The BEPS Monitoring Group

Overall Evaluation of the G20/OECD Base Erosion and Profit Shifting (BEPS) Project

This evaluation has been prepared by the BEPS Monitoring Group (BMG). The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. This paper has not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. Its drafting has been coordinated by Sol Picciotto, with contributions and comments from many members of the Group, especially Anders Dahlbeck, Antonio Gambini, Veronica Grondona, Jeff Kadet, Martina Neuwirth, Annet Oguttu and Francis Weyzig.

It is based on the detailed comments which we have produced on each and every report and discussion draft produced for the BEPS project.[1] We are the only independent commentators who have contributed so comprehensively, and have been represented at all of the public consultations. We have inevitably been vastly outnumbered by the army of paid tax advisers and representatives of multinational enterprises. We understand the need to consult those who will have to comply with the rules, to guard against unexpected outcomes. However, this type of consultation is no substitute for a wider public debate. We therefore hope that both our previous commentaries and this evaluation will help to facilitate such discussion, and encourage other independent commentators to engage with this process of redesign of a key element of global economic governance.

This overall evaluation will be supplemented by a more detailed Handbook analyzing and commenting on all the proposals.

Summary

The G20 mandate for the BEPS project was that international tax rules should be reformed to ensure that multinational enterprises (MNEs) could be taxed ‘where economic activities take place and value is created’. This implied a new approach, to treat the corporate group of a MNE as a single firm, and ensure that its tax base is attributed according to its real activities in each country. Unfortunately, the BEPS project has continued to emphasise the independent entity principle, which starts from the fictitious assumption that affiliates of a corporate group act like separate legal persons, while attempting to counteract its harmful consequences. The BEPS outputs will provide considerable strengthening of the existing rules, giving better tools to tax authorities if they have the capacity and will to use them. Overall, however, the proposals offer a patch-up of existing rules,

[1] Available on our website at BEPS Monitoring Group.

making them even more complex and in many cases contradictory, and do not provide a coherent and comprehensive set of reforms. Nevertheless, this is an important first step on a longer road.

Some of the proposals do mark a significant step forward, enabling the MNE to be considered as a single firm and to ensure that profits relate to economic activity in each country. The proposed template for country by country reports is a major advance, although the arrangements for access by all relevant tax authorities create unnecessary obstacles: publication would be a far easier and better solution. Proposals were also made for limiting deductions of interest by apportioning the consolidated group costs of interest payable to third parties, but these were watered down to recommendations prioritising a fixed cap. Similarly, ensuring taxation of a group's worldwide profits could have been achieved by stronger rules on controlled foreign corporations, but the final report contains only weak recommendations, which will continue to encourage competition between countries to reduce corporate taxes, and to motivate MNEs to shift profits. The proposals on harmful tax practices may slow but will not halt tax competition, since they continue the approach dating back to 1998, based on voluntary rules and secretive self-policing, which has had very limited effects. Already it can be seen that the attempt to apply the broad principles of 'nexus' and 'substance' to innovation boxes is leading only to a complicated system attempting to restrict some aspects, while legitimising the concept. Instead of eliminating such schemes, this is already leading to the opposite: their increased adoption by many states and a consequent decline in corporate taxation.

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

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

These outcomes are clearly only a start. Implementation by states will take time and should be monitored, and key issues remain to be dealt with. The main shortcoming is the failure to develop clear rules for the attribution of profit. Further work is planned on the profit split method, which could provide a way forward. The report on digitalization of the economy recognizes that it raises key issues going beyond the BEPS project, including the basic concepts of residence and source, and where profit should be considered to be earned. Although the BEPS project itself can only be said to have been at best a partial success, it has succeeded in opening space for more far-reaching changes. It should be seen as part of a longer process, involving a wider range of organisations and countries, especially developing countries. This should aim at finally reforming international tax rules to ensure fairness for all, and make them fit for the 21^{st} century.

