The OECD Action Plan on Base Erosion and Profit Shifting

Comments by the TUAC Secretariat
Paris, 26 July 2013

On 19 July 2013, the OECD published its Action Plan on Base Erosion and Profit Shifting (BEPS)[1].The Action Plan was requested by the G20 Finance Ministers Meeting in January 2013, and is expected to be endorsed by the G20 Heads of States meeting in Saint Petersburg in September.

This paper presents the broad features of the Action Plan including examples of aggressive tax planning schemes: manipulating intra group transfer pricing, excessive deduction of debt interest and of other payments, inappropriate treatment intangibles, avoiding permanent establishment status, etc. The paper then suggests key issues for further discussion including: reforming the OECD Transfer Pricing Guidelines, the need for public disclosure of country-by-country reporting and of beneficial ownership, greater transparency over dispute resolution mechanisms, and the implications of BEPS for workers employed by MNEs. Regarding next steps, the TUAC will hold an expert meeting on BEPS, in partnership with the ITUC, on 29 November 2013 at the OECD.

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Overview

For years the OECD has been concerned about the risk of double non-taxation of the corporate income of MNEs between jurisdictions. For the OECD "national tax laws have not kept pace with the globalization of corporations and the digital economy, leaving gaps that can be exploited by multi-national corporations to artificially reduce their taxes". The Base Erosion and Profit Shifting (BEPS) Action Plan provides a roadmap comprising 15 measures aimed at preventing double non-taxation through aggressive tax panning practices by (i) reducing the taxable income base (i.e. Base Erosion) and/or (ii) moving profits away from

[1] http://www.oecd.org/newsroom/closing-tax-gaps-oecd-launches-action-plan-on-base-erosion-and-profit-shifting.htm

economically relevant but high tax-jurisdictions to economically irrelevant but low-tax jurisdictions (i.e. Profit Shifting). The Action Plan also emphasises the specific challenges of the business model of the digital economy, and the treatment of 'hard to value' intangibles (patents, brands, research and developments).

More fundamentally, the OECD is seeking to move away from a purely contractual approach – which allows different forms of fictional corporate structures, empty shells, inappropriate deductions, manipulation of transfer pricing – to put more emphasis on economic substance. For the OECD Secretariat "we clearly have reached the point where the governments don't care any more about taboos, and they just say we cannot be bound by pure contractual arrangements. It's not possible to only allocate the profit through only contractual arrangements"[2].

The Action Plan consists of 15 actions, grouped under four broad objectives, together with a cross-cutting theme:

Pillar (i) "Establishing international coherence of corporate income taxation"
- Action #2 on hybrid mismatch between bilateral tax treaties that allow for multiple deductions from the corporate income tax base of a single debt interest, or the deduction of a debt interest on a debt which in fact does not exist;
- Action #3 on controlled foreign company (CFC) rules that can be exploited to transfer profits abroad to a "non-resident" shell company (i.e. not subject to tax);
- Action #4 on excessive deductions of debt interests and of other financial payments on derivatives;
- Action #5 on the use of bilateral tax treaties' preferential regimes for aggressive tax planning purpose;

Pillar (ii) "Restoring the full effects and benefits of international standards"
- Action #6 on exploiting differences in bilateral treaties and the practice of "treaty shopping";
- Action #7 on avoiding the permanent establishment status (i.e. selling something in a country without taxable legal status in that country);
- Action #8-10 on manipulating intra-group transfer pricing on intangibles, source of financing and capital, and other transactions linked to global value chains;

Pillar (iii) "Ensuring transparency while promoting increased certainty and predictability"
- Action #11 on data collection on the impact of BEPS practices;
- Action #12 on mandatory disclosure by multinational enterprises (MNEs) of their tax planning schemes;
- Action #13 on mandatory country-by-country tax reporting to tax authorities;
- Action #14 on making all the above regulatory changes more predictable for MNEs and facilitating bilateral arbitration through the Mutual Agreement Procedure;

Pillar (iv) "From agreed policies to tax rules: the need for a swift implementation of the measures"
- Action #15 on developing a new multilateral convention to automatically amend the +2000 bilateral treaties with the above;

[2] http://uk.reuters.com/article/2013/07/19/g20-tax-corporate-idUKL6N0FO2ZQ20130719

Cross-cutting theme: the digital economy

- Action #1 on addressing the tax challenges of the digital economy.

In terms of deliverables, this work would for the most part result in new OECD recommendations on changing domestic tax rules, amending existing OECD texts (the OECD Model Tax Convention on Income and on Capital[3] and/or the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations[4]) and/or the development of further analytical research and data collection.

