

Subcommittee on Base Erosion and Profit Shifting Issues for Developing Countries

A. Purpose

This note provides information about the project established by the OECD and G20 to address global concerns with base erosion and profit shifting (the BEPS project). It should not be read as expressing views on the substantive issues examined in that project.

B. Introduction

Over the last decade there has been increasing public interest in the tax paid by multinational enterprises (MNEs). Since 2012 there has been increased global media and political reaction to evidence suggesting that some multinationals pay little or no tax anywhere in the world. There is a wide range of cross-border tax planning techniques that are used to produce such results which are collectively referred to as “base erosion and profit shifting”.

Last year the OECD and G20 jointly established the BEPS project to address global concerns. G20 countries that are not members of the OECD participate as Associates, on an equal footing with member countries.

But it is widely recognized that many other countries need to be engaged in this work if it is to yield the greatest benefits for countries generally, by reducing their vulnerability to base erosion and profit shifting and increasing their ability to respond to it cooperatively and effectively.

The G8 has expressed strong support for the BEPS project and in June 2013 committed to “support developing countries to collect the taxes owed them, with access to the global tax information they need.”

In October 2013, the United Nations Committee of Experts on International Cooperation in Tax Matters established a Subcommittee on base erosion and profit shifting issues for developing countries.

The Subcommittee is mandated to draw upon its own experience and engage with other relevant bodies, particularly the OECD, with a view to monitoring developments on base erosion and profit shifting issues and communicating on such issues with officials in developing countries (especially the less developed) directly and through regional and inter-regional organisations. This communication will be done with a view to:

- helping inform developing countries on such issues;
- helping facilitate the input of developing country experiences and views into the on-going UN work, as appropriate; and
- helping facilitate the input of developing country experiences and views into the OECD/G20 Action Plan on Base Erosion and Profit Shifting (BEPS).

This paper has been prepared to advance the work of the Subcommittee by providing information on these issues with a view to obtaining the views of developing countries. As is clear from the mandate, responses will have a dual role of shaping the Subcommittee’s input into the OECD/ G20 base erosion and profit shifting work and also

informing the continuing UN work on these types of issues, including possible developing country responses.

C. What are the key causes of base erosion and profit shifting?

The global international tax framework reflected in countries' domestic law and bilateral tax treaties assumes that multinational companies will pay tax somewhere on their cross-border income. Generally speaking, it is envisaged that income will be taxable either in the country where the income is earned (the source state) or the state where the multinational is headquartered (the residence state) – depending on the nature of the cross-border activity undertaken by the multinational. A fundamental concern is that international tax standards, both in terms of domestic law and bilateral arrangements, have not kept pace with developments in the global economy. But it is difficult for any country, acting alone, to fully address these issues. This is a global problem that requires a global response, but one calibrated to the needs and situations of all countries, including developing countries.

The important thing to note is that there is not one single cause of base erosion and profit shifting.

In some cases it reflects gaps and inadequacies in the design of domestic laws. Countries' domestic rules for taxing multinationals on their world-wide profits ("controlled foreign company" (CFC) rules) may be inadequate. In other cases countries' rules for taxing investment into their country may be undermined by the use of related-party debt funding to strip out profits.

In some instances, certain transfer pricing practices (i.e. "mispricing") result in base erosion and profit shifting. These practices are particularly prevalent in relation to multinational profits generated by brands, intellectual property or digital services that are highly mobile and can be located anywhere in the world, but can also exist in relation to the pricing of extractive resource-related contracts, for example.

Another set of problems arise from complex interactions between different countries' tax rules. For example, one country may classify a local entity as a company. But the country where the investor in that entity is resident may treat the investor as the direct owner of the assets of the company. That is, that second country does not recognize the existence of a separate legal entity between the investor and the assets. These types of "hybrid entities" can be used to claim the same deduction in two countries and may result in unintended double non-taxation. Similar double non-taxation problems can arise from mismatches in the way different countries classify instruments as being either debt or equity.