A. The general approach and effects of the BEPS project

The G20 world leaders in 2013 mandated the BEPS project to produce reforms of international tax rules which would ensure that multinational enterprises could be taxed 'where economic activities take place and where value is created', and that developing countries should also be able to benefit.[2]

The BEPS project has the potential to put an end to tax avoidance by multinational enterprises through tax havens and other mechanisms, and hence to ensure more equitable taxation, and so help raise government revenues to finance public services and sustainable development in both developing and developed countries. Withdrawing the motivation for MNEs to exploit tax havens and the offshore secrecy system would also greatly contribute to ending their use to facilitate capital flight and laundering the proceeds of crime and corruption.

Reform is long overdue to the existing rules, which are now almost a century old. Their fundamental flaw is that they have been interpreted to require taxation of MNEs as if their various constituent entities are independent of each other and dealing 'at arm's length'. This independent entity concept generates a perverse incentive to create complex and fragmented corporate structures, locating affiliates in convenient jurisdictions to minimise tax. MNEs have increasingly taken advantage of this, and now consist of often complex corporate structures with hundreds of such entities. The ability to minimise tax has become a key competitive advantage, exploited by some MNEs more aggressively than others, damaging purely national firms especially micro, small and medium enterprises (MSMEs), and greatly distorting international investment decisions.

The G20 mandate implied a new approach, to treat the corporate group of a MNE as a single firm, and attribute its tax base according to its real activities in each country. Unfortunately, the OECD has refused to make this explicit, but has continued to emphasise the independent entity principle, while attempting to counteract its harmful consequences. Consequently, the BEPS outputs fail to provide a coherent and comprehensive approach, and offer instead proposals for a patch-up of existing rules, making them even more contradictory and complex.[3]

Regrettably also, several of the initially sensible proposals have been greatly weakened by the insistence of some powerful OECD states on preserving their preferred tax breaks for business, generally in the name of national 'competitiveness'. This has resulted, for example, in weak proposals on Controlled Foreign Corporations (CFCs), interest deductibility and innovation box schemes, all favoured particularly by the UK. Meanwhile, other countries, especially the USA, have stubbornly defended the dysfunctional arm's length principle for transfer pricing adjustments, and resisted alternatives. Hence, despite the best efforts of OECD officials themselves to try to achieve a strong package, the lack of a clear direction, political concerns to preserve tax breaks considered to benefit national 'competitiveness', and the need for consensus among a large group of countries, have led to a package tending to the lowest common denominator.

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[2] Tax Annex to the St Petersburg Declaration, September 2013.

[3] This has also been pointed out by other independent commentators. For example, Prof. Michael Devereux, commenting on the aim of the BEPS Action Plan to 'better align rights to tax with economic activity', said: 'I see this as a new principle, this is saying let's tax where there is economic activity or relevant substance. I think if the OECD had gone back and said we need to review these principles and maybe replace them with a new principle which is this, I would have applauded and said this is just what we needed to do. But actually that doesn't seem to be what's happening, what actually seems to be happening is that we are keeping all the old principles and overlaying a new principle on top, which is actually inconsistent with the existing principles, and what do we end up with? Well, we end up with so many different principles we don't know whether we are coming or going.' (Presentation at the conference of the Oxford University Centre for Business Taxation on Tax Competition and BEPS, June 2014, available at https://www.youtube.com/watch?v=PLVTrhuQDwA&list=PLtXf43N26ZidJfK8KN-ffHkfYfFsidivv&index=1). Prof. Edward Kleinbard commented on the BEPS Project: 'I wish them the best, but I think that they've made their lives very hard for themselves by insisting on the arm's length principle as an untouchable sort of axiom' (interview for a blog on the Tax Foundation, 15 May 2015, http://taxfoundation.org/blog/making-sense-profit-shifting-edward-kleinbard).

The result is that the proposals will make international tax rules even more complex, and largely retain the scope for countries to offer tax breaks, while raising compliance costs for MNEs, yet preserving the systemic incentives for them to devise avoidance structures. The consequence of weak coordination will be an acceleration of unilateral measures: some have already been initiated by countries such as the UK and Australia, and other countries are likely to follow, to protect their tax base.

