Funding the Future

Overall Evaluation of the G20/OECD Base Erosion and Pro...

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The following is the summary of the overall assessment of the OECD BEPS package by the BEPS Monitoring Group, of which I am a member. I'd like to thank Prof Sol Picciotto for this work on this and for granting permission to share it:

We have now published our *General Evaluation of the final outputs of the BEPS Project. It is based on the detailed comments which we have produced on each and every report and discussion draft produced for the BEPS project. This overall evaluation will be supplemented by a more detailed Handbook analyzing and commenting on all the proposals.*

Summary

The G20 mandate for the BEPS project was that international tax rules should be reformed to ensure that multinational enterprises (MNEs) could be taxed 'where economic activities take place and value is created'. This implied a new approach, to treat the corporate group of a MNE as a single firm, and ensure that its tax base is attributed according to its real activities in each country. Unfortunately, the BEPS project has continued to emphasise the independent entity principle, which starts from the fictitious assumption that affiliates of a corporate group act like separate legal persons, while attempting to counteract its harmful consequences. The BEPS outputs will provide considerable strengthening of the existing rules, giving better tools to tax authorities if they have the capacity and will to use them. Overall, however, the proposals offer a patch-up of existing rules, making them even more complex and in many cases contradictory, and do not provide a coherent and comprehensive set of reforms. Nevertheless, this is an important first step on a longer road.

Some of the proposals do mark a significant step forward, enabling the MNE to be considered as a single firm and to ensure that profits relate to economic activity in each country. The proposed template for country by country reports is a major advance, although the arrangements for access by all relevant tax authorities create unnecessary obstacles: publication would be a far easier and better solution. Proposals were also made for limiting deductions of interest by apportioning the consolidated

group costs of interest payable to third parties, but these were watered down to recommendations prioritising a fixed cap. Similarly, ensuring taxation of a group's worldwide profits could have been achieved by stronger rules on controlled foreign corporations, but the final report contains only weak recommendations, which will continue to encourage competition between countries to reduce corporate taxes, and to motivate MNEs to shift profits. The proposals on harmful tax practices may slow but will not halt tax competition, since they continue the approach dating back to 1998, based on voluntary rules and secretive self-policing, which has had very limited effects. Already it can be seen that the attempt to apply the broad principles of 'nexus' and 'substance' to innovation boxes is leading only to a complicated system attempting to restrict some aspects, while legitimising the concept. Instead of eliminating such schemes, this is already leading to the opposite: their increased adoption by many states and a consequent decline in corporate taxation.

The aim of tax treaties has too long been regarded as only the prevention of double taxation, disregarding the equally important purpose of ensuring appropriate taxation, which we proposed should be an explicit provision in all treaties. Instead, inclusion of an anti-abuse rule is proposed, which should at least include a standard principal purpose test. To be effective, this will need systematic information exchange to verify the tax status of recipients, as will the proposals for dealing with treaty abuses by using hybrid entities or instruments through complex rules for denying deductions. Abuse of the separate entity principle by fragmenting functions will be only partially dealt with by the proposal to deem that an entity has a permanent establishment (taxable presence) if activities can be said to be 'preparatory or auxiliary' to sales. This very limited approach allows firms to continue to fragment non-sales-related functions and attribute higher profits to countries where they will be lightly taxed.

The continued reliance on the separate entity fiction has also led to increased complexity of rules on transfer pricing, to allow tax authorities to recharacterise transactions between related parties, but only following a detailed and ad hoc 'facts and circumstances' analysis and searches for 'comparables'. This subjective and discretionary approach will increase enforcement and compliance costs and generate conflicts. Recognising this, and responding to business concerns, it is proposed to strengthen dispute resolution procedures, including an increased use of arbitration. However, it is inappropriate and illegitimate to seek to remedy the failure to agree clear rules by providing procedures conducted in complete secrecy to deal with the inevitable disagreements in their application.

These outcomes are clearly only a start. Implementation by states will take time and should be monitored, and key issues remain to be dealt with. The main shortcoming is the failure to develop clear rules for the attribution of profit. Further work is planned on the profit split method, which could provide a way forward. The report on digitalization of the economy recognizes that it raises key issues going beyond the BEPS project, including the basic concepts of residence and source, and where profit should be

considered to be earned. Although the BEPS project itself can only be said to have been at best a partial success, it has succeeded in opening space for more far-reaching changes. It should be seen as part of a longer process, involving a wider range of organisations and countries, especially developing countries. This should aim at finally reforming international tax rules to ensure fairness for all, and make them fit for the 21st ce