To date, bilateral tax treaties which follow either the UN or OECD models have been focused on removing double taxation between the two countries who signed the treaty and preventing tax evasion and avoidance. Treaty abuses, including the practice of residents of third countries effectively gaining access to treaty benefits intended only for residents in the signatory states (i.e. "treaty shopping") also contributes to base erosion and profit shifting.

These problems can be difficult to identify as revenue authorities require information from multiple jurisdictions which may not be readily available. Even when information can be shared, the detail required to analyse a multinational's arrangements is seldom provided unless specifically requested, and not enough may be known to support such a request to a particular jurisdiction. The proliferation of different information disclosure standards and formats had also at times made it difficult to compare data sets between countries even when information has been exchanged.

D. How does base erosion and profit shifting affect countries?

Base erosion and profit shifting is a global problem because the impact of the tax laws and policies of one country can adversely affect another country's ability to collect tax that should be due to it. This can be an unintended effect, but whether it is intended or not, it has the same budgetary effect on the country losing tax revenue. In turn, this can impede country development.

Historically, countries typically view the setting of domestic international tax laws as a matter for each sovereign state and in making these decisions too often little or no account is taken of either (i) the impact their laws have on other countries or (ii) the impact that the laws of other countries have on them. Reality has shown that this perspective, which many or even most sovereign states take, can give rise to base erosion and profit shifting concerns.

For instance, if some countries do not effectively tax their own multinationals, this may have a knock-on effect of giving these multinationals incentives to shift profits or minimise their taxable presence in other countries where they operate (and therefore pay no tax anywhere in the world).

In the same way, if countries don't tax businesses operating in their jurisdictions in an effective manner, when they should, the incentive on the multinational to escape taxation in the country where they are headquartered increases.

Another concern that base erosion and profit shifting raises for governments is that it may make local businesses that do face comprehensive taxation uncompetitive in a way that is perceived as unfair.

Ultimately, base erosion and profit shifting has adverse implications for the important task of actual tax collection. Efficient administration of many income tax systems depends upon the voluntary compliance of taxpayers. Voluntary compliance is adversely impacted by perceptions of unfairness. If multinationals don't pay their share of tax this is perceived as unfair and that perception may undermine voluntary compliance by other taxpayers.

E. What has happened so far?

G20 countries and the OECD are jointly committed to addressing base erosion and profit shifting. In June 2012, the G20 leaders discussed the need to prevent base erosion and profit shifting at their meeting in Mexico. They asked the OECD to report to them on the issue. The report released by the OECD in February 2013 outlined the problems and promised an Action Plan by mid-2013. The OECD's *Action Plan on Base Erosion and Profit Shifting* was released on 20 July last year. It is available at www.oecd.org/ctp/BEPSActionPlan.pdf. The current paper provides a summary of some of the key items in the OECD action plan.

The OECD action plan makes specific reference to the interests of developing nations and the role the UN is expected to play:

Developing countries also face issues related to BEPS, though the issues may manifest differently given the specificities of their legal and administrative frameworks. The UN participates in the tax work of the OECD and will certainly provide useful insights regarding the particular concerns of developing countries.¹

¹ Page 26, Action Plan on Base Erosion and Profit Shifting, 2013

At the same time, a number of countries began investigating the impact of base erosion and profit shifting in their own jurisdiction. Some have already started to explore options for domestic legislation to address some of the problems giving rise to base erosion and profit shifting.

As mentioned above, in October 2013 the United Nations Committee of Experts on International Cooperation in Tax Matters established a Subcommittee on base erosion and profit shifting issues for developing countries.

F. Other related initiatives

The base erosion and profit shifting work is only one of the many initiatives currently in progress in response to the current international climate of concern about tax avoidance and tax evasion. The G20, the Global Forum on Transparency and Exchange of Information for Tax Purposes (the Global Forum) and the OECD are leading many of these initiatives. In particular the G-20 has called on the EU pilot on automatic exchange of information of information covered by the Foreign Account Tax Compliance Act (FATCA) to be developed into a “global standard”, and has called on the Global Forum to monitor the global implementation of that standard.