Nevertheless, the exercise itself has been enormously valuable in a number of ways. It has educated many governments and innumerable officials on an issue of major import. It has attracted the attention and the helpful analysis of some academics and other interested parties, including a number of civil society organisations that truly care about the financing of services for all members of society. It has also forced the community of international tax advisers at least to consider the need to re-examine the system. They have been confronted with sustained pressures challenging their ingrained assumptions, leading at least some to accept that significant cultural change is necessary.

In our view, it is essential to maintain this momentum. Although the BEPS project itself can only be said to have been at best a partial success, it has succeeded in opening space for more far-reaching changes. Hence, it should be regarded as only the first stage of a longer process, which should aim at finally reforming international tax rules to to ensure fairness for all, especially developing countries, and make them fit for the 21st century.

B. The central issue

The weaknesses of the proposals result from a failure to face up to the reality that the competition between countries to offer tax breaks to business lies at the very heart of the problem, and undermines the power to tax of all states. The continuation of systems that exempt certain foreign income from tax even if the income has not been significantly taxed abroad, and of systems that allow deferral of tax on such income, in practice undermines the ability of both home and host countries to tax MNE income which is earned globally.

We recognise that the BEPS project within its short two-year timeframe, perhaps understandably, expressly chose not to consider a system of formulary apportionment of the consolidated profits of MNEs, which in any case would need careful preparatory work. However, the BEPS project also chose to not even discuss possible alternatives which could be adopted more quickly and which could ensure taxation of the worldwide income of MNEs treated as unitary firms. This could be accomplished for example through mechanisms such as full-inclusion CFC rules or a well-designed worldwide consolidation approach, with credits for foreign taxes paid. Such a system, if adopted by just the relatively few countries that are home to most major MNEs, would largely nullify the benefits of source country tax incentives and would strongly deter profit shifting to low-tax regimes. The BEPS project should have made clear to relevant countries how their territorial and deferral systems are a major part of the systemic incentives for profit shifting. Equally, the formalisation and systematisation of the profit-split method could mark a significant step forward, but work on this has been deferred to a next stage.

We believe that the fact that the BEPS process, from the very beginning, simply closed off any discussion at all concerning either the unitary system or this full-inclusion approach to be one of its biggest mistakes and failings. We needed real international dialogue on this very basic issue that flawed territorial and deferral systems are a serious part of the BEPS problem. Since that discussion could never start during this first two-year BEPS phase, we strongly urge that a real dialogue on this issue should be an explicit part of the post-BEPS agenda.

C. The BEPS project outputs

Those proposals in the BEPS output package which could be effective do indeed move towards treating MNEs in accordance with their business reality as unitary firms. Other proposals, which continue to adhere to the fictional concept of independent entity, will lead to increasingly complex rules that will be hard to administer and create higher compliance costs for taxpayers and governments alike.

Country-by-country reporting

The most important and major advance is the template for Country by Country Reports (CbCRs: Action 13), which would for the first time enable tax authorities to assess tax risks based on a fuller picture of MNE operations. It is noteworthy that this was a specific mandate from the G20 leaders, which the negotiators initially tried to subsume into expanded documentation requirements for transfer pricing. It is now rightly accepted that CbCRs will be important for assessing all BEPS risks, to check that MNEs are indeed taxed where their economic activities take place and value is created. The requirements for a Master File and Local File for transfer pricing documentation are also important, although they fulfil different purposes, and states should ensure they have the necessary legislation in place to obtain them.

However, the threshold for CbCRs of €750m is too high. It has been chosen having regard to the relative importance of firms in the large G20 countries' economies, but would leave smaller countries (especially developing countries) with no access to information on many global as well as the newly emerging investor MNEs, which play a significant role in important sectors of their economy yet are below the threshold. Targeting only the very largest MNEs may make sense for the large OECD and G20 economies, but will leave smaller countries without adequate information on some MNEs which are important to them.

