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# "EVALUATING BEPS"

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**SCHEDULE FOR 2016 NYU TAX POLICY COLLOQUIUM**
(All sessions meet on Tuesdays from 4-5:50 pm in Vanderbilt 208, NYU Law School)

1. January 19 – Eric Talley, Columbia Law School. “Corporate Inversions and the unbundling of Regulatory Competition.”

2. January 26 – Michael Simkovic, Seton Hall Law School. “The Knowledge Tax.”

3. February 2 – Lucy Martin, University of North Carolina at Chapel Hill, Department of Political Science. “The Structure of American Income Tax Policy Preferences.”

4. February 9 – Donald Marron, Urban Institute. “Should Governments Tax Unhealthy Foods and Drinks?"

5. **February 23 – Reuven S. Avi-Yonah, University of Michigan Law School. “Evaluating BEPS”**

6. March 1 – Kevin Markle, University of Iowa Business School. “Income Shifting Incentives and Implicit Taxes.”

7. March 8 – Theodore Seto, Loyola Law School, Los Angeles. “The Nonfalsifiability of Welfarism: Some Implications of Preference-Shifting for Optimal Tax Theory”

8. March 22 – James Kwak, University of Connecticut School of Law. “Reducing Inequality With a Retrospective Tax on Capital.”

9. March 29 – Miranda Stewart, Australian National University. “Transnational Tax Law: Reality or Fiction, Future or Now?"

10. April 5 – Richard Prisinzano, U.S. Treasury Department, and Danny Yagan, University of California at Berkeley Economics Department. "Partnerships in the United States: Who Owns Them and How Much Tax Do They Pay?"

11. April 12 – Lily Kahng, Seattle University School of Law. “Who Owns Human Capital?”

12. April 19 – James Alm, Tulane Economics Department, and Jay Soled, Rutgers Business School. “Whither the Tax Gap?”

13. April 26 – Jane Gravelle, Congressional Research Service. “Policy Options to Address Corporate Profit Shifting: Carrots or Sticks?”

14. May 3 – Monica Prasad, Northwestern University Department of Sociology. “The Popular Origins of Neoliberalism in the Reagan Tax Cut of 1981.”

**DRAFT 1/15/16**

# EVALUATING BEPS

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## 1. Introduction: The Financial Crisis and Inequality

The financial crisis of 2008 and the Great Recession that followed have raised anew the problem of how to address a growing inequality both between the rich and everybody else within countries, and between developed and developing countries. Both dimensions of inequality, the intra- and inter-country ones, have risen in this century, and the Great Recession has made both problems worse. The current rise of populism in both the US and in Europe and the vehement reactions to a tide of migrants from poorer to richer countries show how these two problems are intertwined.

Sixteen years ago, the first author wrote about the challenge that globalization and tax competition pose to the fiscal viability of the post-World War II welfare state.[3] He pointed out that if tax avoidance by multinational corporations is allowed to undermine the ability of both developed and developing countries to provide adequate social insurance for their citizens, a violent reaction against globalization may ensue that risks ending this era of opening borders, just like World War I ended the previous era of globalization a century ago. In 2016, we worry that the lack of adequate response to the Great Recession is leading to the rise of violent anti-globalization sentiments on both the right and the left, embodied in the US by the success of Bernie Sanders and Donald Trump and in Europe by an even more virulent rejection of the open border policies the EU has stood for.

It is imperative for the West to find ways to strengthen the ability of the state to provide adequate social insurance and to reduce inequality before these forces lead to the closing of the borders and to pressures that could result in World War III. But the response so far has unfortunately not been adequate.

Following the financial crisis and ensuing austerity, politicians discovered the problem of tax avoidance. In response, the OECD and G20 launched the Base Erosion and Profit Shifting (BEPS) project in 2013, and this has in October, 2015 culminated with the release of a series of action steps that the OECD and G20 countries have undertaken to adopt.[4] OECD Secretary-

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[3] Reuven S. Avi-Yonah, Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State, 113 Harv. L. Rev. 1573 (2000).
[4] On BEPS see, e.g., Ault, Hugh J., Some Reflections on the OECD and the Sources of International Tax Principles (July 1, 2013). Reprinted from Tax Notes International, Volume 70, Number 12, June 17, 2013, p. 1195; Working Paper of the Max Planck Institute for Tax Law and Public Finance No. 2013-03. Available at SSRN: http://ssrn.com/abstract=2287834 or http://dx.doi.org/10.2139/ssrn.2287834; Dharmapala, Dhammika, What Do We Know About Base Erosion and Profit Shifting? A Review of the Empirical Literature (September 3, 2014). Illinois Public Law Research Paper No. 14-23; University of Chicago Coase-Sandor Institute for Law & Economics Research Paper No. 702. Available at SSRN: http://ssrn.com/abstract=2373549 or http://dx.doi.org/10.2139/ssrn.2373549; Brauner, Yariv, What the BEPS? (March 12, 2014). Available at SSRN:

General Angel Gurria has stated that "Base erosion and profit shifting affects all countries, not only economically, but also as a matter of trust. BEPS is depriving countries of precious resources to jump-start growth, tackle the effects of the global economic crisis and create more and better opportunities for all. But beyond this, BEPS has been also eroding the trust of citizens in the fairness of tax systems worldwide. **The measures we are presenting today represent the most fundamental changes to international tax rules in almost a century: they will put an end to double non-taxation, facilitate a better alignment of taxation with economic activity and value creation, and when fully implemented, these measures will render BEPS-inspired tax planning structures ineffective**".[5]

Is Mr. Gurria justified in his optimism? We do not think so. These efforts are commendable and to some extent have an impact. But in our opinion they are inadequate. The basic problem is that they take as a given the fundamental consensus underlying the international tax regime, also known as the "benefits principle." Under the benefits principle, active (business) income should be taxed primarily at source while passive (investment) income should be taxed primarily at residence. This compromise between the claims of residence and source countries was reached by the four economists in 1923 and still serves as the foundation of the international tax regime. It is embedded in over 3,000 bilateral tax treaties and in the domestic laws of the US and most other countries. Not surprisingly, it is also reflected in BEPS, which is an attempt to improve source-based taxation of active income.

