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The OECD Work on Base Erosion and Profit Shifting

Background

There is a 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 tax treatment. Civil society and non-governmental organisations (NGOs) have been vocal in this respect, sometimes addressing very complex tax issues in a simplistic manner and pointing fingers at transfer pricing rules based on the arm's length principle as the cause of these problems.

Beyond this perception based on a number of high profile cases, there is a more fundamental policy issue: the international common principles drawn from national experiences to share tax jurisdiction may not have kept pace with the changing business environment. Domestic rules for international taxation and internationally agreed standards are still grounded in an economic environment characterised by a lower degree of economic integration across borders, rather than today's environment of global taxpayers, characterised by the increasing importance of intellectual property as a value-driver and by constant developments of information and communication technologies. For example, some rules and their underlying policy were built on the assumption that one country would forgo taxation because another country would be imposing tax. In the modern global economy, this assumption is not always correct, as planning opportunities may result in profits ending up untaxed anywhere.

Political attention

The debate over Base Erosion and Profit Shifting (BEPS) has also reached the political level and has become a very important issue on the agenda of several OECD and non-OECD countries. The G20 Leaders meeting in Mexico on 18-19 June 2012 explicitly referred to "the need to prevent base erosion and profit shifting" in their final declaration. This message was reiterated at the G20 finance ministers meeting of 5-6 November 2012 whose final communiqué states "We also welcome the work that the OECD is undertaking into the problem of base erosion and profit shifting and look forward to a report about progress of the work at our next meeting." On the margins of the G20 meeting in November 2012, the United Kingdom's chancellor of the exchequer, George Osborne, and Germany's finance minister, Wolfgang Schäuble, issued a joint statement, since then joined by France's economy and finance minister Pierre Moscovici, calling for co-ordinated action to strengthen international tax standards and urged their counterparts to back efforts by the Organisation for Economic Co-operation and Development to identify possible gaps in tax laws. Such a concern was also voiced by US President Obama in his Framework for Business Tax Reform where it is stated that "the empirical evidence suggests that income-shifting behaviour by multinational corporations is a significant concern that should be addressed through tax reform".

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The issue in a nutshell

Corporation tax is levied at a domestic level. The interaction of domestic tax systems sometimes leads to an overlap, which means that an item of income can be taxed by more than one jurisdiction thus resulting in double taxation. The interaction can also leave gaps, which result in an item of income not being taxed anywhere thus resulting in so called "double non-taxation". Corporations have urged bilateral and multilateral co-operation among countries to address differences in tax rules that result in double taxation. Domestic and international rules to address double taxation, many of which originated with principles developed in the past by the League of Nations in the 1920's, aim at addressing these overlaps so as to minimise trade distortions and impediments to sustainable economic growth. In contrast, corporations often exploit differences in domestic tax rules and international standards that provide opportunities to eliminate or significantly reduce taxation.

Broadly speaking corporate tax planning strategies aim at moving profits to where they are taxed at lower rates and expenses to where they are relieved at higher rates. These strategies typically ensure: (i) minimisation of taxation in a foreign operating or source country, (ii) low or no withholding tax at source, (iii) low or no taxation at the level of the recipient, as well as (iv) no current taxation of the low taxed profits (achieved via the first three steps) at the level of the ultimate parent. The result is a tendency to associate more profit with legal constructs and intangible rights and obligations, thus reducing the share of profits associated with substantive operations involving the interaction of people with one another.

While these corporate tax planning strategies may be technically legal and rely on carefully planned interactions of a variety of tax rules and principles, the overall effect of this type of tax planning is to erode the corporate tax base of many countries in a manner that is not intended by domestic policy.

Key pressure areas

In addition to a clear need for increased transparency on effective tax rates of MNEs, key pressure areas include those related to:

- International mismatches in entity and instrument characterisation including hybrid mismatch arrangements and arbitrage;
- application of treaty concepts to profits derived from the delivery of digital goods and services;
- the tax treatment of related party debt-financing, captive insurance and other inter-group financial transactions;
- transfer pricing, in particular in relation to the shifting of risks and intangibles, the artificial splitting of ownership of assets between legal entities within a group, and transactions between such entities that would rarely take place between independents;
- the effectiveness of anti-avoidance measures, in particular GAARs, CFC regimes and thin capitalisation rules; and
- the availability of preferential regimes for certain activities.

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The role of the OECD

When implemented effectively, the strategies used to shift profits and erode the taxable base put increased pressure on the rules and on the governments that designed them. This also reflects an important point, namely that BEPS strategies take advantage of a combination of features of tax systems which have been put in place by home and host countries. Accordingly, it may be impossible for any single country, acting alone, to fully address the issue. There is no magic recipe to address BEPS issues, but the OECD is ideally positioned to support countries' efforts to ensure effectiveness and fairness and at the same time provide a certain and predictable environment for business.

OECD member countries share a common interest in establishing a level playing field among countries while ensuring that domestic businesses are not disadvantaged vis-à-vis multinational corporations. 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 and addressing double taxation which exists today. The consequences could be damaging in terms of increased possibilities for mismatches, additional disputes, increased uncertainty for business, a battle to be the first to grab taxable income through purported anti-avoidance measures, or a race to the bottom with respect to corporate income taxes. In contrast, collaboration to address BEPS concerns will enhance and support individual governments' domestic policy efforts to protect their tax base while protecting multinationals from uncertainty or double taxation. In this regard, addressing BEPS in a coherent and balanced manner should take into account the perspectives of industrialised as well as emerging and developing countries.

Next steps

The OECD will deliver a progress report to the G20 in early 2013 on actions to tackle the issue of BEPS, including strategies to detect and respond to aggressive tax planning and ensure better tax compliance. In addition to a clear need for better data and analyses, a reflection on the very fundamentals of the current rules also appears to be warranted. The reflection would primarily focus on issues around whether rules developed in the past are still fit the purpose in today's business environment, particularly when applied to the increasingly digital economy, or whether there is a need for different solutions, as well as on options to implement reform in a streamlined manner.