welcome the delivery of the following documents:

- G20 Members' Comprehensive Growth Strategies, November 2014
- G20 Members' Country Employment Plans, November 2014
- IMF Surveillance Note, November 2014
- Quantifying the Impact of G-20 Members' Growth Strategies, OECD/IMF report, November 2014
- Growth Strategies: G20 Emerging Market Economies – World Bank Group Assessment, November 2014
- Global Infrastructure Facility: Update for G20 Leaders, World Bank Group, November 2014
- G20/OECD Report on Effective Approaches to Support Implementation of the G20/OECD High-Level Principles on Long-Term Investment Financing by Institutional Investors, and Annex, November 2014
- Report on G20 Trade and Investment Measures, WTO, OECD, and UNCTAD, November 2014
- G20 Labour Markets: Outlook, Key Challenges and Policy Responses, OECD, ILO and World Bank Group, November 2014
- Opportunities for Economic Growth and Job Creation in Relation to Food Security and Nutrition, FAO and OECD (with inputs from ADB, IFAD, ILO, IFPRI and WTO), September 2014
- Financial Reforms: Completing the Job and Looking Ahead, Financial Stability Board Chairman's Letter to G20 Leaders, November 2014
- Adequacy of loss-absorbing capacity of global systemically important banks in resolution, Financial Stability Board, November, 2014
- Cross-Border Recognition of Resolution Action, Financial Stability Board, September 2014
- Updated G20 Roadmap towards Strengthened Oversight and Regulation of Shadow Banking in 2015, Financial Stability Board, November 2014

- Report to the G20 Brisbane Summit on the FSB's review of the structure of its representation, Financial Stability Board, November 2014
- OECD Secretary-General's Report to G20 Leaders on Tax Matters, November 2014
- International Organisations' proposal for structured dialogue process with developing countries on tax matters, November 2014

These documents are in addition to those delivered to G20 Finance Ministers and Central Bank Governors, Labour and Employment Ministers, and Trade Ministers at their meetings this year.

G20 Working Group reports

- G20 2014 Brisbane Anti-Corruption Update
- 2014 Brisbane Development Update
- G20 Energy Sustainability Working Group 2014 Co-chairs' Report
- G20 Climate Finance Study Group – Report to Ministers, 2014

Issues for further action

- The FSB proposal for an internationally agreed standard requiring global systemically important banks (G-SIBs) to hold additional loss absorbing capacity in resolution will be subject to public consultation, a rigorous quantitative impact assessment and further refinement before any final measure is agreed by the 2015 Summit. The impact analyses will include consideration of the consequences of this requirement on banks in emerging markets, G-SIBs headquartered in EMEs, and state-owned banks.

- Given the challenges litigation poses and in order to strengthen the orderliness and predictability of the sovereign debt restructuring process, we welcome the international work on strengthened collective action and pari passu clauses. We call for their inclusion in international sovereign bonds and encourage the international community and private sector to actively promote their use. We ask our Finance Ministers and Central Bank Governors to discuss the progress achieved on this and related issues.

- If the US does not ratify the 2010 IMF reforms by end-2014, we ask the IMF to discuss options for next steps shortly thereafter and we ask our Finance Ministers and Central Bank Governors to work with the IMFC to schedule a discussion on these options in their next meeting.

Acknowledgements

We thank international organisations, including the IMF, OECD, World Bank Group, WTO, ILO, FSB and UN, for their reports and recommendations, which have provided valuable inputs to G20 discussions. These can be found at http://www.g20.org/official_resources.

We thank the Business 20, Civil Society 20, Labour 20, Think 20 and Youth 20 for their important contribution to the G20's work.