In our opinion, this consensus should be reconsidered in light of current realities. The shortcomings of BEPS are directly related to its reliance on the benefits principle, because upholding it requires cooperation by too many jurisdictions.

The original rationale for the benefits principle was that economists in the 1920s believed that active (business) income was earned primarily in the country of source, because that is where business activity took place, while passive (investment) income was earned primarily in the country of residence, because that is where the capital invested was accumulated. Economists no longer believe in the validity of this analysis, because most types of income have more than one source.

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http://ssrn.com/abstract=2408034 or http://dx.doi.org/10.2139/ssrn.2408034; Ault, Hugh J. and Schoen, Wolfgang and Shay, Stephen E., Base Erosion and Profit Shifting: A Roadmap for Reform (June 1, 2014). Bulletin for International Taxation, Vol. 68, p. 275, 2014; Boston College Law School Legal Studies Research Paper No. 324. Available at SSRN: http://ssrn.com/abstract=2459646; Dharmapala, Dhammika, Base Erosion and Profit Shifting: A Simple Conceptual Framework (September 25, 2014). University of Chicago Coase-Sandor Institute for Law & Economics Research Paper No. 703. Available at SSRN: http://ssrn.com/abstract=2497770; Vann, Richard J., Policy Forum: The Policy Underpinnings of the BEPS Project-Preserving the International Corporate Income Tax? (August 20, 2014). Canadian Tax Journal, Vol. 62, No. 2, pp. 433-441, 2014; Sydney Law School Research Paper No. 14/77. Available at SSRN: http://ssrn.com/abstract=2483619; Shaviro, Daniel, The Crossroads versus the Seesaw: Getting a 'Fix' on Recent International Tax Policy Developments (July 1, 2015). NYU School of Law, Public Law Research Paper No. 15-20; NYU Law and Economics Research Paper No. 15-11. Available at SSRN: http://ssrn.com/abstract=2605144 or http://dx.doi.org/10.2139/ssrn.2605144; Rosenzweig, Adam H., Building a Framework for a Post-BEPS World (June 24, 2014). Tax Notes International, Vol. 74, No. 12, 2014. Available at SSRN: http://ssrn.com/abstract=2463259; Grinberg, Itai, Breaking BEPS: The New International Tax Diplomacy (September 1, 2015). Available at SSRN: http://ssrn.com/abstract=2652894 or http://dx.doi.org/10.2139/ssrn.2652894.

[5] OECD, Centre for Tax Policy and Administration, OECD presents outputs of OECD.G20 BEPS Project for discussion at G20 Finance Ministers meeting, October 5, 2015.

Nevertheless, the common view (including, until recently, our own) is that the benefits principle still makes sense, because most active income is earned by corporations and most passive income is earned by individuals. Since individual residence is meaningful in a way that corporate residence is not, it makes sense to tax individuals on a residence basis and corporations on a source basis.

This system functioned reasonable well until the 1980s. For active income, it could generally not be earned without taxation by source countries, because corporate investments by multinationals were generally immobile and tax competition was limited in scope. The *Dupont* case (1979) is a good illustration of the limits of tax planning in the pre-globalization era: It involved a multinational manufacturing goods in the US and selling them in Europe, and both activities were subject to high levels of taxation. Dupont tried to avoid this result by routing the sales through a Swiss subsidiary, but the US court rejected this attempt, and Subpart F was enacted in part to prevent it from happening again. The underlying assumption behind the Subpart F compromise (1962) was that active income would be taxed at source, and therefore it was not problematic to permit deferral of active income while taxing passive income and base company income currently.

But these constraints started to erode in the 1980s. Multinationals became much more mobile as the focus shifted from heavy manufacturing to services and intangibles. The result was tax competition as multinationals became able to pit one country against another. By 1995 Intel, which builds a new chip factory every other year, was able to boast that tax competition enabled it not to pay any foreign tax as it pitted Israel against Ireland and Mexico against Costa Rica as new plant locations, earning tax holidays in all of them.

The result has been that by the early 21$^{st}$ century most cross-border income is untaxed. In the case of multinationals, this is because the source jurisdiction either lacks the authority to tax because in the age of electronic commerce it is easy to avoid the required physical presence in the source country; or because source jurisdictions grant tax holidays to multinationals. Residence jurisdictions do not tax active income currently for fear that multinationals will establish their headquarters elsewhere, as the current US inversion saga confirms.

While the BEPS projects is helpful, it is unlikely to solve the underlying issues described above. The project only addresses artificial profit shifting, not tax competition, and it only applies to the OECD and G20, not to the many source countries outside these two organizations. Thus, it is likely that multinationals can avoid BEPS by sourcing income in countries that are not subject to it.

Fundamentally, if the income tax is to be preserved in the 21$^{st}$ century, multilateral solutions are needed. BEPS represents an attempt at such a solution, but it is hampered by the focus on source jurisdictions for active income. There are too many source jurisdictions, since multinationals operate globally.

Thus, in our opinion it is time to re-evaluate the benefits principle. Most of the current issues can be solved if we taxed active income primarily at residence. About 90% of large multinationals are headquartered in the G20, and none of those countries have a tax rate below 20%, so if they taxed their multinationals currently on a coordinated basis and restricted the ability to move out most of the problem would be resolved.

We would therefore suggest that we reconsider the benefits principle in light of the reality of globalization. We should tax active income primarily at residence.[6]

Importantly, like under current rules, this does not preclude the alternative. Once active income is taxed at residence, a credit can be given to source country taxes if the source country responds to the limitation of tax competition by re-imposing its tax. But the key is that the income has already been taxed, so that no double non-taxation ensues even if source countries choose not to tax in the case of active income.

