FEATURED PERSPECTIVES

Can the OECD Mend the International Tax System?

by Sol Picciotto

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This article is dedicated to the memory of Michael J. McIntyre.

The Committee on Fiscal Affairs (CFA) of the OECD has been the main developer and the guardian of the international tax system since 1956. It now faces its biggest challenge in trying to revamp this system for the 21st century, especially as it applies to transnational corporations (TNCs). After a year's study and negotiation, and using a fast-track process bypassing its usual working parties (WPs), its project on base erosion and profit shifting has produced an action plan.[1] The plan envisages an ambitious work program of 30 months, which aims to repair what it accepts to be a dysfunctional system. The report heralds this as no less than ''a turning point in the history of international co-operation on taxation.''

The BEPS action plan entails taking a new look at most of the key elements of the international tax system concerning TNCs. To keep the project within some sort of bounds, the report states that it does not aim to reconsider the basic allocation of taxation rights between residence and source countries, although some countries consider that this is needed. Nevertheless, the actions envisaged would, if taken seriously, involve significant changes, indeed some reversals, of countries' tax policies, and of the positions taken by the OECD itself. The exercise can be likened to disassembling a malfunctioning machine, refashioning the parts, and then putting them back together in the hope that it will work better.

Of the 15 actions identified in the plan, nine refer to specific parts of the system, and they are arranged in three groups. The remaining six deal with methods of reassembly and trying to ensure that the repaired system works.

The first action is to ''Address the Tax Challenges of the Digital Economy'' (DE). This does not involve examining any specific part of the system, but a consideration of the nature of the DE, to see whether the system (as remodeled, and including indirect taxes) can deal adequately with this new business paradigm. This will be regarded by many as a crucial test, since the BEPS project has been powered mainly by the problem of ''stateless income,''[2] identified to a great extent with U.S.-based high-tech firms, as highlighted in news reports[3] and

[1]OECD, Action Plan on Base Erosion and Profit Shifting (Paris, OECD, July 19, 2013).

[2]Edward D. Kleinbard, ''Stateless Income Income's Challenge to Tax Policy,'' *Tax Notes Int'l*, Oct. 29, 2012, p. 499.

[3]In particular, Jesse Drucker, ''Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes,'' Bloomberg (Oct. 21, 2010), *available at* http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html; and more recently, Tom Bergin, ''Special Report: How Big Tech Stays Offline on Tax,'' Reuters (July 23, 2013), *available at* http://www.reuters.com/article/2013/07/23/us-tax-bigtech-idUSBRE96M08W20130723.

inquiries by legislatures.[4] Action 1 aims to produce a report identifying the problems posed by the DE and possible solutions within a year, although this timing is unlikely to be met. In effect, this study will act as a test of the progress being made on more specific issues, hoping to deflect the pressures for unilateral measures in some states, especially France.[5]

This article looks first at the parts identified by the report as in need of repair, then at the reassembly methods proposed, and concludes with an evaluation of whether and how the renovated machine might work.

The Parts

Coherence

The first group of four substantive actions is included under the heading ''Establishing International Coherence of Corporate Income Tax Standards.'' They concern issues the OECD has neglected, essentially because achieving such coherence is no easy task. The first issue identified (Action 2) is that of ''hybrids,'' both entities and instruments. Here the OECD envisages a collective and potentially comprehensive solution, a combination of changes to the model treaty and formulation of model domestic legal provisions. As Lee Sheppard remarks, ''countries are asking the OECD to rescue them from their own folly,''[6] although one can understand why sometimes collective action is necessary to buttress individual resolve.

Indeed, Action 2 of the plan envisages more coordinated measures than did the report on hybrids issued in March 2012,[7] which made only recommendations for the introduction of national rules to link tax treatment in the country concerned to that in another. The action plan now seems to approach the issue more broadly, as well as recognizing that conflicts could result from widespread adoption of unilateral measures to deal with hybrids, noting that ''it may be difficult to determine which country has in fact lost tax revenue.'' In principle, changes to the model treaty, for example to include tiebreaker rules, could deal with these problems, although whether states would agree to such solutions is another question. This could lead to more work for the mutual agreement procedure (MAP), which of course need not be limited to transfer pricing cases.

The next action point, regimes for controlled foreign corporations, has not been examined by the OECD since 1987, as the report mentions.[8] It remains a bone of contention since a number of OECD members contest the claim of home countries of TNCs that they have the ultimate right to tax the foreign earnings of such firms, even if they have been largely untaxed. When CFC regimes first emerged, Switzerland argued that because tax treaties define and allocate rights to tax, a residence country cannot use antiavoidance rules to tax the undistributed income of foreign affiliates validly incorporated in a treaty-partner state, unless the treaty specifically recognizes the applicability of those rules.[9] Other states did not go so far, but the committee nevertheless concluded:

> An international consensus should be established, to which States newly introducing counteracting measures might refer. In this respect, the OECD Committee on Fiscal Affairs . . . would . . . appear to constitute the appropriate forum for the discussion of such policy issues.[10]

The CFA has not in practice played this role, although countries that have introduced CFC rules (around half of the OECD member countries, plus a few others) have followed similar general principles. Essentially, such regimes rest on three tests:

- ownership or control (to identify an ultimate parent);
- passive income; and
- low tax.

All have become increasingly difficult to apply: The first, as TNCs have become more decentralized and

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[4]Notably, Australia: Graeme S. Cooper, ''An Aussie View of the Digital Tax Disruption,'' *Tax Notes Int'l*, Dec. 10, 2012, p. 1001; France: N. Colin and P. Collin, ''Mission d'Expertise sur la Fiscalité de l'Économie Numérique,'' France, Ministry of Finance and the Economy (Jan. 2013), *available at* http://www.economie.gouv.fr/rapport-sur-la-fiscalite-du-secteur-numerique; U.K.: House of Commons Committee of Public Accounts, ''HM Revenue & Customs: Annual Report and Accounts 2011-12,'' 19th Report of 2012-2013; and ''Tax Avoidance — Google,'' 9th Report of 2013-2014, *available at* http://www.publications.parliament.uk/pa/cm201314/cmselect/cmpubacc/112/112.pdf; House of Lords Select Committee on Economic Affairs, ''Tackling Corporate Tax Avoidance in a Global Economy: Is a New Approach Needed?'' 1st Report of session 2013-2014, HL 48; U.S.: Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations, ''Offshore Profit Shifting and the U.S. Tax Code — Part 2 (Apple Inc.),'' hearing, May 21, 2013, and Memorandum of Sens. Carl Levin and John McCain; House Committee on Ways and Means, hearing on ''Tax Reform: Tax Havens, Base Erosion and Profit-Shifting,'' June 13, 2013.