BASE EROSION AND PROFIT SHIFTING

BEPS issues for developing countries

UN Subcommittee mandate

- Draw on the experiences of subcommittee members
- Engage with other relevant bodies (particularly the OECD)
- Monitor developments on BEPS issues
- Communicate issues with officials in developing countries:
  - especially least developed countries
  - directly with officials
  - indirectly through regional and inter-regional organisations

This communication informs developing countries on BEPS issues…

- Subcommittee Note on BEPS released this year shares information on BEPS explaining:
  - background and context
  - key causes of BEPS
  - how BEPS affects countries
  - BEPS Action Plan
- Sharing of information through workshops and forums

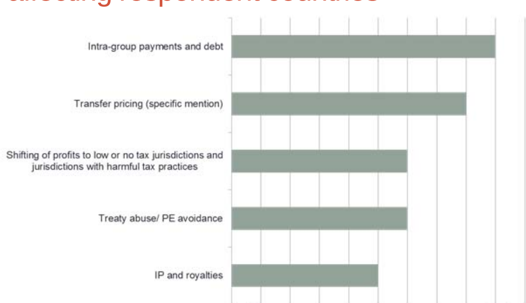
This communication facilitates the input of developing-country experiences …

- Facilitate the input of developing country experiences and views into:
  - on-going UN work
  - the OECD/ G20 Action Plan on BEPS
- Subcommittee questionnaire on BEPS
- Dialogue through workshops and forums

Feedback from the questionnaire…

- Confirmed the importance of the UN effort to reach out to developing countries
- Most responses confirmed their BEPS priorities included:
  - base erosion using interest deductions/other financial payments
  - transfer pricing
  - disclosure of aggressive tax planning arrangements
  - methodologies for collecting data
  - treaty abuse

Common practices and structures affecting respondent countries



Other concerns

- Digital economy
- Offshore sale of tourism packages
- Sale of goods and services over the internet
- High net-worth individuals
- Abuse of tax incentives for new investment

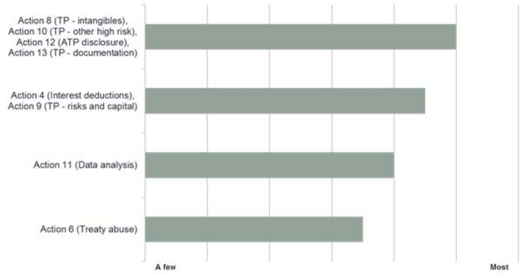
Some responses to these practices and structures

- Enact TP legislation or strengthen existing TP legislation
- Amend VAT legislation
- Thin capitalisation rules
- Withholding taxes
  - technical services fees and royalties
  - Higher withholding rates on payments to low-tax jurisdictions
- Treaties
  - Reconsidering provisions
  - Renegotiate existing treaties
- GAAR and specific anti-abuse legislation
- Focus on human resources – build capacity and train staff

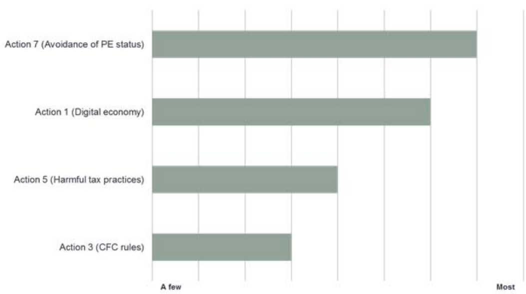
Main obstacles encountered

Most important Action Points

(of those identified by the UN Committee of Experts as important to developing countries)



Important Action Points not identified by the UN Committee of Experts



Other potential practical approaches

- Capacity building was raised by seven countries
  - Training
  - Improving risk analysis tools
  - Technical assistance
  - Access to databases
- Other suggestions included OECD-produced guidelines on BEPS items or for MNEs, and getting MNEs to commit to not pursue BEPS strategies

Feedback from the questionnaire…

- Responses raised wider concerns for developing countries, including:
  - allocation of taxing rights as between source and residence
  - taxation of capital gains
  - AEOI
  - loss of revenue through tax incentives
- Responses requested on-going communication of developments with developing countries

Base Erosion and Profit Shifting (BEPS)

What does the BEPS Agenda mean for Australia?

Presented by
Andrew Mills
Second Commissioner Australian Taxation Office

University of Sydney BEPS Roundtable
18 November 2014

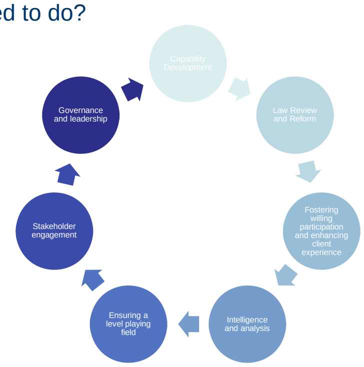
OECD BEPS Action Plan

- Clear framework for dealing with BEPS
- Stronger international tax system supporting all jurisdictions get their far share of tax
- Domestic and international instruments to better align rights to tax with economic activity

What does the BEPS Agenda mean for Australia?