The following unpacks this analysis in more detail. Part 2 analyzes the BEPS response to corporate tax avoidance and its limitations. Part 3 develops the alternative of taxing active income primarily at residence. Part 4 concludes.

## 2. The Limits of the BEPS project

On October 5, 2015, the OECD and G20 released the final BEPS package of 13 reports, which cover 15 actions. It was only two years since the G20 leaders endorsed the ambitious and comprehensive Action Plan to address BEPS at the meeting in St. Petersburg on 5-6 September 2013.

The BEPS package represents the first substantial – and overdue - renovation of the international tax standards in almost a century.[7] The BEPS package is an unprecedented turning point in the history of international tax law. The mission of the BEPS package is to align the location of taxable profits with the location of economic activities and value creation. Some generally accepted principles of international tax law, including the single tax principle, the benefit principle, the anti-discrimination principle and the transparency principle have been reflected in many respects.

Despite considerable progress, there are many shortcomings with the BEPS project due to the short two-year framework. Hence, the BEPS project is not the final destination of international tax law reform. In fact, it is the first step toward the modernization of global tax governance in the long run.

### 2.1 New shoes on the old road: an old approach for the new destination

The primary problem with the BEPS project is that although the new destination has been redefined, new principles and new rules have not been truly established for the new direction, and the old principles have been strengthened by a patch up of current rules.

The core principle of international tax law is the single tax principle, which requires eradication of both double taxation and double non-taxation. Unfortunately, both the governments and the MNES have been active in fighting against the double taxation, and have ignored another danger of double non-taxation. Therefore, the main theme of traditional international tax law has been eradication of double taxation, instead of double non-taxation.

[6] We also believe that passive income should be taxed primarily at source, because there are far fewer source jurisdictions for portfolio investment than residence jurisdictions, and cooperation of tax havens is not required. See Reuven Avi-Yonah and Haiyan Xu, Taxation after the Crisis: Why BEPS and MAATM are Inadequate Responses, and What Should be Done about it (2016), available on SSRN.
[7] OECD (2015), Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project, OECD, p.5.

Based on the single tax principle, the mission of the BEPS project is to prevent and eliminate the double non-taxation. As the G20 leaders pointed out the new principle, 'profits should be taxed where economic activities deriving the profits are performed and where value is created'.[8] Therefore, the new direction of international tax law reform in the context of BEPS project is to safeguard the single tax principle by fighting against the BEPS.

It is well known that the rickety international tax regime, including rules and underlying principles, is one of the primary root causes of BEPS opportunities. Therefore, the new direction demands revolutionary changes to current approaches. The ideal roadmap for the BEPS project is supposed to replace the old principles with a new principle, and to redesign the rules based on the requirement of the new principle.

Unfortunately, many old principles of international tax law have been preserved and continued in the final BEPS package. The mixture of new principle and old principles has substantially compromised the value of the new principle, and made the legal reform of international tax look more like the patch-up of existing rules and principles. The reason is pretty obvious. On the one hand, it is impossible to abolish or even reconsider the dysfunctional current rules,which have been favored by some large countries and MNEs. On the other hand, it is mandatory to change the current rules to some extent, because of the emerging political pressure against BEPS schemes.

Given the fact that two years are very short for serious in-depth research, debate and negotiation, given the strong tradition and interest groups desire to keep the continuity of old principles, given the global voice for closing up the BEPS opportunities, the architect of the BEPS project has no choice but to patch up some loopholes of current rules, instead of fundamental restructuring of current regime.

As a result, complete renovation of current international tax law did not happen, and genuine new rules guided by the new principle have not been formulated. Moreover, the patch-up work has produced many more complex, discretionary, uncertain, costly and in many cases contradictory rules. There are two possible negative consequences. First, it is difficult to translate all the new rules into the reality. Second, even if the BEPS project is implemented as outlined and promised in the book, it is still possible for the creation of either new BEPS opportunities on the part of MNEs, or arbitrariness on the part of tax authorities.

In addition to adhering to the independent entity principle and rejection of the new principle of single unitary entity, the BEPS project is also silent on the basic concepts of residence and source, and where profit should be considered to be earned. As the existing rules based on the old principles have been strengthened, and new rules based on the new principle have not been established, the BEPS project is not so revolutionary and fundamental as it appears at the first sight.

The ironic fact is that the patch up of current rules in the BEPS project was made in the name of new mission and new principle. However, because of the inconsistencies and conflicts between the new principle and old principles, the new principle of international tax law has been compromised or undermined by the strengthened current rules based on old principles. Without the support of new principle and new rules, it is very challenging to achieve the new destination of aligning the taxation of MNE profits with economic activity.

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

2.2 The survival and continuity of notional and illusionary independent entity principle and arm's length principle

The traditional international tax law is designed and interpreted based on the assumption that the various constituent entities or members of MNE group are independent of each other and conduct transactions with each other at arm's length.

While criticizing the independent entity theory as fundamental flaw of the existing rules, the BEPS Monitoring Group identified a new but implied approach in the G20 mandate 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.[9] This means that the new destination of taxing MNEs 'where economic activities take place and value is created' is unlikely to be achieved, without treating the MNE group as a single firm.

In principle, the optimal long-term solution is the single unitary entity principle. In our view, the G20 mandate could be interpreted as both a new direction and a new guiding philosophy, which requires all the BEPS actions should serve the purpose of taxing MNEs where economic activities take place and value is created in the most efficient manner. Guided by the brand new philosophy, the principle of single unitary entity and the basic concepts of residence and source need to be established as the cornerstones to support the design, interpretation and implementation of new measures in the BEPS package.