Another development of note has been the modernizing, in 2010, of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, and the opening of that convention to signature by non-OECD or Council of Europe members. The G20 leaders have now called for all countries to sign the convention. The convention has now effectively been signed by 77 jurisdictions, including all G20 and OECD member countries, and all BRIICS countries. The BEPS action plan also calls on the OECD’s Forum on Harmful Tax Practices to begin evaluating preferential tax regimes in the base erosion and profit shifting context, to engage with non-OECD members on the basis of its existing framework, and to consider revisions or additions to that framework.

G. What does the OECD Action Plan on Base Erosion and Profit Shifting cover?

The Action Plan comprises some significant areas of work which are largely grouped under two themes:

Establishing international coherence of corporate income taxation:

- reviewing the impact of mismatches in domestic law which occur because countries have different tax rules for distinguishing between debt and equity or companies and partnerships.
- reviewing domestic rules for controlled foreign companies (CFCs), which allow countries to tax their multinationals on passive/mobile income that they earn through foreign subsidiaries.
- reviewing domestic rules for limiting interest deductions (e.g. thin-capitalisation rules).
- evaluating countries’ domestic rules which offer preferential treatment on certain types of income in a way that is harmful to the international tax environment as a whole.
- Restoring the full effects and benefits of international standards.

- preventing the misuse of tax treaties (e.g. by investors who shouldn't qualify for tax relief under a tax treaty).
- improving the "permanent establishment" rules in treaties for determining when a business has a taxable presence in a foreign country
- improving "transfer pricing" rules (which ensure that a market price is paid on related-party transactions), by ensuring that transfer pricing rules are in line with the creation of value particularly in relation to debt, financial transactions, intellectual property, contractual bearing of risks, and management services.

Ensuring transparency while promoting increased certainty and predictability:

- developing methods and identifying sources of information which will allow countries to assess the impact of base erosion and profit shifting, and monitor the effect of any solutions.
- designing best practice rules which would require taxpayers to disclose aggressive tax arrangements or transactions.
- improving transfer pricing documentation and introducing country-by-country reporting requiring multinationals to disclose which countries they pay tax in, derive income from, and conduct activities in.
- making dispute resolution procedures in treaties more effective, efficient and accessible.

Lastly the two themes are supported by two projects which span the breadth of the OECD's Action Plan:

- considering whether special tax rules are needed to tax digital goods and services that are provided over the internet.
- developing a multilateral instrument so that solutions can be implemented swiftly without needing to renegotiating individual treaties.

Finally, it is important to note that the Action Plan states that while "a number of countries have expressed a concern about how international standards ... allocate taxing rights between source and residence States" it is not directed at addressing these broader concerns. It goes on to note that the Action Plan will "restore both source and residence taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates" but that the Action plan is "not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income".

ANNEX

Description of OECD action plan on base erosion and profit shifting

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.

Output: Report identifying issues raised by the digital economy and possible actions to address them by September 2014

Comment

International tax principles have developed from historic business practices that emphasised fixed assets, physical presence and relatively simple business structures. This action point will explore how those rules apply to the digital economy, which commonly relies on intangible assets, little or no physical presence and often complex and highly centralised business structures.

Both direct taxation (income taxes) and indirect taxation (value added or consumption taxes) will be considered and a dedicated task force on the digital economy has been established.

Issues to be examined include, but are not limited to:

- How a company can have a significant digital presence in a country but not be liable for tax;
- How data gathered from a country and then sold on (e.g. information relating to individual's consumer preferences gathered from social media sites) should be valued;
- How income from digital enterprises is characterised (e.g. is a song a good? A service? A license?) and how the source rules apply to that income;
- How value added or consumption taxes can be effectively collected from digital good and services supplied from another country.

Action 2 – Neutralise the effects of hybrid mismatch arrangements

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 payor; (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 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.

Output: Changes to the OECD Model Tax Convention and recommendations regarding the design of domestic rules – September 2014

Comment

It is normal for domestic tax regimes to apply different rules to different kinds of transactions or entities. The rules that apply to debt (money lent) are usually different to those that apply to equity or shares (money invested). Interest payments on debt are normally deductible but distributions of dividends are not; interest received is normally income but dividends, in particular foreign dividends, are often exempt from tax.