Illustrative examples

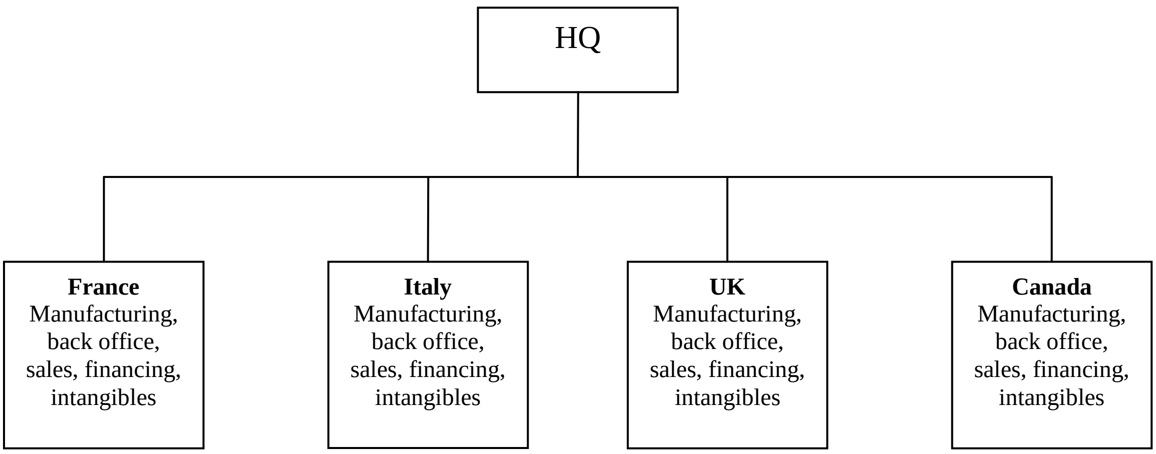
To help understand the issues addressed by the OECD Action Plan, this paper uses a simplified representation of a MNE to illustrate different types of aggressive tax planning:

- Manipulating intra group transfer pricing;
- Excessive deduction of debt interest and other payments;
- Hard to value and shifting of intangibles;
- Avoiding permanent establishment status; and
- Opacity of MNE tax schemes and the need to shift to country-by-country reporting to tax authorities.

Changing structure of the MNE

At the outset it is important to address the changing structure of the MNE in the past two decades. The traditional structure of an MNE, the one prevailing in the 1960-1980s, consists of (i) a headquarters and (ii) stand-alone subsidiaries, each having relative operational autonomy (regarding manufacturing and production, service, back office, financial and intangibles, sales & marketing). Within that structure, each subsidiary generates profits in line with the economic substance of its activities. Figure 1 provides a simplified representation of such a traditional MNE structure with four subsidiaries in France, Italy, UK and Canada.

FIGURE 1: TRADITIONAL STRUCTURE OF A MULTINATIONAL ENTERPRISE

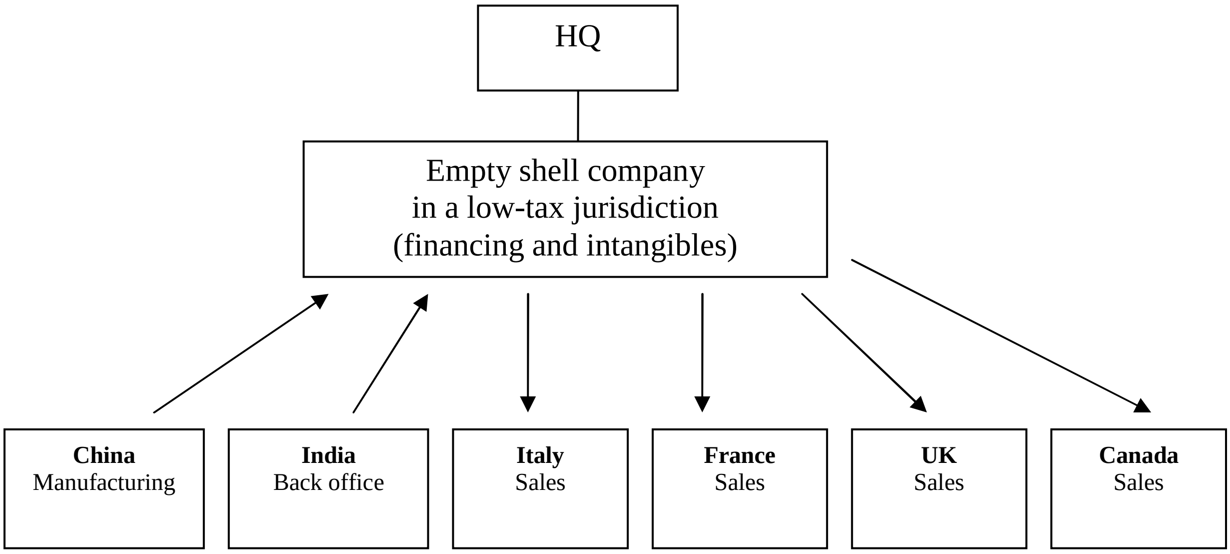


[3] http://www.oecd.org/tax/treaties/47213736.pdf

[4] http://www.oecd.org/tax/transfer-pricing/transferpricingguidelinesformultinationalenterprisesandtaxadministrations.htm

