This bulletin addresses the Base Erosion and Profit Shifting work-stream of the Organisation for Economic Cooperation and Development (OECD) and the OECD's progress report on that topic for the G20. The OECD refers to this as BEPS and it is, in some respects, a wider reinstatement of the work done which began under the banner of Harmful Tax Practices in the 1990s and many of the subsequent projects which have followed it.

The report seeks to address issues which have come to a head as a result of government pressure. That has, in turn, resulted from the need for austerity measures in the light of the global economic crisis and the increased attention from the public, non-governmental organisations (NGOs)/civil society organisations (CSOs) and the media on where the burden of those austerity measures falls. The globalisation of business, the particular issues presented by cross-border digital commerce and shifts in economic power given the increased importance of developing states are all changes that underlie the current tax debate, particularly for corporates.

We consider here the main themes of the debate, analyse the OECD’s progress and assess the way forward.
Background on harmful tax competition, transparency and aggressive tax planning

A 1998 OECD report, 'Harmful Tax Competition, An Emerging Global Issue' responded to a request by members to develop measures to counter harmful tax practices carried out by countries around the world. It laid the foundations for a considerable amount of work which the OECD did in this area. The work initially proceeded on three fronts:

1. identifying and eliminating harmful features of preferential tax regimes in OECD member countries,
2. identifying tax havens and seeking their commitment to the principles of transparency and effective exchange of information, and
3. encouraging other non-OECD economies to associate themselves with this work.

The two elements of the non-OECD member country work were largely carried out jointly through the OECD Global Forum on Taxation throughout the 2000s. The specific working party effectively became a separate forum, the 'Global Forum on Transparency and Exchange of Information for Tax Purposes' in 2009.

Whereas in substance the issues raised in the BEPS work have significant cross-over with this earlier work on harmful tax competition, there is now a very different focus to the approach to these issues. Currently the OECD spotlight is on the actions and behaviour of corporates, in using low tax structures, with any discussion of the role of states, and tax competition in general, not so far featuring greatly in the debate.

The G20 has provided the impetus for this project on BEPS.

As part of the G20 Seoul Summit in November 2010 a Multi-Year Action Plan on Development was agreed and the G20 leaders requested the OECD’s new forum to “enhance its work to counter the erosion of developing countries’ tax bases …”. The G20 asked that the results of the plan be available for the G20 Cannes Summit and a report was delivered early in September 2011.

The focus of that report was largely on transparency and the development of a network of Tax Information Exchange Agreements (TIEAs) to supplement the double tax agreements already covering sharing of such data. But it also noted that developing countries are not a homogenous group and are faced with complex challenges, including in connection with tax administration, which if not addressed could lead to the erosion of their tax bases. One point raised was that non-compliance through the use of structures anchored in other countries and abusive transfer pricing may undermine the domestic tax base of a jurisdiction.

The OECD recognised the importance of tax cooperation in addressing aggressive tax planning (ATP) more widely. A steering group subsequently carried out projects on corporate losses in the banking sector and beyond, on disclosure initiatives and on hybrid mismatch arrangements.

The OECD prepared a progress report on various tax initiatives for the meeting of the G20 in Los Cabos, Mexico on 18/19 June 2012. That report included extensive reference to co-ordinated information sharing and activity. The response from the G20 leaders in their declaration that concluded the summit stated (at para 48)

“...we re-iterate the need to prevent base erosion and profit shifting and we will follow with attention the ongoing work of the OECD in this area.”

This reflects the growing concern about base erosion and profit shifting, not just from lesser developed countries but also from more developed countries, including the US, UK, Australia, France and Germany. These countries have been quick to realise though that unilateral action is unlikely to be effective.

Increasing pressure from these countries led to an agreement for a progress report from the OECD ahead of the G20’s February 2013 meeting.

Globalisation and other commercial drivers

The OECD’s BEPS report of February 2013 notes that:

“... current international tax standards may not have kept pace with changes in global business practices, in particular in the areas of intangibles and the development of the digital economy.”