Unfortunately, the BEPS project refused to make the implied principle explicit, but has continued to emphasize 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.[10]

According to our observation, virtually all the new rules of the BEPS package are still built on the notional principle of independent entity. By its very nature, the untouchable principle of arm's length ultimately derives from the root of independent entity theory. Additionally, many other flawed rules including weak CFC rule; territorial and deferral systems are also indirectly but closely connected with the independent entity principle.

The orthodoxy of independent entity taxation has two basic assumptions. First, the members of the MNE group are regarded as equal, separate and independent legal persons. Namely, the members of MNE group are reasonable legal entities. From the perspective of corporate law, the fiction of independent entity in the context of corporate group derives from the orthodoxy of shareholder's limited liability and the corporate independent status as legal persons in the traditional corporate law. Second, the contracts between the related parties in the corporate group are freely negotiated at arm's length, and the terms of the contract are fair and reasonable dealings. In short, both the entities and the transactions in the corporate group are reasonable, therefore legal and moral.

However, the two beautiful and attractive assumptions do not make sense, and they do not really exist in the commercial reality. The primary commercial reality is that multinational corporate group operates more like a single, unitary entity or enterprise rather than separate independent

[9] The BEPS Monitoring Group (BMG), "Overall Evaluation of the G20/OECD Base Erosion and Profit Shifting (BEPS) Project",Available at: https://bepsmonitoringgroup.wordpress.com

[10] The BEPS Monitoring Group (BMG), "Overall Evaluation of the G20/OECD Base Erosion and Profit Shifting (BEPS) Project",Available at: https://bepsmonitoringgroup.wordpress.com

entities or enterprises. This is made possible by the controlling power of the parent corporation. As traditional international tax law stubbornly insists on the old concept of independent entity, the MNEs have been encouraged to incorporate dozens and even hundreds of affiliates all over the world to undertake aggressive BEPS schemes. The more subsidiaries or members in the MNE family, the stronger the parent corporation in reducing the overall transaction cost, and advance the profitability of the group as a whole. Why?

The answer is very simple. All the commercial activities of the subsidiaries and affiliates are under the effectively direct or indirect control from the parent corporation. Therefore, the profits or benefits could be unlimited by separate but co-ordinated operations of business under the uniform controlling power. On the other hand, the principle of independent entity could better protect the MNEs from unlimited risks and liabilities of group members towards *bona fide* third parties including the tax authorities.Therefore, the legal risks and liabilities of corporate group are limited by law, because there is no joint and several liability between and among the group members unless otherwise agreed by the corporate group members.

Because of the controlling power of the parent corporation on the top of the pyramid of the complicated corporate structure, like a smart spider on the center of grand network of corporate groups, it is unlikely to find real arm's length transaction in the reality. In fact, the related party contracts within the corporate group are always concluded without seriously free, competitive and transparent bargainings and negotiations.

If the BEPS project is designed on the principle of single unitary entity, the BEPS counter-measure will be much more simple and effective, as inter-group transactions will be disregarded, and the profit or tax base will be attributed to its real activities which generate the profit and create the value in the jurisdictions.

Unfortunately, many actions of the BEPS project, including but not confined to Action 2 on hybrid mismatches, Action 7 on PE, and Actions 8-10 on transfer pricing, heavily rely on the legal fictions of independent entity and arm's length transactions. This is understandable given the difficulty of implementing a coherent unitary tax system in a short time frame, but it means that the goals of BEPS are unlikely to be achieved.

### 2.3 The survival and continuity of the problematic benefit principle

The OECD declared that, the goal of BEPS package is "to tackle BEPS structures by comprehensively addressing their root causes rather than merely the symptoms. Once the measures are implemented, many schemes facilitating double non-taxation will be curtailed". [11] Therefore, a key question is whether all root causes, instead of symptoms, have been addressed?

In our opinion, one of the root causes is traditional benefit principle, which has guided the allocation of global profits in the past decades, and has created many BEPS opportunities. Unfortunately, the BEPS project failed in replacing the benefit principle. Instead, the BEPS package was still designed based on residence jurisdictions for passive income and source jurisdictions for active income.

As articulated in this article, our argument is that BEPS concerns will be more effectively tacked if active income is primarily taxed at residence. This new philosophy will help to build a new international tax governance framework of win-win, which will benefit both developed countries

[11] OECD (2015), *Explanatory Statement*, OECD/G20 Base Erosion and Profit Shifting Project, OECD, p.5.

and developing countries. Moreover, the conflicts between the domestic demand for tax revenue and domestic policy to attract foreign direct investment will be better balanced, and the MNEs and domestic firms will be offered a level playing field.

Many scholars have realized the significance of the renovation of basic principles of current international tax law. As Mindy Herzfeld argued observed, "attempts at coordination cannot be successful unless there is agreement on an underlying set of principles for allocating the revenue of global citizens (including natural persons and legal entities). A more rigorous effort to develop such a clear and agreed upon set of principles which rests on economic, philosophic and fairness grounds is needed".[12]

2.4 Limited inclusiveness and multilateralism

Global challenges need global solution. BEPS, as a global concern, is made possible by uncoordinated tax rules at domestic and international levels. Therefore, the global solutions need to be based on inclusive and multilateral global governance. This means each and every country should be offered equal opportunity and equal weight to shape the outcome of the global solutions.

Although OECD/G20 have made great efforts in organizing many non-member countries and NGOs to participate in the development of the BEPS package, the inclusiveness and multilateralism of the BEPS project is limited for a number of reasons.

First, the undisputed fact is that major OECD countries dominated the formulation of the BEPS package in the process of discussions and negotiations. As OECD countries are all developed countries, it is inevitable that the BEPS project is mainly a result of compromise between the rich countries. For instance, weak measures on CFCs, interest deductibility and innovation box schemes are favored particularly by the UK.[13]

Second, although over 60 countries were directly involved in the process of the BEPS project, they only account for less than one-third of 193 UN members.[14] As MNEs have their taxable presence around the globe, including the non-participating countries, the effectiveness of the BEPS project is very limited. The tax competitions between participating countries and non-participating countries will continue. The race to the bottom and the unilateral actions taken by any jurisdiction could hurt all the countries in the world.