The above model, however, is no longer valid. With the emergence of global value chains, production, back office services and sales are on the whole separated from sales and marketing to take advantage of regional and country-specific competitive advantage. Figure 2 provides a simplified representation of a structure of a MNE today. Manufacturing is entirely located in China, back office entirely located in India, while the French Italian British and Canadian subsidiaries retain sales functions only. Importantly, the new MNE structure includes an empty shell company through which all intra-group transactions transit and which is located in a low tax jurisdiction (for example, a non-OECD tax haven but also some OECD jurisdictions such as Ireland, Luxembourg, the Netherlands). The empty shell company also owns key intangibles assets (patents, licenses, royalties). This entity is an empty shell company because its contractual value (ownership of patent rights, royalties, financing of the MNE) is disproportionately high compared to its economic substance (an office, a desk and a telephone line).

FIGURE 2: MNE STRUCTURE BASED ON GLOBAL VALUE CHAINS



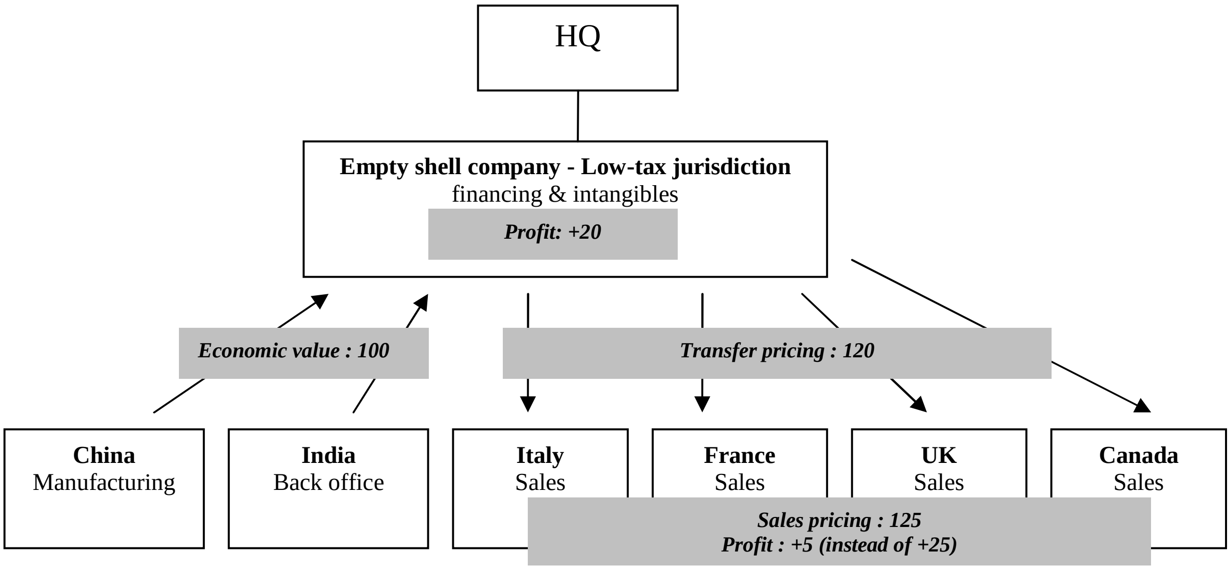
Manipulating intra group transfer pricing (Actions #8, #9 & #10)

Transfer pricing refers to the pricing of transactions within the same corporate group. Unlike transactions between two independent enterprises, transactions between subsidiaries within a MNE can be distorted so as to minimise profits in high-tax jurisdictions (typically where sales to the final consumer occurs) and maximise profits in low-tax jurisdictions (including tax havens). Figure 3 is an example hereof.

The OECD Transfer Pricing Guidelines for Multinational Enterprises describe several pricing methods to avoid such distortion, all of which are based on the arm's length principle (which itself is founded on article 9 of the OECD Model Tax Convention). Central to the arm's length principle is the use of "comparability analysis" which values transactions within a MNE with reference to the conditions that would apply to two independent enterprises in "comparable transactions and comparable circumstances".

In Figure 3, production and services located in China and India are transferred to the European and Canadian subsidiaries (where sales take place) via the empty shell company. If the arm's length principle is not respected or is hard to apply (such as is the case for intangibles), there is a risk that the MNE will manipulate the pricing of each transaction: Chinese production and Indian services, the economic value of which is 100, are transferred from the empty shell company to the sales subsidiaries at 120, hence shifting +20 in profits from the latter to the empty shell company, which is in a low-tax jurisdiction.