[5]*See* Colin-Collin report, *supra* note 4, at p. 121.

[6]Lee A. Sheppard, ''OECD BEPS Action Plan: Trying to Save the System,'' *Tax Notes Int'l*, July 22, 2013, p. 291.

[7]OECD, ''Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues,'' prepared by Working Party 10 on Exchange of Information and Tax Compliance, with the assistance of its Aggressive Tax Planning Steering Group (Paris, OECD, 2012).

[8]OECD, Committee on Fiscal Affairs, ''Double Taxation Conventions and the Use of Base Companies,'' in *International Tax Avoidance and Evasion: Four Related Studies*, Issues in International Taxation No. 2 (Paris, OECD, 1987).

[9]*Id.* at paras 95-97.

[10]*Id.* at para 48.

regionalized, and many have adopted multitier structures; the second, with the growing importance of services and other activities that can be ''virtual''; and the third, with the growth of preferential and low-tax regimes offering ''production havens'' (for example, Ireland).

CFC regimes of EU member countries must now also pass the test applied by the European Court of Justice that CFC rules can only apply to ''wholly artificial'' arrangements in other EU states, otherwise they are considered to restrict the right of establishment, a cornerstone of freedom of movement in the common market. The applicability of the U.K.'s CFC regime to Ireland and Luxembourg was invalidated by ECJ rulings applying this new principle.[11]

These trends have also made it easier for TNCs to pressure their home countries to relax the CFC rules by threatening to relocate (and in some cases doing so), and governments have duly obliged. Thus, the U.S., by accident or design, has allowed subpart F to be emasculated by the check-the-box and passthrough rules. The U.K. largely abandoned its CFC regime and adopted an essentially territorial system, effective from April 2013, and the U.S. is now urged by many to do the same.

Can the OECD reverse this trend, or even develop a more coordinated approach to CFCs? Coordination of CFC measures could make them more effective and perhaps even legitimate. An argument has been made for a collective CFC regime to be developed by a group of countries, which would exempt from attribution the income of CFCs in other group countries (perhaps with exceptions for specific preferential regimes regarded as acceptable), together with continuing coordination through a supervisory body.[12] This could overcome many of the problems of CFC regimes, for example, regionalization of TNCs (attribution rights would be given to the first-tier parent of a multitier corporate group in the CFC group countries) and the definition of passive income (this requirement could be eliminated, relying only on the low-tax criterion).

However, such a plan is very unlikely to be agreed on by all OECD member countries. It would therefore amount to collective action by one group of states against others that they consider as deviating from their corporate tax norms. The targeted deviants would be not only classical tax havens, but also production havens and others that offer preferential regimes considered unacceptable. This would pit one group of OECD member countries against others, unless of course these countries agreed to changes in their tax systems considered acceptable to the CFC group. Since some of these potential ''targets'' are EU member countries (notably Ireland, the Netherlands, and Luxembourg), such a CFC regime would be constrained by the ECJ's ''wholly artificial'' test. The CFC group would also have to consider a joint policy toward exceptions for preferential arrangements to attract investment offered by non-OECD states, especially developing countries.

It may nevertheless be possible to devise a strong collective CFC regime. The plan refers hopefully to ''positive spill-over effects,'' as CFC rules may also deter diversion of income from source countries. Perhaps even the threat of such a plan would also create significant pressure on other countries to eliminate what such a pro-CFC group considers to be harmful tax preferences. But Action 3 of the plan seems to envisage something more modest, referring only to the development of ''recommendations regarding the design of controlled foreign company rules.'' This seems to fall short of a comprehensive approach to restore the ''international coherence of corporate income tax standards.''

It is presumably no coincidence that another of the four actions in this group is to ''Counter Harmful Tax Practices More Effectively.'' However, the plan makes no explicit connection with the CFC issue. It proposes to reactivate and revamp the Forum on Harmful Tax Practices (HTP forum), set up under the previous landmark OECD project against tax avoidance, heralded by its 1998 report ''Harmful Tax Competition: An Emerging Issue.'' This project was of course effectively derailed by a change in U.S. policy, when the new Bush administration accepted arguments that the initiative as first formulated entailed dictating tax policy to other states.[13] The project then refocused on obtaining information from tax havens, laboriously pursued for nearly a decade by negotiation of bilateral tax information exchange agreements. Only now, after the fiscal crisis of 2007-2008, has this effort for fiscal transparency produced the commitment at this year's G-8 summit meeting to establish a new global standard of automatic exchange of tax information, as well as transparency of beneficial ownership.[14]

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[11] *See Cadbury Schweppes PLC, Cadbury Schweppes Overseas Ltd. v. Commissioners of Inland Revenue*, Case C-196-04, ECJ (2006) (a CFC in Ireland); and *Vodafone 2 v. HMRC*, EWCA Civ 446 Case No: A3/2008/2235 CA (2009) (a CFC in Luxembourg).

[12] Chloe A. Burnett, ''Replacing CFC Regimes With a Collective Attribution System,'' *Tax Notes Int'l*, June 20, 2005, p. 1109.