Further, the arrangements for filing and timely access to CbCRs are weak, and frankly seem designed to obstruct access rather than promote it. All relevant countries need easy, timely and automatic access to these reports. Yet that will be problematic under the proposed cumbersome scheme, which prioritises filing with the MNE's home country tax authority. This depends on home countries being able and willing to adopt the necessary legislation to obtain and share the reports, to conclude agreements enabling them to be exchanged, and to comply speedily and in good faith with these arrangements. We urge that countries should be given leeway to overcome these obstacles to access, by using the proposed secondary mechanism for filing CbCRs directly in each country that reasonably believes than an MNE may have a taxable presence.

Also, the CbCRs should be public. Corporations are creatures of statutory law and have no right to secrecy; on the contrary the privilege of incorporation should be subject to adequate disclosure to investors, stakeholders, and the general public. They may be 'legal persons', but they are not individual persons who have a right to privacy. In addition internationally there are now freedom of information laws requiring that data be accessible and individual countries are now enshrining such provisions not only in their Constitutions but also in legislation and policy. There is in any case, and despite the loud rhetoric, no convincing argument that the information in the CbCR could normally be commercially confidential. Attempting to maintain confidentiality will inevitably fail, but will result in partial and unreliable revelations. Publication should be properly organised and in standard format. Only such an open process can reassure the public and restore confidence in international taxation.

Publication would also provide important data for governments; international organizations such as the OECD, the IMF, and the Word Bank; civil society organizations, and academics. As pointed out in the report under Action 11, there is a lack of suitable data to quantify the extent and impact of BEPS, and to help track whether the reforms meet their stated objects, and enable further improvements. CbCRs would be an enormously valuable source of such data. Even if they are not published, arrangements should be made to make them available, under suitable protection, for research purposes. We understand that countries have made commitments to enable this, which would be welcome, especially if the data could be available for all researchers.

Limitation of deductions

The work under Action 4 was confined to limiting interest deductions. Intra-group debt, which often far exceeds the firm's overall borrowing from third parties, is a major cause of BEPS. The proposals sensibly began by treating MNEs as unitary, and suggested apportionment of the group's consolidated interest expenses based on EBITDA (earnings before interest, deductions and amortisation), figures for which are readily available. However, the initial proposals have been weakened, and now recommend an interest deduction cap within a suggested band of 10-30%, with the option of using apportioned consolidated interest costs if they are higher. A fixed cap seems especially inappropriate in view of evidence produced by business groups themselves that debt ratios vary widely both between economic sectors and firms.[4]

In our view, a firm rule is needed that interest deductions should not be greater in aggregate than each corporate group's consolidated interest costs to third parties. We urge countries to consider going beyond the proposals and to introduce rules which would ensure this, as far as possible on a coordinated basis. Countries which insist on using a fixed cap on deductions should use the lowest limit.

CFC Rules

As already mentioned, exemption or deferral of tax on foreign income create strong incentives on MNEs to shift income out of operating affiliates in source countries and park them untaxed in countries with lower effective tax rates. Strong rules on Controlled Foreign Corporations (CFCs) could do much to reduce this motivation. In the event, the proposals (Action 3) are no more than weak recommendations, with a low threshold for defining CFC income. This will be an inadequate deterrent to firms from shifting income out of source countries, and will allow other countries to continue to try to attract corporate headquarters by offering low effective tax rates on foreign income or exempting such income altogether. This will only encourage a continued race to the bottom in tax, damaging all countries. The failure to support strong CFC rules seems due to political decisions by countries such as the UK to maintain their tax incentives, which belie their assertions that they wish to see effective solutions to the problem of taxation of MNEs.

Harmful Tax Practices

The proposals for regulating harmful tax practices (Action 5) would substantially continue the approach dating back to 1998, based on voluntary rules and secretive self-policing, which has had very limited effects. Already it can be seen that the attempt to apply the broad principles of 'nexus' and 'substance' to innovation boxes is only leading to a complicated system, which restricts some aspects of such schemes. An initial review has found existing boxes at least partially harmful, but this is likely to lead only to their revision. Overall, this process has the negative effect of legitimising the concept, thus encouraging all countries to adopt their own regimes.[5] The inevitable result will be a further erosion of the corporate tax rate overall, harming all countries.