FIGURE 3: MANIPULATING TRANSFER PRICING

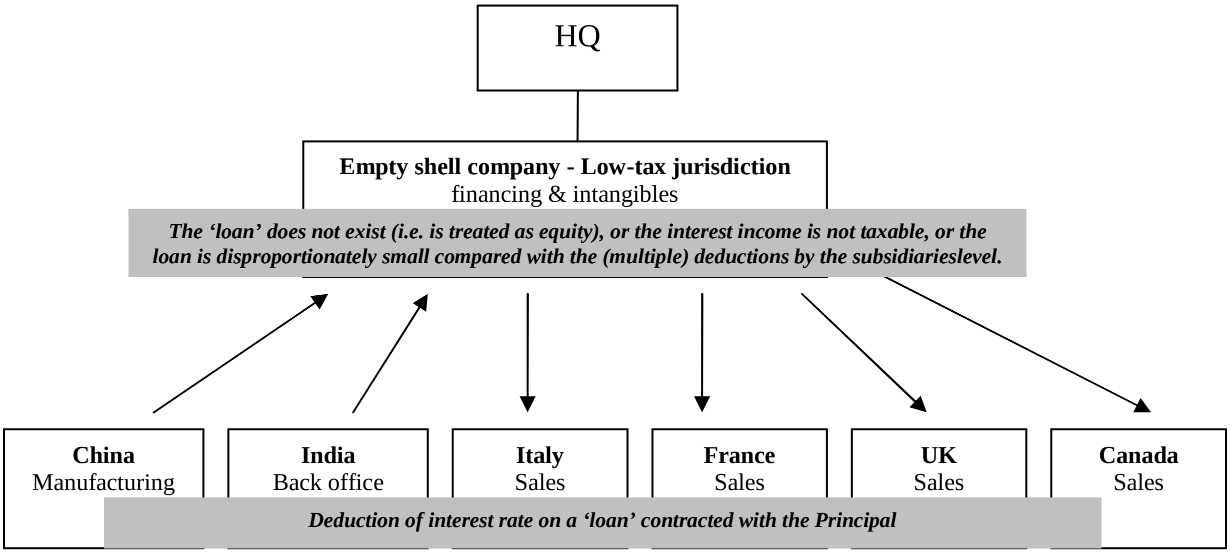


Deduction of debt interest and other payments (Actions #2 & #4)

Another key BEPS practice is the excessive use of deductible payments from the corporate income tax base of subsidiaries. A classic example is the deduction of debt interest from a loan with another entity within the MNE group. Interest payments are deducted from the subsidiaries but on the creditor side the corresponding interest income is either taxed favourably, not taxed at all, or simply does not exist (i.e. in the case of a hybrid mismatch when the same source of financing is treated as debt in the jurisdiction of the subsidiary and as equity in the jurisdiction of the empty shell company).

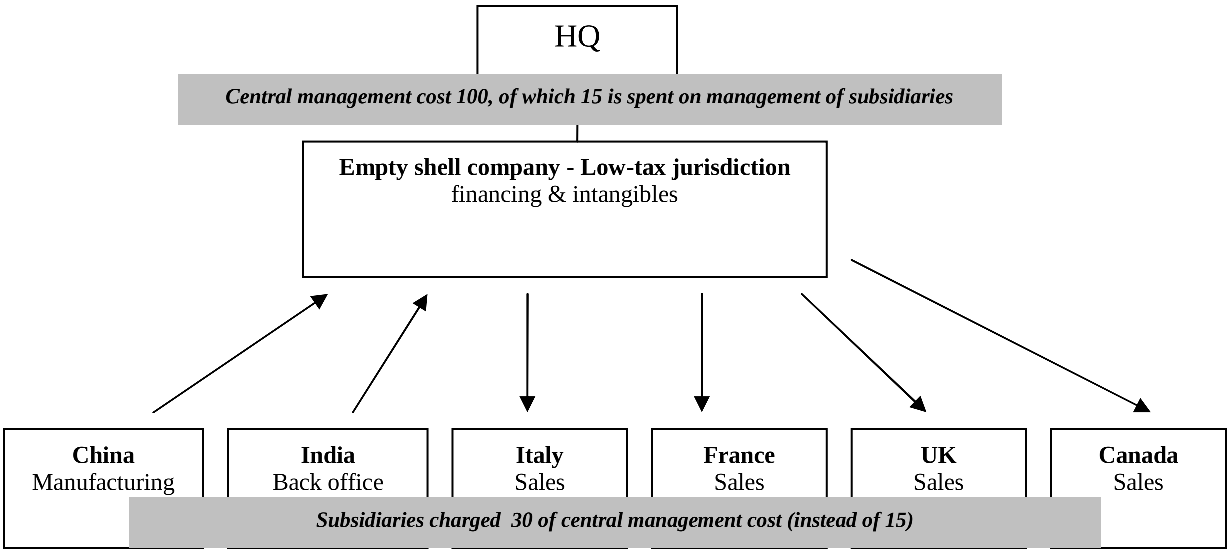
In Figure 4, the MNE subsidiaries are deducting debt interest from their respective corporate income tax bases based on a fictional loan from the principal empty shell company of the MNE.