Businesses are not just operating across borders. They are now truly global. And commercially they are looking to centralise procurement, management and control, the holding and development of intellectual property (IP), financing and many other business activities. All aspects of the business need to be run efficiently on a global basis to compete with other businesses operating in the same way.

International tax rules were developed almost a hundred years ago when products were manufactured, physically transported, and sold. Some of our current laws were first introduced in double tax treaties as far back as the 1920s and 1930s with major advances made by the OECD in the 1960s and 70s. It is not surprising therefore that they are not easy to apply to an age when:

- business doesn’t always require physical presence in a country to operate
- the most valuable assets, such as IP, are not fixed, and
it’s often difficult to establish the value to be taxed at each stage of what can be a very complex business cycle.

The macro issues BEPS is responding to
The OECD’s BEPS work has been focused on looking at whether (and if so why) the current rules allow for the allocation of taxable profits to locations different from those where the valuable business activity takes place. It also seeks to examine whether the tax system regards as having (or reflecting) value can properly be supported.

The main driver behind BEPS seems to be the growing perception that governments lose substantial corporate tax revenue because of planning aimed at eroding the taxable base and/or shifting profits to locations where they are subject to a more favourable treatment. They point to a rise in the number and importance of cross-border tax schemes.

Essentially, what we have seen amounts to complaints from source states about taxing rights being denied to them and flowing to residence countries. The main specific area of complaint concerns various forms of returns to capital. The complaints are greater where income returns on capital are paid out of some states but not remitted to the headquarters state and retained in tax havens (or states with preferential tax regimes) where they are subject to low taxation. This has led to work in recent years on rules such as transfer pricing and intangibles, permanent establishment (and both threshold and attribution PE rules), beneficial ownership etc. It is now being suggested that more fundamental concepts need to be reviewed. Indeed, to quote the OECD:

“... incremental approaches may help curb the current trends but will not respond to several of the challenges governments face.”

Fundamental reform options
There are probably two main options for truly fundamental reform;

1. unitary taxation including alternative formulaic approaches like the EU’s Common Consolidated Corporate Tax Base (CCCTB)
2. a material shift in source: residence taxing rights

Other more radical options have also been suggested (e.g. the sharing of taxing rights and tax collected in the context of advanced cross-border co-operation and mutual assistance between states).

A unitary approach would tax multinationals not according to their legal forms (separate entities), but according to the economic substance of what they do as a whole and where they do it. They would have to prepare a consolidated report for the whole global group, ignoring all internal transfers. The report would also specify the group’s physical assets, workforce and revenues from sales to third parties. The overall worldwide profits would then be divided up among jurisdictions according to a formula weighting these three factors. This approach carries with it problems of achieving consensus on the definitions of those factors and their respective weightings.

A harmonisation of the tax base across different participant countries could facilitate a similar apportionment process. The aggregation of these separate results for the different countries could produce a total taxable amount which could then be apportioned back to those same countries, using agreed weighted factors.

The EU’s proposal for a CCCTB is one example of the formulaic approach but it has not received unanimous support within the EU and wider application would clearly be problematic.

Adopting a greater emphasis on the source of income rather than the residence of the owner is an alternative possibility. But this would require a material rethink of the concepts on which several thousand bilateral treaties have been negotiated. It is not obvious therefore that truly fundamental reform will be possible with a material shift from the current OECD agenda to more of a UN approach.

The OECD’s role
Given the state of the current debate on corporate tax issues and the obvious difficulties with some parts of the existing tax system (especially areas where there is no consensus at all on what the tax rules should be or how existing tax rules should be applied), we support the need for an attempt at a collaborative solution to the issues that have been raised. Overall, we believe that the OECD is the right body to look at the BEPS issue.

• The OECD is currently the premier supranational organisation pursuing a wide range of tax projects, as it has for more than 50 years. It has led a number of major global tax initiatives during that period.
• There are significant human and capital resources available in the OECD’s Committee on Fiscal Affairs secretariat to carry out the necessary reviews and subsequent negotiations.
• There are projects already in progress on a number of the areas specified for review in the BEPS workplan, including transfer pricing (TP), PE, etc.
\textbullet{} Its role in producing its Model Tax Convention and in guiding countries in their implementations of this and other tax principles has given it a prominent position in the sphere of tax.