- Australian Government has already enacted policy reforms aimed at corporate tax erosion and avoidance
- The Action Plan will likely propose further reforms
- The Government will decide what, if any, recommendations to implement
- Australia is supportive of a unified multilateral approach however we already have robust tax legislation compared to the rest of the world

To implement the 15 Action Items, what would the ATO need to do?



Aspects of the BEPS action plan www.ato.gov.au

To implement the 15 Action Items, what would the ATO need to do?

Seven interconnected strategies:

1. Capability Development

- The right skills, experience and guidance
- Profit shifting is a multidisciplinary challenge
- External recruitment / increase in levels of experienced staff
- Provides the empirical evidence to support policy development

Aspects of the BEPS action plan www.ato.gov.au

To implement the 15 Action Items, what would the ATO need to do?

Seven interconnected strategies:

2. Law Review and Reform

- ATO advises Government through Treasury on domestic law reform
- Current focus on international reform through the OECD/G20
- Examples:
  - Domestically: Taxation Ruling 2014/6
  - Internationally: Country-by-Country Reporting
- ATO is already addressing BEPS as part of its ongoing compliance strategy

Aspects of the BEPS action plan www.ato.gov.au

To implement the 15 Action Items, what would the ATO need to do?

Seven interconnected strategies:

3. Fostering willing participation and enhancing the client experience

- Review of APA/MAP Program
- Benefits of APAs – practical certainty / reduction in compliance costs
- Checks required to ensure:
  (i) arrangements have not changed;
  (ii) other related party arrangements, not covered by the APA application, have been disclosed; and
  (iii) improved quality assurance

Aspects of the BEPS action plan www.ato.gov.au

Australian Government Australian Taxation Office

To implement the 15 Action Items, what would the ATO need to do?

Seven interconnected strategies:

4. Intelligence and analysis

- ATO is focussed on:
  - improving information gathering and management to better understand the BEPS impact of transactions and risks;
  - engaging with the community on developments in BEPS initiatives and improving the advice we give taxpayers; and
  - improving case selection to improve compliance outcomes and inform policy development
- BEPS work does not occur in a bubble – recent ICIJ online database raises BEPS issues

Aspects of the BEPS action plan www.ato.gov.au

Australian Government Australian Taxation Office

To implement the 15 Action Items, what would the ATO need to do?

Seven interconnected strategies:

5. Ensuring a level playing field

Focus on active compliance:

1. Dedicated compliance program to address International Structuring and Profit Shifting (ISAPS)
2. Multilateral e-commerce working party
3. Automatic Exchange of Information – Common Reporting Standard
4. multilateral collaboration

Aspects of the BEPS action plan www.ato.gov.au

Australian Government Australian Taxation Office

To implement the 15 Action Items, what would the ATO need to do?

Seven interconnected strategies:

6. Stakeholder engagement

- Global problem requires global solution
- International engagement:
  - Working parties on the OECD BEPS Action Plan
  - Revised JITSIC framework
  - Exchange of information through treaty networks
  - Capability building supporting regional development
  - Engagement with the Asia Pacific region (SGATAR)

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To implement the 15 Action Items, what would the ATO need to do?

Seven interconnected strategies:

7. Governance and Leadership

- Monitoring performance to achieve tangible outcomes

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To implement the 15 Action Items, what would the ATO need to do?

Seven interconnected strategies highlight:

1. ATO already has administrative/legislative initiatives under way to address BEPS
2. A full picture of BEPS recommendations will not be available until the end of 2015
3. A decision by Government is required before BEPS recommendations will be taken on board

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Snapshot of likely direction for 2015