FIGURE 4: EXCESSIVE DEDUCTIONS (DEBT INTEREST)



The problem of excessive use of deductible payments is not limited to loans and debt. Other forms of financial transfer can give rise to similar base erosion processes: intra-group insurance and guarantees on commercial and credit default risk and internal derivatives used in intra-bank dealings. Excessive deductions can also take place with regard to non-financial costs, such as royalties and management costs at HQ level. In Figure 5, the subsidiaries are overcharged for the management costs borne by the MNE headquarters – while the economic value is 15, they are paying 30.

FIGURE 5: EXCESSIVE DEDUCTIONS (MANAGEMENT COSTS)

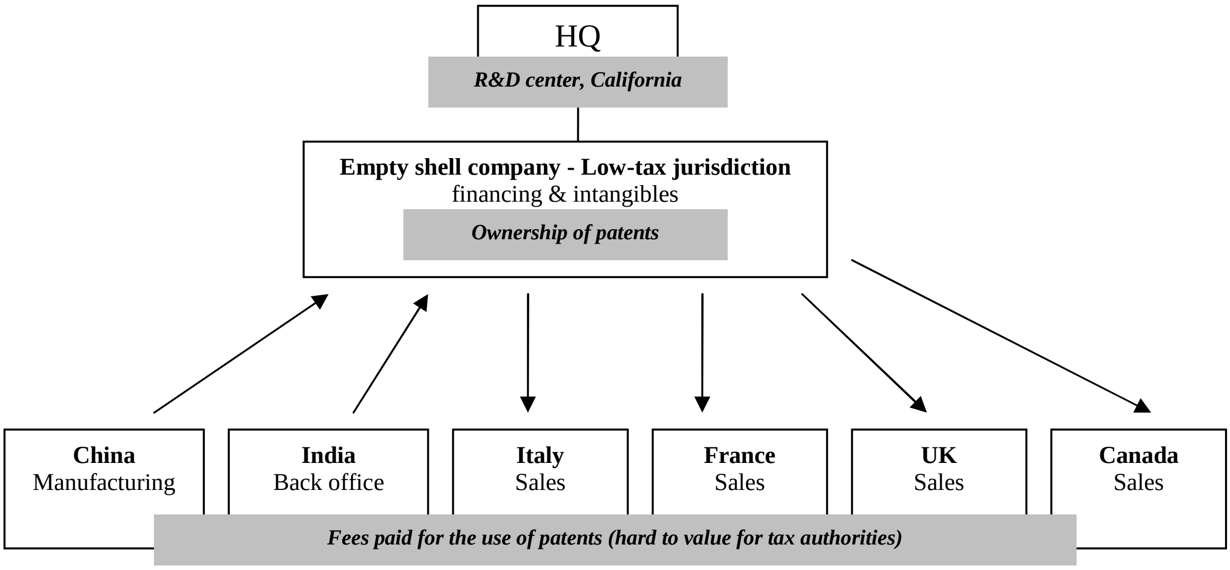


Intangibles (Actions #1 & #8)

The above examples have in common the separation of income from the economic activities that produce that income (the subsidiaries) to reduce the tax base and to shift it to a low-tax jurisdiction (the empty shell company). The problem with these aggressive tax schemes becomes particularly acute when dealing with transfers of intangibles (patents, royalties, R&D), which are hard to value using a comparative market-based approach. That is why the OECD Action Plan pays so much attention to intangibles.

In Figure 6, the patent rights of Research and Development activities produced at the Headquarters of the MNE – say in Palo Alto, California State – are owned by the empty shell company – say in Ireland. The subsidiaries of the MNE pay a fee for the use of the patents. Aggressive tax planning then takes two forms: (i) profit shifting from California to Ireland and (ii) base erosion in the subsidiaries (when the fee paid is excessive compared to the value of the patent).