There may, however, be some constraints on what the OECD is likely to bring to the table.

\textbullet{} At a practical level, it seems unlikely to move away fundamentally from the concepts developed over many years on TP, PE, balance of source: residence taxing rights, etc. (note its spirited rejection of unitary taxation). Whilst this may be comforting at one level, it does perhaps narrow the possibilities for any fundamental re-think of the international tax system.

\textbullet{} The OECD is a consensus-based organisation with 33 member states. It is seeking to build a base of influence in non-member developing countries, so that it may be burdened by a desire to reach broad-based solutions which can accommodate a wide range of interpretations and applications. If this were to happen, any solutions or responses developed may be over-subjective or vague and lack clear bright-line tests with which business can comply.

It remains to be seen how the OECD is able to balance the largely contradictory forces of short-term political pressure for quick fixes and the medium to longer term time horizons needed for considered policy-driven changes to the tax rules.

In our view, we think this means that the response of the OECD is more likely to be built around modifications to existing rules to bring in further anti-avoidance measures and possibly specific rules for ‘special situations’ such as internet businesses (although it remains unclear whether digital business will, as initially indicated, be dealt with by specific rules as a special case or whether any changes intended to apply to e-commerce will apply across the board).

**OECD priorities for BEPS**
The OECD has highlighted a number of specific areas where it has particular concerns. These are:

\textbullet{} use of hybrid financial instruments,
\textbullet{} shifting of mobile resources (capital, intangibles),
\textbullet{} specific tax issues relating to digital business,
\textbullet{} (over) leveraging local operations,
\textbullet{} lack of information,
\textbullet{} use of tax incentives,
\textbullet{} lack of resources to target the issues,
\textbullet{} use of hybrid entities, and
\textbullet{} use of low tax jurisdiction.

The OECD is currently tackling these issues by breaking them down to be addressed by three separate work streams.

1. jurisdiction to tax e.g. residence, PE tests, controlled foreign company (CFC) tests etc
2. base erosion e.g. limitation of benefits (LOB), re-characterisation, anti-arbitrage, etc, and
3. transfer pricing e.g. status of ‘legal’ arrangements, documentation, risk allocation and enforcement, etc.

**Change options**
The list of areas set out above clearly raises a very wide range of issues. We recognise the realities of the short-term political pressures in this area. However, if the OECD is to be successful in taking on these issues and developing responses based on a proper consideration of policy, as well as political matters, we consider various questions will need to be addressed by the OECD in forming its action plan.

\textbullet{} Is the diverse nature of the issues to which the OECD seeks solutions clear?
\textbullet{} Are we clear we will be better off (and by what standard) after any change?
\textbullet{} How much tax should in any event come from business profits?
\textbullet{} Is it obvious that all the issues complained of really are a problem? Is it acceptable for nations competing for business and tax revenue to use tax competition/ tax incentives as they do now to attract business?
\textbullet{} Can multilateral agreement really be achieved in principle and executed in practice?
\textbullet{} How do we execute/migrate to any new tax rules and over what time period?

**Thematic changes BEPS might bring**
As a result of the BEPS work (and notwithstanding that it’s not a policy aim to change the balance of source-based and residence based taxing rights as discussed later in this paper), we think there is likely to be a shift towards a more source-based approach. If so, there would be countries which gain additional revenue from such a move, all other things being equal (e.g. US, China, India). Others are more likely to lose revenue in such circumstances (e.g. UK and Switzerland). It will also be necessary if this is to achieve its aims for the power of TP to be materially reduced to prevent profit being sucked out of source jurisdictions.