Economically harmful tax incentives have proliferated in recent years, with many countries sacrificing large tax revenues for limited return to themselves, while facilitating erosion of the tax base of other countries. As recommended by the OECD/World Bank/IMF and UN to the G20 in 2011, G20 members should take the lead in following best practice in transparency, monitoring, review, and accountability of tax incentives. The draft toolkit on tax incentives prepared for the G20

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[4] See the study by PwC included in the comments submitted by the Business and Industry Advisory Committee (BIAC) on Action 4, February 2015.

[5] The UK's strong defence of its 'patent box' introduced in 2012 resulted in a compromise agreed with Germany, based on a `modified nexus approach', and a transition to the new standard by 2021; other countries quickly announced that they would introduce their own schemes (Ireland, Italy, Switzerland), and business pressures have led to proposals elsewhere also (Germany, US).

Development Working Group published for comment in July 2015 limited itself to some technical analysis and anodyne recommendations that countries should conduct cost-benefit analyses of such measures. It largely ignored the spillover effects of incentives which encourage BEPS behaviour, and the fact that benefits of individual measures can hardly be measured.

We support the call by civil society organisations for the G20 Leaders to adopt a High Level Declaration which would commit all states to end all harmful tax practices and ensure transparency especially of tax incentives and tax rulings. At a minimum there should be much stricter rules on economic substance, and a more binding framework, with provisions for counter-measures.

Transfer pricing

The proposals on transfer pricing (Actions 8-10) are particularly disappointing. This seems largely due to the stubborn insistence of the US and some other states on defending the arm's length principle. Extensive revisions have been made to the Transfer Pricing Guidelines, to strengthen the possible power for tax authorities to adjust them. However, they still insist on beginning from the legal fiction of treating affiliates within a multinational corporate group as independent, and respecting the agreements between them, although the notion that these are freely negotiated contracts is a fiction. Under the independent entity approach which is being retained, the attribution of the tax base of MNEs will remain largely a matter of negotiation between tax authorities and MNEs, with no clear criteria for allocation, since the concepts to be applied to attribute profit are discretionary and subjective. Since this will be done independently by national authorities, the result will be either under-taxation or conflicting assessments.

The revisions will make the Transfer Pricing Guidelines incoherent and contradictory. Although they start by treating related parties as independent of each other, tax authorities will be allowed to challenge intra-firm arrangements by recharacterising transactions. Tools have been devised to tackle the glaring abuses encouraged by the separate entity principle, attributing large profits to affiliates supposedly performing important functions such as managing intellectual property rights, or finance (a 'cash box'). However, applying them will require a detailed and ad hoc 'facts and circumstances' analysis of functions, assets and risks, and searches for 'comparables', which both theory and practice show do not exist.

This will require considerable skilled resources, challenging even for OECD tax authorities,[6] let alone developing countries. It will also increase compliance costs especially for SMEs, and leave wide scope for subjective and discretionary decisions. The report on how developing countries should deal with the problem of lack of comparables, to be prepared for the G20 Development Working Group, is likely to recommend greater use of safe harbours. Yet this approach has been given limited scope by OECD countries, because it gives MNEs themselves more options to choose the most favourable pricing method.

We were pleased that work was begun on the profit split method, which could offer a way forward, abandoning the separate entity fiction and developing principles for allocating the tax base according to where economic activities take place. We hope that this will involve a broad examination of the issue, and aim for clear, simple and easy to administer methodologies, rather than the complex techniques that some tax advisers are already developing for 'value chain analysis'. It is essential for countries to begin work on formulating principled approaches to attribution of profit to provide clear guidance to companies rather than the current arbitrary approach. In the meantime the revised Transfer Pricing Guidelines should be considered provisional.

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[6] Even the US Internal Revenue Service was obliged to hire outside consultants to help with its audit of Microsoft, at a cost of over $2m.