Third, although some developing countries were consulted for the BEPS project, it does not necessarily mean that their core proposals were finally accepted by the BEPS package. As observed by independent commentators, 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'.[15]

Fourth, less influential participating countries and more than 120 non-participating counties might be hurt due to the effect of negative spill-over arising from the implementation of the BEPS

[12] Mindy Herzfeld, "The Limits of Tax Coordination", working draft, October 11, 2015.
[13] The BEPS Monitoring Group (BMG), "Overall Evaluation of the G20/OECD Base Erosion and Profit Shifting (BEPS) Project", p.3. Available at: https://bepsmonitoringgroup.wordpress.com
[14] http://www.un.org/depts/dhl/unms/whatisms.shtml#states
[15] The BEPS Monitoring Group (BMG), "Overall Evaluation of the G20/OECD Base Erosion and Profit Shifting (BEPS) Project",Available at: https://bepsmonitoringgroup.wordpress.com

project in the future. They are weak not only because of their limited influence in the renovation of the current rules, but also because of their limited experience and resources to enforce the BEPS actions.

Fifth, the process of public debate and consulting was relatively insufficient. BEPS Monitoring Group, an active tax justice advocate, complains that they have been vastly outnumbered by the army of paid tax advisers and representatives of multinational enterprises. [16] Although stakeholder interest, including invaluable interactions with business and civil society, saw more than 12,000 pages of comments received on the 23 discussion drafts published and discussed at 11 public consultations,[17] it is unknown to what extent these valuable proposals have been adopted by the BEPS package. More importantly, detailed reasons for rejecting different proposals have not been published.

Given the fact that it is impossible to guarantee that countries and stakeholders really had the equal opportunity to influence and shape the outcome of the BEPS package on really equal footing, OECD and/or G20 is not the truly global platform for comprehensive reform of international tax law. To transform the current BEPS project into truly global, coherent, co-ordinated and inclusive actions, the UN should undertake the leadership in the next stage of international tax law reform.

The third paragraph of Article 1 of the Charter of the UN recognizes that the third purpose of the UN is to achieve international co-operation in solving international problems of an economic, social, cultural, or humanitarian character. The fourth paragraph of Article 1 of the Charter of the UN recognizes its fourth purposes is to be a centre for harmonizing the actions of nations in the attainment of these common ends.

We believe that the UN will be more qualified, impartial, transparent, credible and influential than the OECD/G20 in rewriting and renovating the international tax rules including the BEPS counter-measures. All UN members have the right to be heard and represented in the process of international tax law reform. As the working group of the UN, the UN Tax committee is expected to make great difference in this regard.

We urge that the UN Convention of Anti-BEPS should be made as the cornerstone of the global response to BEPS in a more coherent, inclusive and multilateral manner. Compared with the partial multilateral approach of OEC/G20, the global BEPS actions launched by the UN will better address the BEPS concerns and restore the integrity of international tax principles of single tax, neutrality, transparency, fairness.

### 2.5 The limits of Action 1

Action 1 was unable to propose all the solutions to the BEPS concerns in the digital economy for the following two reasons.

The first reason is that although the digital economy has exacerbated BEPS risks, it has not generated genuinely unique BEPS issues. Almost every BEPS issue is directly or indirectly relevant to digital economy. Additionally, all the BEPS actions interconnect and interact with each other in the digital economy. Therefore, the ideal Action 1 report is supposed to focus on universal philosophy and methodology of the BEPS project from the perspective of digital

[16] Ibid.
[17] OECD (2015), Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project, OECD., p.5.

economy. It is challenging and unwise for the TFDE to produce some unique measures in parallel with other measures of the BEPS project.

The second reason is that the staggered time frame of the BEPS Project makes it impossible for TFDE to foresee and analyze the effectiveness of the future BEPS package in addressing BEPS concerns in the digital economy in advance. For the same reason, it is difficult for TFDE to evaluate the ultimate scope of the more systemic tax challenges in the area of nexus, data, and characterization, and potential options to address them.

However, the limit of Action 1 report could be overcome by continuing research on the broader tax challenges of the digital economy, and by proposing detailed and viable options to address those challenges, with appropriate focus on multi-sided business models and the participation of users and consumers in value creation. On the one hand, TFDE need to assist the implementation of other BEPS actions, such as Action 3 on CFC rules, Action 7 on artificial avoidance of PE, Actions 8-10 on transfer pricing. On the other hand, TFDE should update the Action 1 report based on the experience, performance and outcomes of the BEPS Project.

As planned by TFDE, a supplementary report reflecting the outcomes of the continuing work will be finalized by December 2015.[18] We doubt whether the intended outcomes of the BEPS project would be available for assessment, given the fact that the implementation of the 15 actions is a lengthy process domestically and internationally. In our opinion, the Action 1 report should be updated regularly based on the changing business models of digital economy.

### 2.6 The limits of Action 2

The solutions of Action 2 are soft recommendations, instead of minimum standards. Although countries have agreed to a general tax policy direction in neutralizing the effects of hybrid mismatch arrangements, it is difficult to achieve the agreements on minimum standards at this stage. As a result, the Action 2 has to choose a common approach to encourage the countries to converge over time through the implementation of the recommendation at the levels of internal law and bilateral treaties.

However, it is not clear how long it will take the countries to converge in a harmonized way, because changes of domestic law are up to the free choice of sovereign states, based on the consideration of complex factors including different legal traditions. Some jurisdictions might wish to continue to treat certain instrument as indebtedness, while some jurisdiction might continue to treat it as equity. For similar reasons, some jurisdictions will continue to treat certain hybrid entities and reverse hybrid entities as fiscally transparent conduits, while some jurisdictions will continue to treat them as separately taxable entities.