At a practical if not also a technical level, we are also likely to see much greater focus on the substance of an entity (or PE) in the attribution of business profits. Are there sufficient people of a relevant quality and experience at a particular location to derive a quantified level of profit for tax purposes? For example, more focus may be given to the significant people functions tests applied for TP and derived from the Business Profits Article (Article 7) of the OECD Model Tax Treaty.
A proliferation of anti-avoidance measures may be aligned with an increased level of suspicion being applied by the tax authorities. Anti-avoidance is perceived to bring dual benefits, firstly in terms of providing a tool to counteract the benefits of ‘inappropriate’ taxpayer strategies and secondly by way of discouraging the kind of behaviour whereby taxpayers consider such strategies. The number of countries adopting general anti-avoidance rules or general anti-abuse rules (GAARs) may well grow. There may also be more targeted anti-avoidance rules. New rules will probably be developed with a strong anti-avoidance agenda, such as the OECD proposals on beneficial ownership, PE threshold and intellectual property.

Alongside this it will probably become harder to deal with tax authorities and secure agreements on particular tax transactions. We have already seen this to a degree in recent months in some quarters and the position may deteriorate further. As we reported in our October 2012 Tax Policy Bulletin providing an update on OECD tax projects 1, the OECD-led Forum on Tax Administration (FTA) is expected to rebrand its enhanced relationship positioning to present it as involving essentially ‘cooperative compliance’. The FTA’s hard work in recent years to foster a more constructive relationship between large businesses and tax administrations has unfortunately been undermined to some extent by concerns – often at a political level – that it leads to inequality between taxpayers.

Conceptual options
More specifically, it may help to consider some of the different ways that the OECD could address the perceived ‘mischiefs’ enjoyed by tax ‘haven’ companies. These include measures directed at the categories below.

1. Recognition of ‘Offshore’ location of haven companies
This might alternatively be framed as the perceived problem with a residence test being based on mere incorporation. Approaches include:

- a substance requirement
- adopting a special PE rule for intermediate entities, and
- strengthening CFC rules, although there may be other constraints such as those imposed by ‘freedoms’ in the Treaty on the Functioning of the European Union.

2. Recognition of payments to ‘haven’ companies
Alternative approaches might include:

- widening the ability to re-characterise transactions
- introducing some kind of substance test for TP – either generally or by reference to certain types of asset or service (e.g. IP)
- narrowing requirements for beneficial ownership
- widening the use of limitation of benefits clauses in bilateral treaties, and
- GAARs.

3. Quantum of payments to ‘haven’ companies
The main option here would seem to involve tightening up TP comparables requirements.

4. Withholding obligations
A withholding of tax may be possible on certain types of payments or on payments in certain situations.

5. Effect of payments to ‘haven’ company
To counteract benefits derived in relation to the payment to a company based in a tax ‘haven’ the OECD may consider:

- introducing double non-taxation articles into treaties to withdraw treaty benefits, and
- adding domestic anti-arbitrage rules (e.g. similar to existing UK rules) including rules to apply to hybrid instruments or to hybrid entities.

6. Cross-border financing projects
The scope of provisions targeted at cross-border financing arrangements might include interest, guarantee fees, arrangement fees, credit support, etc. Options the OECD could seek to advance might focus on:

- strengthening thin cap rules,
- introducing other specific rules that take account of the identity and circumstances of payee, and
- limiting the extent or timing of reliefs more generally.

Conceptual options for digital business companies
For digital businesses, options depend on whether it is considered preferable to extend the existing OECD Article 5 of the Model Tax Convention:

- introducing a new PE regime for digital businesses
- regarding servers potentially as fixed places of business (although given the inevitable difficult question as to what value would be attributable to them this may not represent much of an advance), and
- widening the ‘services PE’ rule to apply where business sells via the internet.

Problems remain generally with the determination of the quantum of attributable profit and also with how such businesses could be made to comply.

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1 http://www.pwc.com/gx/en/tax/newsletters/tax-policy-bulletin/update-oecd-tax-projects.jhtml
It may also be attractive to the tax authorities to require specific consumption tax rules (whether VAT/GST or otherwise). For example EU VAT rules applicable to fixed establishments are in some cases substantially different from those applicable in other regimes, although the OECD has been working on a more harmonised approach to such taxes.