Similarly the taxation of a company will not be the same as the taxation of a partnership. A company will usually be separately liable for tax on its profits before it can distribute those profits to its investors (i.e. shareholders). But a partnership is generally not taxed and any profits or deductions are taxed directly in the hands of the partners in the partnership.

Hybrid mismatch arrangements refer to situations when two countries see either a particular instrument differently because of their specific domestic law definitions. This can arise, for example, if one country classifies an instrument based on its legal form and the other based on its economic substance. For example:

Company A in Country Y supplies \$100 to Company B in Country Z. The tax rules in Country Y define this arrangement to be equity; Country Z defines it to be debt. When Company B makes a payment to Company A it will be able to claim a deduction as the payment will be defined as interest however Company B will not have to pay tax on the payment as it will be considered an exempt dividend. A deduction has been allowed for the \$100 but no corresponding income tax has been charged.

Differing treatments of entities can have similar effects. For example:

Globe Co is a business that is resident in Country Y but owned by investors from Country Z. Country Y sees Globe Co as a company; Country Z sees it as a partnership. When Globe Co makes an interest payment Country Y allows a

deduction for Globe Co, as it is required to pay tax as a company, and Country Z allows a deduction for the investors as it sees Globe Co as partnership. Globe Co has been able to claim a double-deduction.

This action point will investigate whether changes to the OECD model tax treaty and amendments to domestic rules can be made to counter these arrangements.

Action 3 – Strengthen CFC rules

Develop recommendations regarding the design of controlled foreign company rules. This work will be co-ordinated with other work as necessary.

Output: Recommendations regarding the design of domestic rules – September 2015

Comment

Controlled foreign company (CFC) rules apply when the residents of one country own a significant interest in a foreign company. These rules typically treat certain types of the foreign company's income (generally this is limited to passive income such as royalties, interest, dividends) as earned or derived by the investors regardless of whether that income is distributed to the investors in that year – or in any future year.

These rules have two primary objectives: first, they reduce the incentive to shift income into low tax jurisdictions and second, they prevent the long-term deferral of tax which would otherwise occur if the foreign company did not distribute profits.

Company A, which is resident in Country Y, receives interest from investments in Country Y bonds. The company realizes that it could gain a tax advantage by incorporating a subsidiary (Company B) in Country Z, where tax rates are lower, and transferring the investments to Company B.

Under normal income tax conventions Company B is a separate legal entity earning income in Country Z and unless it distributed that income back to Company A, there would not be any liability for tax in Country Y. The CFC rules look through Company B, as it has a 100% owned by Company A, and attributes that income to Company A – as it is earned rather than when it is distributed. Depending on the jurisdiction's particular tax credit rules, Company A may be able to gain a credit for any tax paid in Country Z to offset any tax liability in Country Y.

Active income, such as manufacturing, retail, services etc, is generally not attributed back to the shareholders under CFC regimes. This exclusion is made both to ensure the company remains competitive (i.e. it is only paying tax in one country) and because active income is much less mobile than passive income as it usually requires some kind of physical infrastructure (e.g. factories, employees, warehouses etc).

This action will consider how CFC rules could be strengthened or made more effective to counter BEPS.

Action 4 – Limit base erosion via interest deductions and other 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 hybrids and CFC rules.

Output: Recommendations regarding the design of domestic rules – September 2015; changes to the OECD Transfer Pricing Guidelines – December 2015

Comment

Multinational enterprises (MNEs) may finance a particular business venture by loaning money from one group member to another. If the borrower is situated in a high-tax jurisdiction and the lender in a low or no-tax jurisdiction then there is an incentive to maximise the debt or interest payments. This reduces their global tax burden as it reduces the profit reported in the high-tax jurisdiction (as interest is deductible) and increasing the profit in the low or no-tax jurisdiction (as the interest received will be taxable but at a lower rate). For example:

Company A (resident in Country Y, a low tax jurisdiction) has a subsidiary called Company B (resident in Country Z, a high tax jurisdiction). Country Z makes a profit of \$500,000 per annum. Company A lends Company B \$10 million at 5% per annum. Company B pays Company A \$500,000 of interest each year which shifts all of its profit out of the high tax jurisdiction and into the low tax jurisdiction.