FIGURE 6: INTANGIBLES

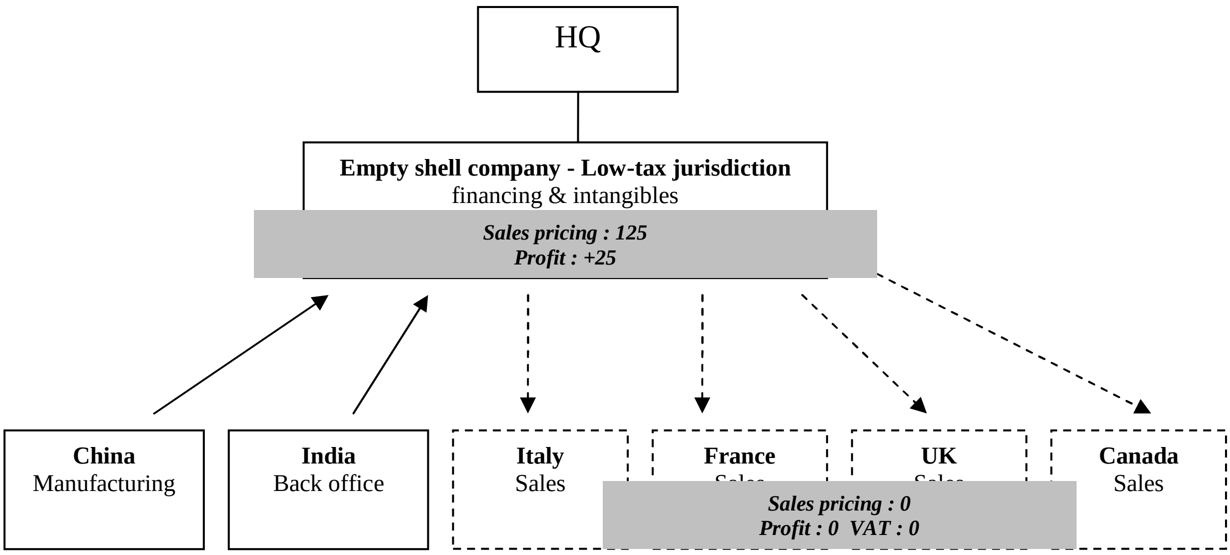


Transfer pricing of intangibles is particularly challenging for the OECD's "preferred" transaction pricing method based on the arm's length principle. And indeed, since intangibles are unique in nature, and hence in value, there is no market benchmark against which to conduct an objective comparability analysis. That is why the OECD Transfer Pricing Guidelines for Multinational Enterprises, revised in 2010, allow for the tax treatment of intangibles to depart from the market based arm's length principle and to use the "profit split method". The profit split method measures the combined profits of the two MNEs entities involved in the transfer and then split the profits between the two based on allocation keys – sales, staff, investment. As discussed below, NGOs and unions involved in aggressive tax planning campaigns have a strong preference for the profit split method and at group level (not on a case-by-case approach as allowed for by OECD).

Avoiding permanent establishment status (Action #7)

BEPS can also originate from the legal status of the subsidiaries. In the above MNE structure, the subsidiaries where sales take place (France, Italy, Canada, UK) act as distributors, with a sales-force employed and generating their own sales and profits and, where appropriate, collecting VAT locally. If, on the other hand, subsidiaries act as "commissionaire" their sales-force do not "sell" products or services themselves but take a commission on the sales. In Figure 7, the MNE avoids the "permanent establishment" status in the countries where it sells products. The sales are contractually with the empty shell company located abroad in the low-tax jurisdiction and so the profits for these sales are not taxable locally in the countries where the subsidiaries are based (or at least not at the level that they would be if the sales were made by a distributor). Shifting the subsidiaries' status from distributor to commissionaire hence results in shifting profits out of the country in which the sales take place (but without any corresponding change in the economic substance of the subsidiaries).