[13] *See* Statement of Paul H. O'Neill Before the Senate Committee on Governmental Affairs Permanent Subcommittee on Investigations, ''OECD Harmful Tax Practices Initiative,'' July 18, 2001. The change was symbolized by the replacement of the term ''competition'' by ''practices,'' signaling that tax competition cannot be harmful. The last substantive report on preferential tax regimes was in 2004, with an update in 2006. Among the many commentaries on the initiative one may single out the somewhat divergent evaluations by J.C. Sharman, *Havens in a Storm: The Struggle for Global Tax Regulation* (Ithaca, Cornell University Press, 2006), and Reuven Avi-Yonah, ''The OECD Harmful Tax Competition Report: A Retrospective After a Decade,'' 34 *Brooklyn J. Int'l Law* 783 (2009), who indeed proposed that it should be followed up by concerted action against CFCs.

[14] *See* 2013 Lough Erne Leaders' Communiqué:

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The redirection of the HTP initiative by the U.S. in 2000 left the EU with the responsibility of dealing with preferential regimes offered by EU member countries. Since direct tax coordination is possible in the EU only by unanimity, which gives each state a veto, this had to be done through a voluntary and consensual process: the Code of Conduct for Business Taxation. The code was applied via scrutiny of preferential measures by a secretive group of state representatives (named the Primarolo Group, after its chair), attempting to achieve ''standstill'' and even ''rollback.'' It had some success, although much of it was attributable to the availability of the more direct threat of legal action by the European Commission against any preferences that could be considered state aid. That threat led Ireland to abandon its 10-year tax holidays for a generally applicable low corporate tax rate, now 12.5 percent.[15] However, the code process seems to have reached the limit of its potential. Even pressure from Germany, which has been the main source of funds to help rescue eurozone banks in Ireland, has not succeeded in persuading Ireland to make any further changes to its preferential tax arrangements, which have broad political support there.

Realizing the limits of national measures, especially when subject to the restrictions formulated by the ECJ to defend freedom of movement of capital, the European Commission changed its approach, moving away from tax treaty principles. It has worked for 10 years to develop a formulary apportionment system within the EU, the common consolidated corporate tax base. Following the Merkel-Sarkozy fiscal pact the proposal was tabled and approved by a large majority by the European Parliament in March 2012. However, once referred to the Council of Ministers, it has inevitably run into opposition from a substantial number of member states.

The OECD action plan proposes to revamp the HTP forum and refocus it, accepting that it is no longer possible to define preferential regimes in terms of ''ring fencing,'' as the 1998 report did, as they now offer rate reductions for specific types of income, such as income from financial activities or from the provision of intangibles (such as the U.K.'s patent box). It identifies the need to adopt more effective solutions, but it is vague as to how this might be done, apart from the hopeful statement that ''agreeing to a set of common rules may in fact help countries to make their sovereign tax policy choices.'' Without the stronger coercion that might come from concerted anti-CFC rules, all that remains is peer pressure, which generally produces at best a gradual attrition of some measures, only to be replaced by others.

The fourth coherence action concerns limitation of deductions on interest and other payments. Where the other proposals aim to restore the tax jurisdiction of residence countries, this type of measure is usually considered to protect source taxation, and hence benefit host states, especially developing countries. However, the action plan also points out that ''a company may use debt to finance the production of exempt or deferred income, thereby claiming a current deduction for interest expense while deferring or exempting the related income.'' This suggests that deduction limitation measures should be coordinated, or companies may wind up having them disallowed everywhere. The plan therefore proposes that in addition to developing ''recommendations regarding best practices'' for national rules, transfer pricing guidance will be formulated, and this work will be coordinated with that on CFCs and hybrids. Reconciling deduction limitation provisions via the transfer pricing arrangements will create further strains on that system, including the MAP. Stronger coordination than best practice recommendations is likely to be needed to enable states to introduce such measures in the face of competition to attract investment, and there is a role here for the IMF to assist developing countries with such measures.

Restoring International Standards

Next, the plan aims to restore the ''full effects and benefits of international standards'' by modifying tax rules ''to more closely align the allocation of income with the economic activity that generates that income.'' It proposes to attempt this not by changing any particular rules, but through antiabuse provisions. Action 6 refers rather widely to developing model treaty provisions as well as recommendations for national rules. The model treaty has long been largely ineffective for preventing double nontaxation, as Sheppard has pointed out, because neither the text nor the commentary contain a clear statement that all income must be taxed somewhere, and national courts have been unwilling to use domestic antiabuse rules to override (or even to help interpret) treaty rules.[16]

> We commit to establish the automatic exchange of information between tax authorities as the new global standard, and will work with the Organisation for Economic Co-operation and Development (OECD) to develop rapidly a multilateral model which will make it easier for Governments to find and punish tax evaders. . . . We agree to publish national Action Plans to make information on who really owns and profits from companies and trusts available to tax collection and law enforcement agencies, for example through central registries of company beneficial ownership.

Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207771/Lough_Erne_2013_G8_Leaders_Communique.pdf.

[15]Fiona Wishlade, ''When Policy Worlds Collide: Tax Competition, State Aid, and Regional Economic Development in the EU,'' 34 *European Integration* 585 (2012), at 587-588.

[16]For example, the decision by the Indian Supreme Court that India's general antiabuse rule could not invalidate the use of the India-Mauritius tax treaty for conduits: *Union of India a.o. v. Azadi Bachao Andolan and Shiv Kant Jha*, Supreme Court of India,

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This could be remedied if suitable antiabuse provisions were included in the actual model treaty, rather than as at present tucked away in the commentary (mainly to article 1). Even better, such provisions could be included in the multilateral treaty envisaged by the action plan, which might override existing treaties (discussed further below). However, business is likely to object that general antiabuse provisions would create uncertainty. Presumably to forestall this, the plan refers to ''tight'' treaty antiabuse clauses. It remains to be seen whether, for example, a ''subject to tax'' provision is considered to be sufficiently tight to be put forward. One solution might be a provision clearly stating that the purpose of tax treaties is to prevent both double taxation and double nontaxation, and that domestic antiabuse provisions can be used as an aid to interpretation to ensure the fulfillment of both these aims.