Therefore, if a few countries are very slow in the convergence process, the whole process of convergence will be delayed. Although all countries may argue that their own measures or paths are consistent with the right direction of the BEPS project, the real consequences might depart from the direction originally decided by the BEPS project. Even worse, it is possible that a few jurisdictions will return to the race to the bottom. In this event, the original direction of neutralizing the effects of hybrid mismatch arrangements might be compromised in some jurisdictions.

[18] OECD (2014), *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, p.21. *http://dx.doi.org/10.1787/9789264218789-en*

Our proposal is that the international community needs to replace the common approach by global minimum standards in the near future. To better coordinate the Action 2 with other relevant Actions, in particular on interest expense deduction limitations, CFC rules and treaty shopping, the latter Actions should be also upgraded.

### 2.7 The limits of Action 3

Strong CFC rules are supposed to play an important role in tackling BEPS schemes. The Action 3 should serve as a backstop to transfer pricing and other rules. Unfortunately, the CFC rules in the Action 3 are very weak. The building blocks in this Action are very soft,weak recommendations based on best practices, instead of hard minimum standards. In particular, the threshold for defining CFC income is very low.

The reason for the weak CFC rules could be explained by the stubborn insistence on the tax incentives by some OECD countries in particular the UK. According to BEPS Monitoring Group, the UK and other countries 'belie their assertions that they wish to see effective solutions to the problem of taxation of MNEs'.[19]

Therefore, it is very difficult to expect that the Action 3 will effectively reduce and deter the motivation of MNEs to abuse the system of exemption or deferral of tax on foreign income, and to shift income from operating affiliates in source jurisdictions to the tax havens. Moreover, it is also likely for the race to the bottom to continue to attract the headquarters of MNEs, and hurt all the countries in the end. On the one hand,traditional tax havens will feel free to continue their behaviors. On the other hand, other countries will be motivated to adopt low effective tax rates on foreign income or exempting such income altogether to attract foreign direct capital.

Although the compromise is inevitable in the process of developing Action 3, the OECD/G20 should seek the win-win solution by maximizing the common denominator of international tax. We urge the international community to strength the weak CFC rules of Action 3, and to adopt full-inclusion CFC rules in the future. Of course, the recommendations should be replaced by minimum standards.

### 2.8 The limits of Action 4

As lower transaction cost and more business opportunities are the core features and advantages of the corporate group, it is extremely abnormal and even ridiculous for the interest deductions to be greater in aggregate than each corporate group's consolidated interest costs to third parties. Theoretically speaking, if the interest cost of intra-group loans is unreasonably higher than the loans from third parties, the group and its members would reduce the interest loans.

But the reality does not support this logic. One of the pressure areas for the BEPS concerns is that intra-group debt usually exceeds the firm's overall borrowing from third parties, and the interest deductibility is almost out of control. Therefore, the limitation of deductions of interest should be strong enough to root out the BEPS opportunities.

Unfortunately, the Action 4 Report is not minimum standard. Its philosophy is to facilitate the

[19] The BEPS Monitoring Group (BMG), "Overall Evaluation of the G20/OECD Base Erosion and Profit Shifting (BEPS) Project", Available at: https://bepsmonitoringgroup.wordpress.com

convergence of national rules in the area of interest deductibility. Therefore, its success is entirely dependent upon voluntary coordination between and among countries in enacting new domestic rules. If the progress of implementation and operation of the recommendations is not satisfactory as anticipated, the effectiveness of this Action will be compromised. It is very challenging for the jurisdictions to address excessive deductible payments and address competitiveness considerations at the same time, and to ensure that appropriate interest expense limitations do not themselves lead to double taxation.

More problematic is the substance of Action 4, which prioritized an interest deduction cap within a suggested band of 10-30%, with the option of using apportioned consolidated interest costs if they are higher. Such a recommendation is not as powerful and strong as the audience anticipated. Moreover, the formula of fixed cap does not match best with every sector and firm. That is why the Action 4 report recognizes the need to develop suitable and specific rules that address BEPS risks in banking and insurance industries. Although it does make sense to respect the specific features of banking and insurance industries, other industries might also claim the special treatments from the BEPS project. It is not realistic to design the specific rules for every firm, industry or sector.

Before the proposal of a fixed cap was adopted, there were also other better proposals. For instance, based on the doctrine of unitary entity, a proposal suggested apportionment of the MNE group's consolidated interest expenses based on EBITDA (earnings before interest, deductions and amortization), figures for which are readily available. However, the initial proposals have been watered down to recommendations prioritizing a fixed cap. [20]

We strongly urge that the bottom line of international tax law reform is that interest deductions may not be greater in aggregate than each corporate group's consolidated interest costs to third parties.

Anyway, the recommendations in Action 4 do not prohibit the countries from seeking better alternative solutions for effective control of interest deductibility. If the countries really have no other choice but to follow the default recommendation of fixed cap on deductions, they should use the lowest limit to deter aggressive interest deductions by MNEs. In fact, even the lowest limit still falls in the range of unrelated loans. Of course, coordination is always important to prevent the MNEs from defeating all the countries by abusing the different rules around the world.

### 2.9 The limits of Action 5

The harmful tax practices proliferating in many countries represent the major form of race to the bottom. Such practices have triggered and increased numerous BEPS opportunities. Hence, Action 5 is designed to effectively reverse the history of beggar-thy-neighbor, which damage all countries, including the jurisdiction having harmful tax practices.

Different from the Actions 2-4, the Action 5 sets out a minimum standard in terms of substance and transparency, and includes the results of the application of the elaborated substantial activity and transparency factors to a number of preferential regimes. Unfortunately, Action 5 is still very weak and even disappointing, as it continued the traditional but unsuccessful approach.