Many developing countries are particularly concerned with problems of transfer pricing in the extractive industries, which can be very important to their economies. In addition to issues common to other sectors, profit attribution may be highly dependent on valuation of commodity exports. A number of developing countries have adopted a so-called Sixth Method for dealing with this, based on the use of exchange-quoted prices. The aim of this method is to establish a clear and easily administered benchmark, avoiding the need for subjective judgment and discretion. Yet, the proposals under Action 10 suggested that such a quoted price can be used as a 'comparable uncontrolled price' (CUP), which would mean that tax authorities would still need to conduct comparability analyses for all transactions. In our view, quoted prices should be used as a guide, taking into account comparability factors, on the basis of which the tax authority should establish a defined benchmark price. Such a price should be one that results in an appropriate level of profit for the affiliate based on its activities in the country, and taking into account the value it creates for the MNE as a whole. This includes the benefits of providing a source of supply and access to raw materials, combined with the management of stocks and of ultimate delivery, which are a type of location-specific advantage. It should also ensure that profit is not attributed to intermediaries especially located in low-tax jurisdictions and which perform only notional activities.

Hybrid mismatches

The exploitation for tax advantage of differences between states in their treatment of hybrid entities and hybrid instruments also relies on the legal fiction of independent entity. The proposals under Action 2 for dealing with this are technically sophisticated and highly complex, and although designed to be applied independently by states, would need cooperation to be effective. As with the transfer pricing proposals, the sophistication and complexity result from the reluctance to take the more direct route of treating corporate groups as unitary firms, and to disregard intra-group transactions. Adoption of full-inclusion CFC rules, and capping interest deductions by apportioning consolidated third party interest costs, would deal with hybrid mismatch problems much more simply and easily.

Digitalisation and the attribution of profits

The problem of attribution of profits has been greatly exacerbated by the digitalization of the economy, which is part of a much wider challenge resulting from dematerialisation of production, the fragmentation of functions and creation of supply chains, and the shift to services. The BEPS project was again hobbled from the start by the decision stated in the Action Plan that it should not reconsider the traditional split between residence and source taxation, which has long been a concern for developing countries, as largely host countries for MNEs.

The weakening of source taxation has now also become a concern for some OECD countries, due to the ability of internet-based companies to pay little or no tax on profits from delivery of goods or services in countries where they have large sales, and to attribute such profits to affiliates in countries where they are lightly taxed. The Task Force assigned to study this issue under Action 1 of the BEPS project rightly found, in its report in September 2014, that digitalisation affects all economic sectors. Hence, more general solutions are need.

We applaud the acceptance in the final report on Action 1 that the digitalisation of economic activity increases the challenges to existing international tax rules, especially the concepts of residence and source, and the allocation of profits. The options it outlines are far-reaching, and deserve serious consideration. This is especially important since the issue goes well beyond the problem of digital sales of physical products, which is the main concern of developed countries. The proposals in the Action 7 report (discussed below) do not deal with the problem of fragmentation of pre-sales functions, or the shift to services and dematerialised products.

We therefore welcome that the Action 1 report opens up up much wider issues, including possible use of a new test of significant economic presence, and consideration of formulary apportionment.

We hope that other issues will also be considered, such as the wider application of the anti-fragmentation test included in Action 7. The issues raised clearly affect all countries, perhaps developing countries most of all, since they go beyond BEPS, and open up the basic concepts of residence and source. This very clearly demonstrates the unsuitability of the present institutional architecture, in which the OECD countries dominate the discussions and negotiations. It also shows that the haste in the BEPS project to make rapid repairs to a rickety system overlooked the need to begin by diagnosing the causes of its failures.

This report clearly shows that although the BEPS project has accomplished much, it is only a beginning. Further work should begin by a reconsideration of the underlying principles of the system.

Taxable presence and the concept of a permanent establishment

A key problem is that the definition of taxable presence still rests on the antiquated concept of the Permanent Establishment (PE), requiring physical presence for a period of six or twelve months in relation to the particular activity generating the profit attributable to it. The PE definition was addressed in Action 7, but within a narrow remit to address only its 'abuse'. The resulting proposals, like those on transfer pricing, continue to accept the independent entity principle. Although they include an anti-fragmentation rule, this is limited to activities which can be said to be 'preparatory or auxiliary' to sales. Furthermore, the terms 'preparatory or auxiliary' are not defined. This will be a recipe for disagreement and conflict.