Regarding the effectiveness of specific antiabuse provisions, such as limitation on benefits or beneficial ownership provisions, both experience and lengthy study, notably by the U.N. tax committee,[17] show that the devil is in the details. This is why both the OECD and the U.N. committee have until now offered only sample provisions in the commentary. But negotiating treaties based on the model is difficult enough, especially for tax authorities in developing countries, without trying to draft suitable specific antiabuse clauses, even if based on the examples in the commentary, let alone pressing them through the process of comment from business and negotiation with treaty partners. Some way must nevertheless be found to remedy the surprising lack of effective targeted antiabuse provisions in the tax treaties of many countries.

The second action under this heading is also expressed as an antiabuse principle, to ''prevent the artificial avoidance of PE status.'' The permanent establishment concept is of course an old chestnut, an issue that has been under virtually continuous review for over a decade. It was addressed in relation to the question of electronic commerce, beginning with ''clarifications'' to the commentary on article 5 that were recommended in a 2000 report,[18] followed by a lengthier study by a technical advisory group (including business representatives) resulting in a report in 2005.[19] These essentially concluded that no significant changes were needed to the PE concept to deal with e-commerce and that a website should not be considered a PE, although a server could be.[20] Given the physical characteristics that are central to the way a PE has been defined since 1928, this was entirely logical and seemed appropriate to many at that time. Now that the likes of Amazon have cut a destructive swath through bricks-and-mortar retailing, it seems unsuitable.

In parallel, the OECD conducted a radical reexamination of the concept of a PE and of the attribution of profits to a PE, starting in 2001, essentially to bring it into line with the separate entity principle that had been embedded into the transfer pricing guidelines in 1995. This resulted in the concept of ''functional separation'' of a PE, and rejection of the ''force of attraction'' principle for attribution of profits. It was implemented first in 2008 by changes to the commentary to article 7 on the attribution of business profits to PEs, and then by amending the text of the article itself in 2010.[21] However this new approach to the PE concept was rejected by the U.N. tax committee and developing countries generally, as well as some OECD countries, and others are being cautious in implementing it. So far, only a handful of treaties incorporating the changes have been negotiated; hence, there is a bewildering variety of versions of article 7 in bilateral treaties.[22] In 2011 a new consultation was launched on a

S.L.P. (C) Nos. 20192-20193 of 2002. This was confirmed in *Vodafone International Holdings B.V. v. Union of India*, Supreme Court of India, Civil Appeal No. 733 of 2012; S.L.P. (C) No. 26529 of 2010.

[17]See U.N. Committee of Experts on International Cooperation in Tax Matters, ''Report on the Fourth Session'' (Oct. 20-24, 2008), Economic and Social Council Official Records 2008, Supplement No. 25, E/2008/45, E/C.18/2008/6, at Section III-D, and accompanying papers.

[18]*Clarification on the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the Model Tax Convention on Article 5*, Committee on Fiscal Affairs (Paris, OECD, 2000).

[19]*Are the Current Treaty Rules for Taxing Business Profits Appropriate for Taxing E-Commerce?* Final Report of the Technical Advisory Group (Paris, OECD, 2005).

[20]*See* new commentary to the model convention (2010), para. 42.2: ''an Internet web site, which is a combination of software and electronic data, does not in itself constitute tangible property. It therefore does not have a location that can constitute a 'place of business.''' This was relied upon by an Income Tax Appeal Tribunal in India to reject an attempt to tax Google and Yahoo on revenue from advertising generated in India, despite the position expressed by India on the commentary that a website ''may constitute a permanent establishment in certain circumstances''; the tribunal held that this reservation had not clarified the circumstances in which a website might be considered a PE: *Income Tax Officer v. Right Florist PVT Ltd.*, ITA 1336/Kol./2011 (2013), Income Tax Appellate Tribunal, Kolkata B Bench.

[21]This also excised the residual provision allowing formulary apportionment of PE profits, which had been in article 7(4) of the OECD model until then; it remains in the U.N. model.

[22]Countries that have reservations on new article 7 are: OECD members Chile, Greece, Mexico, New Zealand, and Turkey; non-OECD countries Argentina, Brazil, Hong Kong, India, Indonesia, Latvia, Malaysia, the People's Republic of China, Romania, Serbia, South Africa, and Thailand. Despite the OECD's attempt to introduce its new approach quickly by incorporating it first into the commentary to existing article 7, the new interpretation would not normally apply to prior treaties; *see* M. Kobetsky, *International Taxation of Permanent Establishments: Principles and Policy* (Cambridge University Press, 2011). The U.S. announced that the new ''authorized OECD approach'' in the revised commentary would be applied only to the earlier treaties

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number of issues concerning the PE definition, including some again relating to e-commerce, and a revised consultation draft issued in October 2012 is still under consideration, after receiving copious comments from business.[23]

Formulating the PE issue in the BEPS action plan in terms of prevention of abuse of the concept signals that no fundamental reconsideration is envisaged. There seems to be no desire to reopen issues dealt with relatively recently, despite the reservations and hesitations of many states, and the confusion resulting from the attempted changes.

The exclusion from the ambit of the BEPS project of any reconsideration of the balance between residence and source taxation also sidelines other contentious issues regarding the PE concept, notably its application to services. This of course is of particular concern to many non-OECD countries, which generally still prefer the U.N. model retaining the separate provision on services in article 14.

Thus, the plan's Action 7 firmly points to specific aspects of the PE concept to be addressed: ''the use of commissionaire arrangements and the specific activity exemptions'' and ''profit attribution issues.'' It is possible that this reference to profit attribution will be taken broadly and could lead to a reevaluation of the new ''authorized OECD approach'' adopted in 2008. Indeed, it is hard to see how the challenges posed by the DE can now be dealt with without reopening the whole can of worms of the PE concept. In fact, the interim report ''Addressing BEPS'' of February 2013 referred to the need for ''updated solutions to the issues related to jurisdiction to tax, in particular in the areas of digital goods and services.'' If the BEPS project does not take on a reevaluation of the PE and profit attribution, the concerns of states such as France and India will no doubt be pursued in more unilateral ways.