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[20] The BEPS Monitoring Group (BMG), "Overall Evaluation of the G20/OECD Base Erosion and Profit Shifting (BEPS) Project", Available at: https://bepsmonitoringgroup.wordpress.com

First, the effectiveness of implementation of Action 5 is still up to voluntary self-regulation and self-monitoring by individual countries. No one is able to bite her own nose. Irrational developed and developing countries could be addicted to harmful practices, in the name of national competitiveness or attracting international capital.

Second, although the work of the Forum on Harmful Tax Practices (FHTP) will be refocused to develop more effective solutions, no penalty could be imposed by FHTP. In fact, all 43 preferential regimes reviewed by the FHTP were inconsistent with the nexus approach.[21] However, there is no effective penalty against the violators. It is very challenging for all countries to voluntarily bring their IP regimes into compliance with the nexus approach.

Third, the application of the broad and general principles of 'nexus' and 'substance' to innovation boxes might create different and divergent standards and interpretations in different countries. The consideration of national competitiveness or specific domestic circumstances might lead to new forms of harmful preference regimes.

Fourth, some developed countries have set bad examples for the developing countries in fighting against the harmful practices. As observed by BEPS Monitoring Group, the UK's strong defense 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).[22]

As the harmful tax practices always end up hurting every country, we urge the international community to abandon the voluntary self-policing model, and to establish mandatory monitoring model based on transparency, accountability, condemnation and even economic sanctions depending on the seriousness of the harmful schemes. Harmful tax practices are unjustified and immoral. They are against the core value of international tax law. Therefore, it is inadequate, and even inappropriate to require countries to conduct cost-benefit analyses of the harmful incentives. In fact, many addicted countries still attempt to acquire the limited selfish benefit at the price of negative spill-overs on the other countries. The harmful tax practices themselves have demonstrated the failure of voluntary self-policing approach.

Of course, all countries should be encouraged to behave themselves in terms of higher standard of transparency, monitoring, review and accountability of tax incentives. If a country really wants to win the trust from the global community, it must take the firm initiative in this regards. To activate the monitoring function of FHTP, the mechanism of transparent investigation, impartial peer review, reasonable reward and adequate sanction will be indispensable.

### 2.10 The limits of Action 6

Although the three-part approach adopted by the Action 6 will help to counter treaty abuse, either LoB article or PPT provision has its own pros and cons. Although the LoB article is easily understood and applied, a proliferation of treaty-specific varieties of LoB articles would lead to over complexity in the treaties or domestic legislation.

[21] Joint Committee on Taxation, *Background, Summary, and Implications of the OECD/G20 Base Erosion and Profit Shifting Project* (JCX-139-15), November 30, 2015, p.21. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

[22] The BEPS Monitoring Group (BMG), "Overall Evaluation of the G20/OECD Base Erosion and Profit Shifting (BEPS) Project", Available at: https://bepsmonitoringgroup.wordpress.com

Although the PPT provision is general enough to cover all the treaty shopping schemes, its interpretation and application heavily depend on discretionary decisions of the tax authorities or the courts. Therefore, the success of PPT article relies on the individual country's competence, expertise and resources, especially the useful information relevant to the treaty shopping behaviors. Unfortunately, many developing countries do not have the necessary capacity and information resources to make the best use of the PPT provision. To offer useful guidance and reference to the developing countries, we urge the OECD/G20 to publish all the latest decided cases or rulings on the PPT article on a regular basis.

To sharpen the competence of developing countries in applying the anti-abuse clauses, spontaneous, systematic exchange of information between treaty partners should be established to ascertain the pre-requisites for the taxpayer to enjoy treaty benefits. Of course, a more ambitious, global, spontaneous, comprehensive and systematic platform for exchange of BEPS data between and among all jurisdictions should be created in the future. CbCR is one of the important parts of this data bank.

Although the countries may vary substantially from each other in terms of the legislation framework, judicial interpretation tools and administrative ability, all countries involved should do their best in endorsing the minimum standard of protection against treaty shopping. In this way, the model treaty provisions included in the Action 6 report will be better adapted to the specificities of individual states and the circumstances of the negotiation of bilateral conventions.

To reduce the treaty renegotiation cost and prevent the emergence of new treaty shopping platforms, a clear and effective anti-abuse provision should be incorporated as the core article of the proposed multilateral convention.

Finally, another important issue is the policy considerations relevant to treaty entitlement of collective investment vehicles (CIVs) and non-CIV funds.[23] The OECD will continue to evaluate issues related to entitlement to treaty benefits by certain types of investment funds by early 2016. [24] But it is challenging to achieve a satisfied consensus on some key issues, as there are different definitions of CIV in different jurisdictions. Furthermore, CIV may be organized in different forms, including partnerships, agreements, trusts or incorporated entities.

## 2.11 The limits of Action 7

Although Action 7 developed changes to the definition of PE in Article 5 of the OECD Model Tax Convention, the changes are not substantially innovative. This is because the definition of taxable presence still rests on the obsolete PE concept, which requires physical presence for a period of six or twelve months in relation to the particular activity generating the profit attributable to it.

Both the traditional PE definition and the proposed changes in Action 7, are based on the independent entity principle. Without disconnection between the taxable presence and the independent entity principle, it is unlikely to make ground breaking progress in changing the definition of PE.

[23] OECD (2014), Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, P.20. http://dx.doi.org/10.1787/9789264219120-en

[24] Joint Committee on Taxation, *Background, Summary, and Implications of the OECD/G20 Base Erosion and Profit Shifting Project* (JCX-139-15), November 30, 2015, P.22.

Action 7 only targets abuse of the PE definition, instead of rewriting the definition of PE itself. However, not all forms of abuse are covered in this Action. The anti-fragmentation rule in Action 7 is only applicable to artificial fragmentation of sales functions, but not to the artificial fragmentation of non-sales-related functions. This means that MNEs will be free to continue fragmentations of non-sales-related functions, and attribute higher profits to tax havens.