This action will consider how these arrangements, as well as similar strategies using guarantees, derivatives or insurance arrangements, can be countered by both domestic rules and the OECD Transfer Pricing Guidelines.

Thin capitalisation rules attempt to limit the effect of these arrangements by restricting the amount of debt financing that can be used to fund an operation. Once this limit is met no further interest deductions are allowed.

MNEs who have loaded debt into an operation up to the thin capitalisation threshold may still be able to increase their interest deductions by making the debt more expensive – i.e. increasing the interest rate. Transfer pricing guidelines can offer a counter to this by requiring the interest rate to be equivalent to the rate that would be offered by an unrelated lender.

However, countering these payments through transfer pricing is often complex and challenging. One issue is that a loan from an unrelated lender can be viewed as different from a loan within an MNE group as the internal lending carries less risk when both the borrower and lender are commonly controlled.

Another option to address expensive debt is an earnings stripping rule. Such a rule allows interest deductions only up to a certain fraction of earnings. Since the rule is based on interest deductions, not amount of debt, it can counter both excessive amounts of debt (like thin capitalization rules) and expensive debt (like transfer pricing rules). There are drawbacks, however. For example, an interest stripping rule could result in interest denial if a company's earnings fall due to an economic downturn, even if the company does not have excessive amounts of debt.

Action 5 – Counter harmful tax practices more effectively, taking into account transparency and substance

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.

Output: Finalise review of member country regimes – September 2014; Strategy to expand participation to non-OECD members – September 2015; revision of existing criteria – December 2015

Comment

Countries compete to attract foreign investment into their economies. This competition may include lowering tax rates, providing incentives, exempting certain forms of income or granting tax holidays.

This action will consider how, given that nations have the sovereign right to set their own tax rules, the effects of this tax competition can be countered. Part of the work related to this action is focused on a review of the OECD member countries to identify which nationals have preferential regimes and engagement with non-OECD members on the framework developed to assess these regimes.

Other work will look at improving transparency so that the impacts and effects of preferential regimes can be more easily identified, and developing a common set of rules that countries could base tax policy decisions on. One such rule could be requiring substantial activity to be carried out in a jurisdiction before a business becomes eligible for tax incentives.

Action 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.

Output: Changes to the OECD Model Tax Convention and recommendations regarding the design of domestic rules – September 2014

Comment

Tax treaties are bilateral agreements between two countries which set out how the countries will share taxing rights so that double taxation is avoided. Such treaties normally include certain benefits such as reduced withholding tax on interest, dividend or royalty payments. Countries negotiate these treaties on the basis that any taxing rights that are given up are balanced by benefits received.

Treaty abuse includes a practice that is often referred to as “treaty shopping”. This occurs when a person obtains the benefits of a tax treaty that they should not be entitled to. For example:

Company A is resident in Country X and is earning royalty income from licensing intellectual property rights to company B, a resident in Country Y. There is no tax treaty between Country X and Country Y so the royalty income attracts a high domestic rate of non-resident withholding tax in Country Y.

Company A incorporates a subsidiary Company C which is a shell company in Country Z and transfers the intellectual property to Company C. Country Z has tax treaties with both Country X and Country Y.

The result is that the royalty income paid by Company B is now paid to Company C. As there is a tax treaty between Country Y and Country Z a lower rate of withholding tax applies.

This action will consider how domestic rules and the OECD Model Tax Convention could be amended to prevent treaty benefits being claimed inappropriately through treaty shopping or other forms of treaty abuse.

Action 7 – Prevent the 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.

Output: Changes to the OECD Model Tax Convention – September 2015

Comment

A foreign enterprise can operate and earn profits in a country by performing its activities directly through a branch in its own name rather than operating through a local subsidiary. In these cases the question of whether the country in which the activities take place can tax that enterprise depends on whether the enterprise has a “permanent establishment

Permanent establishment (PE) is a term used to describe the threshold beyond which a taxing right in a particular jurisdiction is triggered. In general terms the question turns on whether the foreign enterprise has established a fixed place of business through which the business of the enterprise is carried on. Other factors can also be relevant. The criteria which are used to determine whether a presence in a jurisdiction is a PE are open to interpretation as they are qualitative and based on the nature of the activity.