Transfer Pricing

It is not surprising that transfer pricing is among the issues to be tackled, but it is perhaps an indication of the difficulties it raises that it merits a separate group of no less than three actions.

Action 8 is of course the key problem of intangibles. Chapter VI of the transfer pricing guidelines of 1995 attempted to articulate the hard-won compromises resulting from the sharp conflicts over several years among OECD member countries following the introduction by the U.S. in 1986 of the commensurate with income principle and the arm's-length return method. Intangibles have continued to be the major source of transfer pricing conflicts, which widened as countries such as China and India got into the game, so that in 2010 the OECD finally launched a new project to reevaluate Chapter VI.[24] By this time the issue of income shifting through intangibles was front and center, and the project aimed to ensure that profits from intangibles are attributed ''in accordance with . . . value creation.''

The drafts released so far are full of ambivalence and equivocation, as indeed are the transfer pricing guidelines in general. On the one hand, they continue to stress the identification of specific and distinct intangibles, legal ownership, and analysis of transactions.[25] On the other hand, the new emphasis on ''value creation'' proposes that the returns attributable to the parties should depend on the contributions each makes to ''the anticipated value of the intangibles through its functions performed, assets used, and risks assumed'' (para. 73). Functions are stated to include ''design and control of research and marketing programmes, management and control of budgets, control over strategic decisions regarding intangible development programmes, important decisions regarding defence and protection of intangibles, and ongoing quality control''

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with the U.K. (2001) and Japan (2003), because the changes were contemplated at the time those treaties were concluded; but it has also been applied by competent authority agreements with Canada in 2012 and Belgium in 2013. Some OECD countries have begun to negotiate new treaties based on the 2010 model or sign protocols modifying article 7 — for example, Germany (with Luxembourg and the Netherlands) and the United Kingdom (with Barbados, Liechtenstein, the Netherlands, Norway, and Panama). However, the recent U.K. treaties with Bahrain and Ethiopia are based on the U.N. model, and that with Spain on the old OECD model (but omitting article 7(4)). Others are being more cautious; for example, Australia asked for a review by its Board of Taxation, which published a consultation paper (''Review of Tax Arrangements Applying to Permanent Establishments,'' Discussion Paper, Oct. 2012), then submitted a report, which would be published if and when a government policy is decided. France is also holding its fire; the Colin-Collin report on the digital economy noted that France had accepted the OECD changes to articles 5 and 7, but recommended that it should now press for modification of the PE concept to include a ''virtual'' PE (cited in note 4 *supra*, at p. 123).

[23]*OECD Model Tax Convention: Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment)* (Paris, OECD, 2012).

[24]A scoping paper was issued in 2011, then a discussion draft in 2012 of a complete revision of Chapter VI on intangibles of the transfer pricing guidelines, which received more than 1,000 pages of comments from over 70 sources. The further revised draft (*Revised Discussion Draft on Transfer Pricing Aspects of Intangibles*) issued on July 30, 2013, states that it ''should be considered a work in process and portions of it may be revised during the course of the work on BEPS.'' As well as a complete rewrite of the draft Chapter VI issued in 2012, it included a new section for Chapter I dealing with local market features, location savings, assembled workforce, and corporate synergies; and a new subsection on transfer pricing aspects of the use of corporate names. However, some important contentious issues remain, notably cost contribution arrangements.

[25]2013 discussion draft, para. 38. Subsequent citations are also to this document.

(para.79). Assets may include ''intangibles used in research, development or marketing, (for example, know-how, customer relationships, etc.), physical assets, or funding'' (para. 82). Risks that may be important include those related to development (such as lack of success), product obsolescence, infringement, and risks related to products and services based on the intangibles such as product liability (para. 87). The extent to which any of these functions, assets, and risk factors affect value is stated to depend on the facts and circumstances in each case.

These elaborations introduce a wide range of factors that can be taken into account in evaluating and adjusting transfer prices, to be done on an ad hoc, case-by-case basis. More are added with the inclusion proposed in the 2013 report of various ''location factors.'' This concept was previously mentioned by the OECD guidelines only in relation to restructurings, but has been favored by non-OECD countries such as China and India, and the OECD now accepts that it may apply more widely. Four such factors are discussed in the draft: local market features, location savings, assembled workforce, and corporate synergies. The report also includes a new subsection on transfer pricing aspects of the use of corporate names.

All of these provide criteria for re-attributing revenue attributable to intangibles from the original developer, or more usually the legal owner (often an affiliate in a low-tax jurisdiction), toward affiliates that make other contributions, even simply through use. How is the attribution of profits to be decided, based on these various value creation factors? The issue is still nominally approached in terms of the arm's-length method and comparability analysis: The 2013 intangibles report states that ''depending on the specific facts, any of the five OECD transfer pricing methods'' may be appropriate, adding for good measure that ''the use of other alternatives may also be appropriate'' (para. 154). However, it also points to the ''difficulty of identifying comparable uncontrolled transactions and intangibles in many, if not most, cases'' (para. 149), and rejects ''one-sided methods'' such as resale price and the transactional net margin method as generally too unreliable to be used directly (para. 159). It concludes that the most useful are likely to be the comparable uncontrolled price and the transactional profit-split methods (para. 163). Yet it immediately accepts that ''it should be recognised that the identification of reliable comparables in many cases involving intangibles may be difficult or impossible'' (para. 164).

Apparently reluctantly, yet inexorably, we are led to profit split. Yet so far the revised Chapter VI draft has little new to add on how in practice the analysis of value creation factors could guide application of profit split.

Action 9 aims to prevent accrual of ''inappropriate returns'' to an entity solely because it has provided finance or assumed risks, either through transfer pricing rules or ''special measures.'' Again, the principle here is ''alignment of returns with value creation.''

Finally, Action 10 also proposes to develop ''transfer pricing rules or special measures'' to deal with ''other high-risk transactions,'' which would not normally occur between unrelated parties, such as fragmentation of functions in global value chains, and payment of fees for joint expenditures such as head office expenses and management fees.