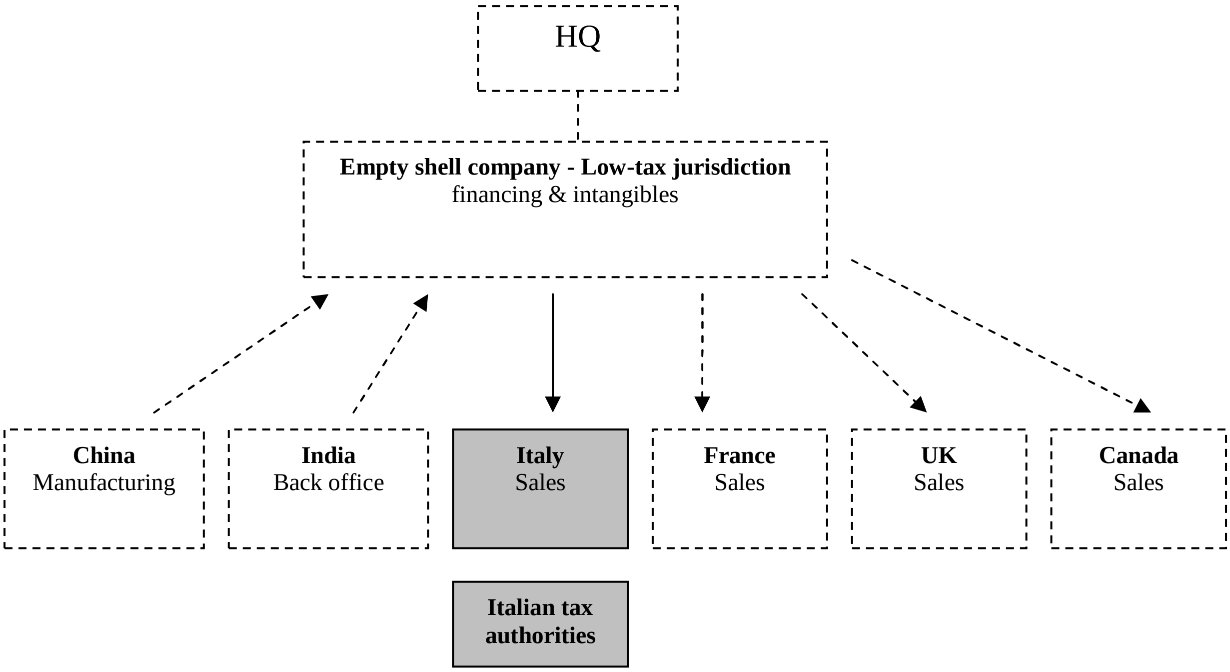
FIGURE 7: AVOIDING PERMANENT ESTABLISHMENT STATUS



Country-by-country reporting (Actions #12 & #13)

As the OECD argues "Tax administrations have little capability of developing a "big picture" view of a taxpayer's global value chain". As shown in figure 8, the Italian tax authorities only have access to documentation relevant to the Italian subsidiary. They do not have information on either the parent empty shell company, or the rest of the group. That is why the OECD Action Plan emphasises the need for greater corporate reporting to tax administrations (although "taking into consideration the compliance costs for business") and for such reporting to be delivered on a group-wide consolidated basis. Action #13 requires "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". In essence this is a requirement for country-by-country tax reporting, a central civil society campaigning objective, although at this stage the OECD only foresees such reporting to be to the tax authority, so there will be no public disclosure on a country-by-country basis.

FIGURE 8: WHAT A NATIONAL TAX AUTHORITY "SEES"



What is missing

The TUAC[5] and the ITUC[6] welcomed the release of the Action Plan on 19 July 2013. The plan has the ambition to effectively curb aggressive corporate tax planning – but it needs to be effectively implemented. The British TUC also welcomed the OECD Action Plan[7]. Reception was more measured (if not negative), however, on the part of business and NGOs, although for opposing reasons. For Oxfam, Christian Aid and other members of the Tax Justice Network, the BEPS Action Plan does not go far enough. It is "a step forward but fails poor countries" because, *inter alia*, it does not call for a radical shift in measuring transfer pricing, moving away from the arm's length principle to a unitary formulary apportionment method (a.k.a. "unitary taxation") and because its fails to require public disclosure of country-by-country tax reporting. Similarly for the US-based Global Financial Integrity advocacy group, the OECD initiative lags behind because it "fails to endorse [publicly disclosed] country-by-country reporting" which is a "necessary precursor to curtail corporate tax dodging"[8].

On the business side, the tone is also very measured. The British CBI is reassured by the commitment that "administrative and compliance burdens on businesses" will be taken on board[9]". Deloitte stresses that the Action Plan "rules out fundamental change to the international tax architecture, such as the adoption of a global unitary tax system" but flags

[5] http://www.tuac.org/en/public/e-docs/00/00/0D/40/document_news.phtml
[6] http://www.ituc-csi.org/ituc-welcomes-oecd-action-plan-to?lang=en
[7] http://www.tuc.org.uk/economy/tuc-22388-f0.cfm
[8] http://www.gfintegrity.org/content/view/626/70/
[9] http://www.cbi.org.uk/media-centre/press-releases/2013/07/cbi-responds-to-oecd-international-tax-action-plan/

up “potential dangers, such as the possible misuse of confidential information” should country-by-country reporting to tax authorities become reality[10].

As the initial NGO reactions show, country-by-country tax public disclosure and shift to unitary taxation of MNEs (formulary apportionment method) are missing elements of the BEPS action plan. Other important issues are also missing however and as discussed below.