There is a concern that some MNEs have been able to artificially avoid PE status (and therefore a taxable presence). One example is a concern that PE status can be avoided by replacing a distributor arrangement, in which a subsidiary purchases and on-sells the MNE’s products, with a commissionaire arrangement, where the subsidiary acts as a facilitator between the customer and the off-shore parent company. While these two types of arrangements are quite different in their legal form, the actual functions performed by the subsidiary can be viewed as very similar.

This action will explore whether certain aspects of the PE definitions can be strengthened to prevent artificial avoidance of PE status.

Actions 8, 9, 10 - Assure that transfer pricing outcomes are in line with value creation: intangibles (8), risks and capital (9) and other high-risk transactions (10)

Action 8 – 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; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements.

Action 9 – Risks 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 deductions and other financial payments.

Action 10 – 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.

Output: Initial changes to the OECD Transfer Pricing Guidelines and possibly to the OECD Model Tax Convention – September 2014; remaining changes to the OECD Transfer Pricing Guidelines and possibly to the OECD Model Tax Convention – September 2015

Comment

These three actions all consider the application of the OECD's Transfer Pricing Guidelines and how those guidelines could be improved to prevent MNEs from shifting profit. The *United Nations Practical Manual on Transfer Pricing for Developing Nations* describes transfer pricing in this way:

A significant volume of global trade nowadays consists of international transfers of goods and services, capital (such as money) and intangibles (such as intellectual property) within an MNE group.

The structure of transactions within an MNE group is determined by a combination of the market and group driven forces which can differ from the open market conditions operating between independent entities. A large and growing number of international transactions are therefore no longer governed entirely by market forces, but driven by the common interests of the entities of a group.

"Transfer pricing" is the general term for the pricing of cross-border, intra-firm transactions between related parties. Transfer pricing therefore refers to the setting of prices for transactions between associated enterprises involving the transfer of property or services.

Transfer pricing does not necessarily involve tax avoidance, as the need to set such prices is a normal aspect of how MNEs must operate. Where the pricing does not accord with internationally applicable norms or with the arm's length principle under domestic law, the tax administration may consider this to be "mispricing", "incorrect pricing", "unjustified pricing" or non-arm's length pricing, and issues of tax avoidance and evasion may potentially arise.

Simply stated the arm's length principle is that the compensation given for a transaction within an MNE group should be equivalent to the price of an identical transaction between two un-related parties.

Action points 8, 9 and 10 consider three areas of transfer pricing where the current guidelines may not prevent income being separated from the economic activity that generated it.

Intangibles include assets such as trademarks, patents and brands. A common practice has been for MNEs to sell an intangible asset into a low or no-tax jurisdiction and then strip profits out of higher tax jurisdictions by charging a royalty or license fees. Action point 8 will consider what is defined as intangible assets; how to ensure that profits from

intangibles are aligned with economic activity; how to deal with hard to value intangibles, for instance partially developed technologies; and cost contribution arrangements.

An MNE has two companies (Company A and Company B) in two different countries (Country Y and Country Z respectively). Country Y is a high tax jurisdiction, Country Z is a low tax jurisdiction. Company A designs, manufactures and retails a brand of products. When Company A develops a new product line it sells the patent for that product to Company B. Company A then pays Company B an annual royalty which has the effect of shifting profit out of the high tax jurisdiction and into the low tax jurisdiction.

Another common strategy is for MNEs to provide capital from, or assign risk to, a low tax jurisdiction. This allows profits to be shifted from one jurisdiction to another through interest payments or guarantee fees. These transactions are problematic as there is often no change to the MNEs overall capital position or risk exposure as a result of the transfer and yet there is a substantial change in the MNEs tax position. Action point 9 will consider how these transactions can be better aligned with the MNE's economic activity.