In all these intractable areas of transfer pricing what is evident is a shift away from transactional pricing and toward profit split, or even ''other'' methods or ''special measures.'' In introducing this group of actions, the report mentions cryptically that ''special measures, either within or beyond the arm's length principle, may be required.'' Nevertheless, reassurance is provided that there is no intention of replacing the arm's-length principle by ''alternative income allocation systems, including formula based systems'' due to the ''practical difficulties associated with agreeing to and implementing the details of a new system consistently across all countries.''

So the OECD continues to face both ways on transfer pricing: valiantly asserting its support for the arm's-length principle, while in practice moving toward greater use of profit split. Unfortunately, there seems to be no willingness to face up to the implications of this, by trying to place profit split on a more rigorous basis. Since this method has been used for over two decades, not only unilaterally but also bilaterally and multilaterally, there is considerable experience on which to build a stronger foundation for profit split.

Yet the transfer pricing guidelines still adopt an essentially ad hoc approach to specifying how the method should be applied. They refer vaguely to the need for the accounts of the related parties to be ''put on a common basis as to accounting practice and currency, and then combined,'' and accept that ''financial accounting may provide the starting point for determining the profit to be split in the absence of harmonized tax accounting standards.'' There is some discussion of the various factors or ''allocation keys'' used in practice for allocating profits, but little attempt to formalize or systematize them. In the absence of such a more systematized basis, profit split will continue to be regarded as a regrettable fallback, an arbitrary method involving bazaar-style haggling both between the tax authority and the taxpayers and between tax authorities.

Reassembly

Six of the 15 actions in the plan aim to guide the reassembly of the parts, or to ensure that the reassembled system works better.

As already mentioned, Action 1 will be a study on the DE. The plan recognizes that the DE poses fundamental challenges, being ''characterised by an unparalleled reliance on intangible assets, the massive use of data (notably personal data), the widespread adoption of multi-sided business models capturing value from externalities generated by free products, and the difficulty of determining the jurisdiction in which value creation occurs.'' Yet it counters that ''the fact that new ways of doing business may result in a relocation of core business functions and, consequently, a different distribution of taxing rights which may lead to low taxation is not *per se* an indicator of defects in the existing system.''

Certainly, the issues to be considered are broad, but all that Action 1 aims for is ''a thorough analysis of the various business models in this sector.'' Clearly, the hope is that the reforms achieved in the various other actions identified, as well as perhaps the use of indirect and other specific taxes by countries especially concerned by the issue, will resolve the problem. The real point however is that the DE is not a separate sector, but a pervasive feature of the world economy, and one that has further revealed the defects of the international tax system. Any serious study of this problem would conclude therefore that radical changes are needed to that system, but the OECD is unlikely to come to any such conclusion.

Three actions are headed ''Ensuring Transparency While Promoting Increased Certainty and Predictability.'' Action 11 aims to establish methods to analyze BEPS and collect data both on its scale and economic impact, and on the actions to deal with it. The interim report ''Addressing BEPS'' of February 2013 included a chapter surveying the evidence, which concluded that on the basis of available data it was difficult to reach ''solid conclusions'' as to the scale of the problem, although there is ''abundant circumstantial evidence that BEPS behaviours are widespread.'' Estimating the ''tax gap'' due to international avoidance of course faces the special problem of identifying a benchmark, since the jurisdictional allocation of income is contested. Companies can claim, on the whole correctly, that they pay the tax strictly due in each country, so any measure of ''losses'' must be in relation to a hypothesis of what they should be paying. The debates are familiar: Substantial reductions in headline corporate tax rates in most countries (except the U.S.) have generally been accompanied by base broadening, so corporate tax revenues in relation to GDP have remained stable or declined slightly; but given the boom in corporate profits, this suggests a significant proportionate fall in corporate tax contributions. Effective tax rates could be a reliable indicator, but are very hard to calculate effectively. Maybe the OECD statisticians can produce better data.

Action 12 targets disclosure of aggressive tax planning arrangements. It will formulate recommendations for national mandatory disclosure rules, drawing from existing practice of several countries, as well as establishing improved information sharing among tax authorities about such schemes.

Action 13 concerns transfer pricing documentation requirements. Although the OECD has not examined this since the transfer pricing guidelines were issued in 1995, the ramping up of transfer pricing enforcement around the world had prompted it to begin work on the greatly increased documentation burden, and a white paper was issued within a couple of weeks of the action plan.[26] This finally recognizes the scope for international coordination of documentation requirements, which if well done should ease the burden on firms as well as facilitating the task of administrations. The white paper surveys existing practice, finding that the national approaches adopted mean that countries generally have inadequate information on the global business of the TNC group.

It sensibly proposes adoption of a coordinated documentation approach with two tiers, building on the EU's voluntary code adopted in 2006. There would be a global documentation package or master file that the firm could submit to every relevant country, and a local file with supplementary documentation for each one regarding the specific local entities and their activities and transactions. The report rightly points to the need for a ''reasonably complete picture of the global business, financial reporting, debt structure and tax situation'' of the multinational enterprise, but it is still tentative and cautious, leaving open at this stage important issues such as incentives for compliance, and form of implementation. There is surely scope for much more work here by the OECD, notably in developing a template for tax accounts as a basis for consolidated accounts, especially in view of the increased use of the profit-split method, as mentioned above. There are still significant differences in financial accounting standards, and they are in any case an unsuitable basis for calculating tax liability. Other elements in the proposed masterfile should be defined as carefully as possible if the information is to be useful.

While business is likely to be at best ambivalent about most of the action points, there will be strong support for Action 14, which aims to make dispute resolution more effective, especially if it finally delivers on the central desire expressed by firms since 1935 for mandatory arbitration. There has certainly been a major growth of cases referred to the MAP in recent years.[27] If the various actions envisaged in this plan do result in effective measures, contentious cases and conflicts will undoubtedly increase further. However well they are designed or coordinated, many of these measures entail strengthening of national claims to tax,

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[26] *White Paper on Transfer Pricing Documentation* (Paris, OECD, July 30, 2013). *See also* Global Forum on Transfer Pricing, *Draft Handbook on Transfer Pricing Risk Assessment* (Paris, OECD, Apr. 30, 2013), which included a section of recommendations on documentation requirements.