Action 1	Address the Tax Challenges of the Digital Economy
Action 2	Neutralise the effects of hybrid mismatch arrangements
Action 3	Strengthen CFC rules
Action 4	Limit Base Erosion via interest Deductions & other financial payments
Action 5	Counter harmful tax practices more effectively taking into account transparency & substance
Action 6	Prevent Treaty Abuse
Action 7	Prevent the artificial avoidance of PE status
Action 8	Assure that Transfer Pricing Outcomes are in line with Value Creation / Intangibles
Action 9	Assure that Transfer Pricing Outcomes are in line with Value Creation / Risks an Capital
Action 10	Assure that Transfer Pricing Outcomes are in line with Value Creation/Other High-risk transactions
Action 11	Establish methodologies to collect and analyse data on BEPS
Action 12	Require taxpayers to disclose their aggressive tax planning arrangements
Action 13	Re-examine Transfer Pricing Documentation
Action 14	Make dispute resolution mechanisms more effective
Action 15	Develop a Multilateral Instrument

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Action 1
Address the Tax Challenges of the Digital Economy

- This is the economy
- Will be addressed through other action items
  - PE issues
  - TP – intangibles, data, value chains
  - CFC rules

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Action 2 – Hybrid Mismatches

- Heard about the recommendations in some detail yesterday
- We have a number of hybrid rules but do we have appropriate anti-mismatch rules? Limited in entity space (Div 830) and none in instrument space.
- Would require legislative response
- Likely follow any changes to OECD Model?

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Action 3 – Strengthen CFC Rules

- Australian rules strong now
- Unlikely to be any watering down – query whether simplification still an option
- Interplay with GAAR
- Ability to deal with digital economy
- So: some level of review/re-examination likely but not likely to lead to significant changes (more adaptation)

Action 4 – Limit base erosion via interest deductions

- Will be ongoing examination of OECD work in this area – not only December draft but thereafter
- Domestically, query if thin cap is most appropriate design response to this
- Should debt creation rules be reintroduced?

Action 5 – Counter Harmful Tax Practices more effectively

- Lack of consensus
- Patent box developments – new UK/German agreement
- Not just legislation/regulation based practices – also rulings and "deals"; compulsory exchange of rulings initiative (including APAs?)
  - – work has commenced on ability to do this
  - – including whether EoI provisions allow

Action 6 – Prevent Treaty Abuse

- Updated Treaty preamble
- New section in Commentary
- Specific anti-abuse rules – Principle Purpose Test &/or LOB
- Treaties Unit in Treasury issue - no doubt will be picked up in negotiations

Action 7 – Prevent Artificial Avoidance of PE

- Query actual practice versus purported practice – whether PE exists under current provisions
  - Question of fact
- Nonetheless, 31 October 2014 consultation draft raised options
  - would be need to address treaty and domestic law provisions if were to take up some of suggestions

Action 8 – 10: Ensure TP outcomes consistent with Value Creation

- Hard to value intangibles (8), risks and capital (9) and other high risk transactions (10)
  - themes of risk, recharacterisation and special measures
  - actual conditions that exist/lack of comparable
- Need to determine whether Australia's new TP rules already can address these

Action 11 – methodologies to collect and analyse data

- Trying to identify indicators of scale and economic impact of BEPS
- Develop best practice
- Likely to be an administrative response only required

Action 12 – Taxpayer disclosure of aggressive tax planning

- Look at experience of existing mandatory regimes (e.g. UK)
- Choose parts most appropriate for our conditions
- Whether, like TP documentation requirements and current Reportable Tax Position regime, this can be done through administrative means?
- Need to await 31 March 2015 Consultation Draft

Action 13 – CbC reporting

- Master file, country-by-country report and local file
- Can currently ask for it but strictly no requirement under law to create it
- Whether legislative/regulatory change required to compel it (given broader purpose
- What to do with information – is it just a lead to more questions?
- How to ask follow up questions/information of other States – whether current EoI sufficient?

Action 14 – More Effective Dispute Resolution

- Access to and timeliness of MAP
- Mandatory and binding arbitration clauses
- Encourage multilateral MAPs and APAs
- Clarifying role and status of mutual agreements
- Interest and penalty concerns
- Partly administrative and partly Treaty negotiation

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Action 15 – Establishing a multilateral instrument

- Designed to streamine treaty changes
- Optional adoption of certain BEPS measures may mean reviewing bilateral treaties both as to
    - the appropriate interpretation and
    - what other changes may be necessary over time.

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What does the BEPS Agenda mean for Australia?

ATO role in BEPS:

1. Support Treasury in its consideration and advice to Government
2. Competently administer the law
3. Ensure administrative competence results in international cooperation and global compliance

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