These changes could affect some MNEs such as those engaged in internet-based selling and which own warehouses in the country of sales. However, they would not deal with sales of immaterial products, or services, so they would affect physical but not electronic books, and DVDs but not streaming services. They also leave continued scope for fragmentation of production functions and their location in jurisdictions where the profits would be lightly taxed. Already many MNEs have restructured their production chains to separate basic manufacturing, which can be allocated a 'routine' profit, from functions such as R&D or design, which may be considered high-value-adding, and can be located where they will be lightly taxed.

This report has also not yet dealt with the issue of attribution of profit to a PE, which will presumably be aligned with the proposals on transfer pricing. The OECD's 'authorised approach' of attributing profits to PEs using the 'functionally separate entity' approach can be exploited since it allows deductions for notional internal payments that exceed expenses actually incurred by the taxpayer. Many countries have not adopted the OECD's approach due to concerns that it would result in serious detrimental tax revenue consequences particularly through allowing financial services businesses deductions for notional payments on internal loans and derivatives involving PEs. We therefore hope that the continuing work will entail a reconsideration of this approach.

Dispute resolution

Understandably, the greater scope for subjectivity and discretion resulting from many of the proposals has led to fears of greater conflicts. The response in Action 14 is to propose stronger dispute settlement, including a commitment by many OECD countries to mandatory binding arbitration. It is a totally inappropriate response to deal with problems caused by vague rules by entrusting decisions involving often hundreds of millions of dollars to a secret and unaccountable procedure of third party adjudication.

In our view, arbitration can only be effective and accepted as legitimate if the rules to be applied are clear, and it is conducted under due process standards. This means that arbitrators should be drawn from outside the closed circle of tax advisers and should have no conflicts of interest, and the procedures must be open and transparent to the public, including the publication of reasoned decisions. Countries should not be pressurised into accepting arbitration if they consider that it is unsuitable for them. Adjudication should not be seen as a remedy for failure to reach agreement on the norms to be applied, as it can only be effective if the rules are clear and precise.

Preventing abuse of tax treaties

The aim of tax treaties has too long been regarded as only the prevention of double taxation, disregarding the equally important purpose of ensuring appropriate taxation. It is therefore essential that existing treaties should be amended as quickly as possible to redress this balance, and to end treaty-shopping and other abuses in future. Regrettably, our proposal for inclusion of a clear statement in all treaties that their purpose is to ensure that tax is paid where activities take place and value is created has not been accepted. Instead, what is proposed is inclusion in tax treaties of a statement in the preamble that the aim is to eliminate double taxation without creating opportunities for tax evasion and avoidance, and of a specific provision on treaty-shopping.

Moreover, the OECD countries have disagreed on whether addressing treaty shopping is best achieved by a Limitation of Benefits (LoB) article, or a principal purpose test (PPT). While the proposed LoB approach based on minimum elements could result in more simple LoB rules, a proliferation of treaty-specific varieties of LoB articles would also create a lot of complexity. It may therefore be preferable that all countries include the proposed PPT provision, without modifications, in new and existing treaties. However, its general and discretionary nature could make it difficult to apply by countries where capacity is weak and access to information limited (which is often the case for developing countries). Therefore it is essential that anti-abuse clauses are complemented by systematic exchange of information between treaty partners, making it easier to determine whether the pre-requisites for treaty benefits are met.

To avoid renegotiation of thousands of bilateral treaties and prevent the emergence of new treaty shopping platforms, it is important that all OECD and G20 countries as well as all other key countries commit to the inclusion of an effective anti-abuse provision as the core article of the proposed multilateral convention. We are pleased that it seems that the USA has now decided after all to join in the negotiation of this convention, and hope that this will also be followed by its ratification.

D. The Future of BEPS

This package of proposals, although important, is only a first step. They now need to be implemented, and continuing and follow up work is also needed on issues which remain incomplete. It is also clear that this two-year project has mainly aimed at patching up the existing system, although some proposals begin to lay the foundation for a new approach, which in our view is essential.