[27] The OECD data show a jump in new cases for OECD countries from 1,036 in 2006 to 1,670 in 2012, and of pending cases from 2,352 to 4,061; *see* http://www.oecd.org/ctp/dispute/mapstatistics2012.htm.

which will inevitably overlap. Indeed, some such overlaps are already identified in the plan, as mentioned above, notably hybrids and limitation of deductions. Transfer pricing in relation to intangibles, which has long been a major source of conflicts, will surely generate even more with the shift to attribution on the basis of value.

There is therefore a clear need to improve the dispute settlement regime for international tax. The OECD introduced some significant changes in 2007, after three years of discussion and consultation. These included arbitration provisions, which have now been included in the 2010 version of the model treaty. The 2011 U.N. model now also offers a version of article 25 with a similar arbitration provision, although in the U.N. model referral to arbitration depends on the competent authority and not the taxpayer. Although inclusion of arbitration provisions in treaties has become increasingly widespread, many states are reluctant to include them, especially developing countries.

Caution should, however, be exercised in bringing in arbitration to resolve the problems of the international tax system. Introducing mandatory arbitration would be in line with the more general trend toward legalization, and even judicialization, of international governance, which some commentators have seen as a response to the need for greater certainty and predictability.[28] However, the effectiveness and legitimacy of such judicialization rest on two key conditions.

First, the rules must be clear and well understood. The delegation to adjudicators of contentious issues based on rules that embody a high degree of discretion could further undermine public confidence in the international tax system, the restoration of which is one of the aims of the BEPS project. For example, an editorial in the *Financial Times* commenting on the publicity given to Starbucks opined that the way the tax system treats multinationals ''has turned tax into a largely voluntary gesture for such businesses.''[29] The changes envisaged so far in the action plan seem unlikely to make the rules more precise, even the contrary. For example, the move toward ''value'' tests for attributing intangible income, however much of an improvement it would be on the current approach, would introduce a wider scope for debate and disagreement. No doubt the proposal for arbitration is born out of frustration by some tax administrations at the difficulties experienced in reaching mutual agreements with some of their counterparts: the disagreements between India and the U.S. have received particular publicity. But it would be inappropriate to introduce arbitration to resolve fundamental differences in national perspectives.

Relatedly, the second condition for giving such important powers to adjudicators is that its procedures and outcomes must be open and transparent. This would help allay public concerns that deals are being made in private between unaccountable technocrats. This can be seen by comparing the experience of the dispute settlement system of the World Trade Organization with international investment dispute arbitration. Although it has not avoided controversy, the WTO has become widely accepted, largely because of the establishment of its appellate body, which functions very much like a court. Investment arbitration, in contrast, has come under much criticism, both because of the direct right of access to adjudication it gives to corporations, and for its ad hoc and relatively secretive nature. In response, there have been moves to improve transparency, including publication of decisions. There could of course be safeguards to protect commercial confidentiality, but just as domestic tax court decisions are published, so should those of international tax arbitrators. Indeed the case is stronger in view of their importance. Such publication would also make the system more effective, as the principles expressed in the decisions would provide guidance for other taxpayers. However, corporations have so far been unwilling to accept such conditions in exchange for mandatory arbitration, and tax administrations are equally reluctant to accept more transparency for such procedures.

The final action for implementing the plan is the most ambitious: ''a multilateral instrument to amend bilateral treaties,'' which the report rightly describes as ''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.'' Certainly there are few parallels for such an instrument. Perhaps the closest is the WTO's Agreement on Trade-Related Intellectual Property Rights, which both incorporated most of the main provisions of existing multilateral treaties on intellectual property and extended them further, mainly by adding stronger enforcement provisions. In the tax field, the harmful tax practices initiative aimed to extend existing treaties by strengthening the information exchange provisions, *inter alia* encouraging states to join the OECD/Council of Europe Convention on Mutual Administrative Assistance (which was also revised, and opened to all states).

The BEPS proposal, however, is for a treaty that would not only extend but also override existing bilateral treaties. This would raise some tricky legal problems. It should be borne in mind that such an instrument could apply only between those states that accept it. It could therefore help to ensure rapid implementation of agreed changes, avoiding the need for lengthy negotiation of new treaties or treaty protocols, but obviously this would not deal with the problem of states

[28] J. Goldstein, M. Kahler, R.O. Keohane, and A-M Slaughter, ''Introduction: Legalization and World Politics,'' 54 *International Organization* 385-399 (2000); and for a critique, S. Picciotto, ''The WTO's Appellate Body: Formalism as a Legitimation of Global Governance,'' 18 *Governance* 477-503 (2005).

[29] Oct. 20, 2012.

that are reluctant or unwilling to agree. It could have the reverse effect, making it harder to reach agreement among a sufficiently large group of states on an overall package that is sufficiently effective. Nevertheless, any move toward a clearer multilateral standard for international tax coordination, rather than the current chaotic network of bilateral treaties, should be welcomed.

Will It Work?

The OECD operates by consensus, and hence generally very slowly. Furthermore, since the BEPS project is a G-20 initiative, non-OECD members of the G-20 have been invited to take part as associates, ''on an equal footing.'' This extends the number of states whose interests need to be accommodated to over 40.[30] Yet by the OECD's normal standards, the BEPS project aims to get results very quickly: The actions have proposed deadlines of September 2014, September 2015, or December 2015. However, this will entail only delivery of reports: implementation is another matter.

In its first 12 months the BEPS project has been developed by a small steering group working through three WPs or ''focus groups,'' although the reports have ultimately been approved by the CFA. The next phase of developing specific proposals under the various actions will be done through the relevant CFA WPs, although the Aggressive Tax Planning steering group of WP 10 will now become a new WP, to deal with several issues (CFC rules, hybrid mismatches, interest deductibility, and disclosure rules). Also, the study on the DE will be done by a separate task force, the Forum on Harmful Tax Practices will be resurrected to deal with Action 5, and expert international lawyers will be recruited to advise on the proposed multilateral treaty.