Instead of selling a patent to Company B and then paying a royalty, Company B may loan Company A funds and strip profits out through interest deductions (see Action 4 for an expanded example). Note that while Company B has loaned Company A the money the MNE group as a whole (which includes both companies) has taken on any debt.

Lastly action point 10 will consider transactions that are rarely, if ever, seen outside of internal MNE arrangements. These are considered high risk as the arm's length principle relies on comparing the MNE's transactions with similar transactions between unrelated parties.

In the previous two examples the profit shifting has been linked to a specific transaction – the sale and leaseback of a patent or the provision of a loan. Another way that Company B could strip profit from Company A is to charge a management fee for provided strategic advice or planning services. These charges are difficult to challenge as it is rare to see a company seek these services from an unrelated party, so it is difficult to establish what a reasonable comparable would be.

Action 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 are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address base erosion and profit shifting 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.

Output: Recommendations regarding data to be collected and methodologies to analyse them – September 2015

Comment

This action seeks to gain a clearer picture of the impact of base erosion and profit shifting based on currently available studies and to identify what further data is required, and which methods should be employed in the future, to quantify the impacts of measures taken as a result of the action plan. This analysis will examine not only the tax impact of base erosion and profit shifting, and counter-measures, but also the broader impacts on a jurisdiction's economy and wealth.

Action 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 tax schemes between tax administrations.

Output: Recommendations regarding the design of domestic rules – September 2015

Comment

Tax planning arrangements are often uncovered during audits or once annual tax returns are filed and analysed. For MNEs this can mean considerable gaps between when an arrangement is made and when it is identified, especially if information from other jurisdictions is required.

This action considers whether taxpayers should be required to disclose aggressive tax planning arrangements at the time they are constructed. Early detection of these arrangements will allow for more targeted audits and faster policy responses if gaps in tax rules are identified.

Co-operative compliance agreements, where taxpayers and revenue authorities agree to have a more transparent and collaborative relationship, and improved information sharing between jurisdictions, will also be considered.

Action 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.

Output: Changes to OECD Transfer Pricing Guidelines and recommendations regarding the design of domestic rules – September 2014

Comment

This action point will consider whether a global template can be developed for transfer pricing documentation. This template will include a high level view of the MNE's global activity, commonly known as country-by-country reporting, and detailed information on the MNE's activity in the local jurisdiction.

In addition to providing the tax authority with detailed accounts setting out the activities within that jurisdiction, the MNE may also have to provide an overview of the profit earned and tax paid, assets owned and number of employees in each of the jurisdictions it operates in. This information can be useful for tax authorities trying to identify whether an MNE is leaving an amount of income in a jurisdiction that fairly reflects the economic activity undertaken in that country.

Action 14 – Make dispute resolution mechanisms 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.

Output: Changes to the OECD Model Tax Convention – September 2015

Comment

The mutual agreement procedure (MAP) is available under many tax treaties and is used by taxpayers who believe that they are not being taxed in accordance with the terms of the treaty. Representatives of each country's tax authority (known as the competent authorities) then attempt to resolve the issue, which will often involve a discussion about which country has the taxing right or the extent of that taxing right.

Dispute resolution under the MAP or other process can be difficult as, unlike disputes between two domestic parties, there is no court or governing body available to make a binding decision if agreement cannot be reached. Stalemates can occur. This action will consider whether there are alternative ways of resolving disputes when the existing MAP is either not available or not successful.

Action 15 – Develop a 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 global economy and the need to adapt quickly to this evolution.

Output: Report identifying relevant public international law and tax issues – September 2014; develop a multilateral instrument – December 2015

Comment

Once agreement is reached on a specific solution to a BEPS issue the focus will shift to giving effect to the required changes. While amendments to the OECD Transfer Pricing Guidelines or Commentary on the OECD Model Tax Convention can be made with relative speed, amendments to the network of over 3,000 bilateral tax treaties would require these treaties to be individually renegotiated. Not only would this be an extremely lengthy process requiring significant resources, but may prove problematic if there are existing tensions between countries who may not wish to enter into a negotiation without a full reconsideration of the terms of the treaty.

This action will investigate the creation of a new multilateral instrument which would allow countries to adopt specific measures without having to individually renegotiate treaties.