Implementation and follow-up

The proposals fall into three types involving different forms of implementation. These could apply to all states, not only those which have been involved in the project. First, many are recommendations for national legislative or administrative action. These will require careful consideration by all countries, including in appropriate cases through regional or sub-regional organisations.

Secondly, some take the form of international standards, which could have some direct effects as international 'soft law'. This is especially the case for the proposals on transfer pricing, many of which take the form of revised versions of the OECD Transfer Pricing Guidelines. Once adopted, the OECD considers that its member states are committed to applying these in practice. Indeed, they are given statutory status to be used as guidance for tax treaty interpretation in some states, including some non-OECD members (although in some cases along with the UN Manual on Transfer Pricing).[7] Our recommendation is that countries should consider the changes carefully

[7] For example, Nigeria, Tanzania.

before deciding whether, how, and to what extent they implement them. While in some respects the revisions improve the existing Guidelines, overall they will add greater complexity and hence administrative burdens. The UN Tax Committee is already committed to an evaluation of what changes should be made to its Manual as a result of the revisions. Indeed, the OECD itself is committed to further work, especially on the profit split method and attribution of profits to a PE. There is a clear need to upgrade the UN Tax Committee, and provide it with adequate resources, so that it can play a more effective role as the only global tax body.

Thirdly, some proposals take the form of changes to the texts of the OECD model tax treaty and its Commentaries. To speed up the process of implementation, which would otherwise involve renegotiation of thousands of bilateral treaties, Action 15 proposes negotiation of a Multilateral Instrument. This is to be done through an ‘ad hoc Group’, open to all states, hosted and serviced by the OECD, which will hold its inaugural meeting on 5-6 November 2015. In view of the great importance of the issues involved, we strongly urge full transparency of this process, including release of proposals and negotiating drafts for public debate and comment.

It is clear that effective implementation will require considerable coordination, technical advice and support, and different kinds of monitoring of the various commitments states have made. It is therefore important, as stated in the Explanatory Statement (para. 21) that a suitable framework should be devised, involving all interested countries. However, it is also essential that this should not be just a matter of the OECD/G20 designing a framework to ensure that other countries implement the rules which the OECD/G20 have devised.

Beyond the BEPS project

In parallel with the BEPS project, other priority issues for developing countries have also been identified by the G20 Development Working Group. However, these are being addressed only by developing toolkits, written by the OECD, IMF and World Bank. From the evidence we have seen so far, they will generally adhere to orthodox approaches approved by the OECD.

In our view, what is needed instead is more imaginative alternative approaches, complementing and going beyond the work of the OECD. These should include cooperation between non-OECD countries themselves, building on regional groups such as ATAF and CIAT. Adequate global solutions cannot emerge only from the one-sided perspective of the OECD. It was highly regrettable that some key OECD countries opposed and succeeded in blocking the institutional reform proposal from developing countries at the 3rd International Conference on ‘Financing for Development’. The creation by the OECD of global forums and other such structures cannot fill this gap. Given this unsuitable institutional framework, it is hardly surprising that the measures produced by the BEPS project will be at best partially effective, and will pose major problems of implementation, especially for developing countries.

It is clear from these outputs that the BEPS project has only been a first phase in a longer process. This includes coordination and monitoring of implementation and provision of technical assistance, which require involvement of a much wider range of parties than the OECD or even the G20. More importantly, the BEPS project has opened up a wider range of issues, which require re-examination of some of the fundamental concepts and principles of the system, especially the concepts of separate entity, residence and source, as well as development of appropriate criteria for allocation of profits. This has been made clear in the report on Action 1, which envisages a further 5-year program of work. The work on profit split which remains to be done could also provide an important building block.

It is also clear that all countries, especially the least developed states, should be involved in the formulation of this wider agenda. For the actual engagement with this work agenda, a new institutional framework is clearly essential. The different international organisations have their various types of special expertise to contribute, which should be fruitfully combined. Above all the task of building an international tax system for the 21st century requires the establishment of a truly global intergovernmental tax body