**Migration toward a recommended solution**

It would be helpful if the OECD’s action plan gave some careful thought to the optimal path to the solutions it recommends. This will depend to a large extent on the nature of those solutions. But it seems likely that changes may be required in the way that existing bilateral treaties are applied. Options, which are not necessarily mutually exclusive, include:

- a mechanism that it is agreed overrides existing treaties (is it feasible?)
- a process for altering a number of treaties at once
- renegotiating individual treaties (which would obviously be very time consuming)
- altering the Model Tax Convention articles (which presumably would have only prospective effect), and
- altering the Commentary to the Model Tax Convention (which raises the long-standing question about the extent to which treaties ‘ambulate’, i.e. whether such changes can affect the interpretation of existing treaties).

Some of these options set out above seem deeply problematic (and therefore most unlikely in practice).

There are likely also to be OECD recommendations for domestic actions by individual countries. It needs to be clear how domestic law changes should interact with existing treaties (as potentially adjusted in accordance with the above) and whether, or to what extent, domestic law overrides those treaties.

Most importantly, there will need to be clarity on the start date for any changes made and there is a strong case for changes not having retrospective scope.

**OECD timeframe**

Questions arise as to whether the timeframe the OECD is working to is realistic, optimistic or idealistic. There is also a subsidiary question as to whether this will be considered acceptable by other stakeholders. The G20 accepted the initial report at its meeting in Moscow on 15-16 February 2013:

> “... we welcome the OECD report on addressing base erosion and profit shifting and acknowledge that an important part of fiscal sustainability is securing our revenue bases. We are determined to develop measures to address base erosion and profit shifting, take necessary collective actions and look forward to the comprehensive action plan the OECD will present to us in July.”

The July date is commensurate with the OECD’s intention to get its action plan signed off by its Committee on Fiscal Affairs by June 2013. There is an obvious concern at the speed at which the OECD is proposing to address these issues, even though we understand the political pressure for a response. Given that what is required will involve:

- the development of a range of specific solutions,
- a process to check that the solutions will work in practice and not create material and unintended collateral damage, and
- the building of consensus amongst states for (presumably) co-ordinated or concerted implementation (in line with the OECD’s required collaborative approach for this topic).

The overall timescale of less than six months to reach an agreed action plan seems extremely short. It is arguably more a function of political pressure in this area than reflecting the time realistically needed to develop sound policy solutions (or even a map for future travel in this area). Certainly, recent country experiences in dealing with specific rules such as a GAAR would indicate this timescale is unrealistic.

Further OECD consultations to agree detailed matters, such as appropriate wording, could take many months if not years. History shows that international agreement takes time – the issues are complex and stakeholders will need to be clear what issues they are resolving and how.

**Early indications of the OECD’s approach**

The early indications of the OECD’s direction on BEPS suggest that there is little prospect of unitary (or similar) options for fundamental tax reform being pursued. It also seems that the OECD does not wish as a policy matter to effect any material change to the existing balance of taxing rights between source and residence -based taxing rights.

It does seem to accept, though, that in attempting to bolster existing tax rules it may well strengthen existing source and residence based taxing rights. Any impact on source or residence based taxing rights therefore seems likely to be more an effect than a policy goal of the OECD’s approach to BEPS.
Will the OECD’s action plan provide a solution?
The OECD’s timeframe, partly specified in its report and partly implicit, may not yet be fully clear to governments. If the (lengthy) period required for fundamental reform is seen as unacceptable, we are likely to see more interim measures carried out domestically and perhaps by other organisations such as the European Commission. Indeed, there may even be questions as to whether the political momentum to support fundamental change can be maintained over such a long timeframe.

There remains too an issue as to whether solutions will be feasible without broad co-operation and support from the business sector. In the event of no such support (or only limited support) the pressure on individual governments may mount and some may be tempted to step back from the OECD initiative.

Perhaps the most fundamental question though will relate to whether and how the output of the BEPS project can be reconciled with the widespread tax competition policies pursued by states, including OECD member states.

Future challenges
For all the reasons discussed in this bulletin, the work on BEPS is clearly a very challenging project. It represents the OECD’s biggest tax challenge to date. However, we consider the existing position – as reflected in the current high profile public debate on corporates and tax – a long way from satisfactory. For that reason we support the OECD’s review in this area yet remain nervous, having regard to the breadth of the project and the narrowness of the timescale, as to whether the OECD can be wholly successful in its endeavour.

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