Country-by-country tax reporting and beneficial ownership

The OECD Action Plan would require country-by-country tax reporting to national tax authorities. This is welcome. It follows on from the commitment made at the G8 Summit in Northern Ireland (June 2013) to “create a common template for multinationals to report to tax authorities where they make their profits and pay their taxes across the world”[11]. The Action Plan should go further, however, and require full public disclosure of tax paid locally, in line with recent reforms in the US and in the EU. The Dodd-Frank Act requires country-by-country tax disclosure but only for the oil, gas and mining companies. In the EU, recent agreement has been reached to force similar requirements for companies in the extractive sector. Importantly, the draft negotiated between the Council (i.e. Member States) and the European Parliament around the new Capital Requirement Directive IV for banks, includes mandatory disclosure by banks of their country-by-country positions, including tax payments.

In line with tax reporting, a missing element in the OECD Action Plan is the disclosure of “beneficial ownership”: that is the full identity of owners of shares and other securities and assets. In many jurisdictions – and not just offshore tax havens – disclosure of beneficial ownership is still problematic.

Formulary apportionment method

NGOs are right to call for a radical shift away from the arm’s length principle to a unitary taxation system. The fundamental problem with the arm’s length principle is that it creates a fiction insofar as it treats entities of an MNE “*as if* they were independent entities” and does not treat the MNE as a single entity. Compared with the arm’s length principle, formulary apportionment has the great merit of considering an MNE for what it is: a single entity, not an aggregation of separate entities. As such it would eliminate a large part of current tax arbitrage opportunities and resolve many of the above mentioned risks of base erosion and profit shifting.

The OECD Action Plan opposes the shift to a formulary apportionment method because it is “not a viable way forward”, it is “unclear” what “behavioural changes” companies might adopt in response to the use of a formula, and because of the “practical difficulties associated with agreeing to and implementing the details of a new system consistently across all countries”. The OECD, however, does not wholly reject the formulary approach: “special measures, either within or beyond the arm’s length principle, may be required with respect to intangible assets, risk and over-capitalisation to address these flaws”.

[10] http://www.deloitte.com/view/en_GX/global/services/tax/cross-border-tax/international-tax/1137f8684e7ff310VgnVCM2000003356f70aRCRD.htm#.Ue-5-9K9mMq . A full selection of public reactions can be found here: http://www.internationaltaxreview.com/Article/3234619/ITR-Premium-News-and-Analysis/The-OECDs-BEPS-report-How-did-others-react.html

[11] https://www.gov.uk/government/news/g8-summit-prime-ministers-remarks

Transparency over dispute resolution mechanisms

Transparency over dispute resolution mechanisms may be another sticking point. The action plan calls for facilitating and removing obstacles to the use of mutual agreement procedure (MAP) between a tax authority and a MNE. There is nothing wrong with promoting arbitration as opposed to traditional judicial procedures, as long as it meets minimum standards for transparency, which is not the case today. For the Tax Justice Network "these procedures must become fully transparent and with publication of outcomes. There must be no secret deals when hundreds of millions of tax revenue dollars may be at stake. Publication would also improve the system, by establishing a record of the principles applied, to guide other taxpayers".

Impact on MNE workers

Last but not least, it will be important for TUAC to specifically address the impact of aggressive tax planning on workers employed by the MNE, wherever contractual arrangements do not reflect the economic substance of the MNE organisation. Central to this discussion is whether the profit shifting and tax base erosion schemes, as outlined in the Action Plan, have an impact on the salary levels and collective bargaining of current and future workers. Another point for discussion is whether the opacity created by aggressive tax planning constitutes a barrier to workers' right to information and consultation about the MNE's business plan and foreseeable risk factors.

It would also be important to address the extent to which workers' pension funds actively address the risk of BEPS through their shareholdings in listed assets, but also their business relationships with private funds, including hedge funds and private equity groups.

Next steps for TUAC

The TUAC Plenary Meeting in May 2013 agreed that the TUAC Secretariat should increase substantially its work on aggressive tax planning.

On 29 November 2013 the TUAC will convene a trade union tax experts meeting on transfer pricing and business restructuring at the OECD Conference Centre and in partnership with the ITUC. This meeting will help reach out to trade union centres of tax expertise – unions covering tax administrations and labour-oriented tax lawyers – as well as MNE worker representatives with experience of business restructuring – including members of European Works Councils (EWCs). Given the need to reach out to EWCs, the active participation of the ETUC and Global Unions Federations would be needed.

Ahead of that meeting, the TUAC and the ITUC will explore further through policy research and analysis the concrete implications of aggressive tax planning practices for workers' rights and for collective bargaining, with a particular focus on MNE workers facing business restructuring for tax purpose.

Other than participating in the OECD implementation of the BEPS Action Plan through consultations, the deliverables of the TUAC will include: (i) advocacy for the OECD to develop special guidance on the observance of the tax chapter (XI) of the OECD Guidelines for Multinational Enterprises and (ii) developing tools to increase the awareness and understanding of trade unions of aggressive tax planning.