It is clear that the action plan targets a number of issues on which states are sharply divided. Certainly, tackling base erosion could benefit many states; but on the other hand a significant number would consider themselves adversely affected by some of the measures contemplated. Furthermore, there are not many opportunities for trade-offs to achieve an overall package deal, on which complex negotiations of this kind generally depend. The fiscal crisis, which is a main political driver of the initiative, would also make it harder for the states that would be adversely affected by anti-avoidance measures to accept changes.

The project can be compared to the harmful tax competition initiative, already mentioned, which also resulted from the G-7 group (at a time when Russia was still waiting in the wings to be included in such summits, and the importance of the BRICS (Brazil, Russia, India, China, and South Africa) countries was yet to be recognized). The earlier project could be said to have had at best modest results, and the drive for tax transparency, which was its main outcome, has now been subsumed into the new G-8 initiative, again entrusted to the OECD.[31] Yet its scope was much less ambitious, especially once it became refocused on transparency. The original report of 1998 was issued over the objections of two countries, Switzerland and Luxembourg, although now, finally after 15 years, much of that resistance has crumbled. The change has resulted from determined unilateral action, often controversial, notably criminal prosecutions of tax evaders by countries such as Germany and the U.S. using data leaked by or purchased from whistleblowers, as well as the introduction of the Foreign Account Tax Compliance Act and its extensive regulatory obligations on financial institutions.

The BEPS project has much more radical aims: to remodel the international tax system to ensure that TNCs are taxed according to where they actually do business. This is a major shift of perspective for the OECD: For decades it has prioritized the prevention of double taxation, but only recently has it begun to talk about the problem of double nontaxation. Jeffrey Owens, head of tax at the OECD for most of this period and now an adviser at EY, has been quoted as saying: ''Governments have made the business tax system more friendly since the mid 1980s. Now it is payback time.''[32] But this perhaps too lightly passes on the blame for the current problems to governments. Politicians have only paid attention to international tax rules when they sensed that something had gone wrong. The arcane details have been left to officials working through the OECD, who have generally consulted closely with business. Now they have the responsibility for repairing the system they have devised, which has plainly become increasingly dysfunctional.

In opting for repair rather than a redesign, the OECD has taken on a difficult task. It will have to surmount significant political obstacles as well as technical difficulties to come up with effective measures under the various actions in the plan, as well as coordinating the overall reform. There are of course many who have argued that it is time to abandon the separate entity/arm's-length principle and move toward a unitary approach to taxation of TNCs.[33] The OECD's response

[30]In addition to 11 of the OECD's now 34 member countries and the EU, the G-20 includes the main emerging economies: Brazil, Russia, India, China, and South Africa, as well as Argentina, Indonesia, and Saudi Arabia; all except Saudi Arabia have apparently confirmed that they will join the BEPS project.

[31]*See supra* note 14.

[32]Vanessa Houlder, ''Taxation: Unsafe Offshore,'' *The Financial Times*, Jan 13, 2013.

[33]To cite only a few: S.I. Langbein, ''The Unitary Method and the Myth of Arm's Length,'' *Tax Notes*, Feb. 17, 1986, p. 625; R.S. Avi-Yonah, K.A. Clausing, and M.C. Durst, ''Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split,'' 9 *Florida Tax Rev.* 497; R. Couzin, *The End of Transfer Pricing?* 17th annual David R. Tillinghast Lecture

(Footnote continued on next page.)

is essentially that this would be politically unattainable within a reasonable time frame.[34] In the words of the action plan, ''there is consensus among governments that moving to a system of formulary apportionment of profits is not a viable way forward'' (at p. 14), and ''the importance of concerted action and the practical difficulties associated with agreeing to and implementing the details of a new system consistently across all countries mean that, rather than seeking to replace the current transfer pricing system, the best course is to directly address the flaws in the current system'' (at p. 20).

Yet it should be clear that the method chosen by the OECD faces equivalent difficulties. The difference is that its preferred part-by-part repair of the existing system will mean tackling a series of political obstacles over a period of time, instead of the more direct confrontation that a comprehensive reform would require. It is possible that this salami-slicing approach will be easier, but the danger is that it may lead to drawn-out debates over detailed technical issues, resulting in a series of watered-down compromises. There are doubtless many who will hope that the spotlight of political attention will move to other issues, and perhaps even that economic growth will return and fiscal pressures abate, so that the project gradually dissipates into ineffectiveness.

The bigger question, however, is whether even a serious and sustained repair effort can result in a functioning system. The power of the argument for a unitary approach is that it would provide a more sound foundation for the international tax system, one that matches the economic reality of TNCs as integrated firms. In contrast, the separate entity/arm's-length principle cannot provide a comprehensive basis for taxation of TNCs, since it limits states to taxing their various parts. It is therefore no surprise that the system is porous, since it actively encourages TNCs to create complex corporate structures that often bear little relation to their real business activity. However, a determined effort to strengthen taxation of the various parts will inevitably lead to increased overlaps and conflicts in the jurisdictional claims of states to tax. If countries cannot agree on general principles for allocating TNCs' income, they are equally unlikely to agree to a package of effective provisions for separate entity taxation that does not create increasing case-by-case conflicts. The BEPS project has opened a new era in international tax, but one that has a long way to run, and whose outcome is uncertain. ◆

on International Taxation (New York University, Sept. 13, 2012); S. Picciotto, ''Is the International Tax System Fit for Purpose, Especially for Developing Countries?'' International Centre for Tax and Development Working Paper 13 (Sept. 2013); M.C. Durst, ''Analysis of a Formulary System for Dividing Income,'' 22 *Tax Management Transfer Pricing Report* (Part I in Issue 2, Part II in Issue 5, Part III forthcoming).

[34] *See* Testimony from Pascal Saint-Amans, House Ways and Means Committee, June 13, 2013.