According to the findings of the BEPS Monitoring Group, the proposals of Action 7 could only affect some MNEs such as those engaged in internet-based selling and which own warehouses in the country of sales. However, the proposals 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. In fact, the MNEs have already 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.[25]

Even the rules against artificial fragmentation of sales functions have some loopholes. For instance, although an entity will be deemed to have a PE, if activities can be said to be 'preparatory or auxiliary' to sales, the terms 'preparatory or auxiliary' are not clearly defined. Therefore, uncertainties and disputes are likely to arise in the future.

It should be noted that there are different legal rules in the agency, especially the indirect agency in the civil law families and the common law families. Different jurisdictions may have different definitions of the agent. In European civil law jurisdictions, a commissionaire acts in their own name for the account of a principal, but no relationship is created between the customer and the principal. As a commissionaire is not generally viewed as a dependent agent by virtue of the commissionaire status, the activities and place of business of a commissionaire are not attributed to the principal in civil law jurisdictions. However, such arrangement could create agency in common law countries.[26] Therefore, the anti-fragmentation rule should adopt a functional approach, which should be compatible with the different legal traditions of agency law in different countries.

According to the Action 7 report, follow-up works will be undertaken to provide additional guidance on profit attribution to the PEs resulting from the proposed changes, and to incorporate the proposed changes into the Model Tax Convention.[27] For the latter work, additional clarification on the new treaty wording should be provided, any unintended consequences of the changes should be addressed, and the BEPS issue related to the global trading of financial products should be considered.

We urge that the limited scope of the anti-fragmentation rule will be expanded to cover all the schemes of abuse of the PE definition. If possible, the continuing work should also reconsider the fundamental weakness of the 'functionally separate entity' approach and reorient the future reform of anti-fragmentation based on the single and unitary entity principle.

### 2.12 The limits of Actions 8-10

[25] The BEPS Monitoring Group (BMG), "Overall Evaluation of the G20/OECD Base Erosion and Profit Shifting (BEPS) Project",Available at:

[26] https://en.wikipedia.org/wiki/Commissionaire. For more details of the differences of agency law between the civil law jurisdiction and the common law jurisdiction, see also, The Research on the Agency Law in the Common Law Jurisdiction (YING MEI DAI LI FA YAN JIU), by Haiyan Xu, Press of Law, Beijing, 2000.

[27] OECD (2015), Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project, OECD., p.8.

Actions 8-10 are the most important part of the BEPS project in addressing related party transactions of MNEs. Of course, the transferring pricing documentation requirements in Action 13 are also closely relevant to these three actions. The purpose of Actions 8-10 is to assure that transfer pricing outcomes are in line with value creation. The proposals on transfer pricing have made extensive revisions to the OECD Transfer Pricing Guidelines, which in fact will further strengthen the discretionary power for tax authorities to adjust them. Many proposals take the form of international standards, which could have some direct effects as international 'soft law'.

Although the goal is totally correct, the approach of Actions 8-10 is very problematic. The solutions still focus on patch up of the dysfunctional rules built on the arm's length principle, which again is rooted in the principle of separate independent entity. According to the arm's length principle, all intra-group transactions are supposed to be rational and reasonable as commercial transactions between unrelated parties in comparable economic circumstances.

To implement the arm's length principle, Actions 8-10 made transfer pricing rules more sophisticated and complex, so as to authorize tax authorities to re-characterize the related party transactions within the MNE group. To find the available comparables, the tax authorities are required to make careful, informed judgement in good faith based on subjective analysis of detailed facts and circumstances relevant to the functions, assets and risks actually undertaken by different group members located in different jurisdictions.

As the approach of Actions 8-10 is inevitably subjective and discretionary, the real effect of attribution of the tax base of MNEs will rely on the interactive bargaining and negotiation between MNEs and tax authorities. If the game is not fair enough, either under-taxation or over-taxation will arise. To avoid under-taxation, tax authorities will tend to maximize their discretionary power of re-characterizing, which might lead to the strong opposition from the MNE taxpayers. For the similar reasoning, to avoid over-taxation, MNEs might upgrade their aggressive BEPS schemes. As a result, both enforcement and compliance costs will be increased, and more disputes will be created. Moreover, as the subjective judgement will be made independently and separately by different national authorities, different jurisdictions might make conflicting re-characterization conclusions on the same intra-group transacton.

The complicated and uncertain approach of re-characterizing intra-group transactions is most challenging for the developing countries, as they do not have the necessary resources and expertise to administer the revised version of Transfer Pricing Guidelines. Of course, it is also very costly or even impossible for the developed countries to search for really precise and genuine comparables. Although the G20 Development Working Group promised to help the developing countries to deal with the problem of lack of comparables, it is not clear whether a simple, effective win-win solution on pricing method will be made available in the near future. We don't wish to see any form of one-sided solutions, including purely subjective discretion favored by tax authorities, and purely notational transfer pricing method favored by MNEs.

As indicated earlier, the principle of the separate independent entity and the principle of arm's length are at most beautiful legal fictions, which do not actually exist in the commercial reality. In fact, even the terms of transactions between independent and unrelated parties are not necessarily fair and reasonable, if the two parties do not have equivalent negotiation powers on a level playing field. As the comparability analysis is not practical and feasible as anticipated, we propose the formulary apportionment system based on the single unitary entity principle. In other words, MNE group will be treated as single and unitary entity, and all intra-group transactions will be disregarded. Compared with the approach of separate entity, this route will be more simple, direct and effective in addressing the BEPS concerns arising from intra-group related party transactions.

In fact, the OECD has already noticed the proposed alternative income allocation systems, including formula based systems. Unfortunately, the OECD finally refused to replace the current transfer pricing system. The reason is not the flaw of the proposed alternatives, but the familiarity with the current approach and the reluctance to switch to new approach by launching ambitious reform. In the words of the OECD, "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 the best course is to directly address the flaws in the current system, in particular with respect to returns related to intangible assets, risk and over-capitalization".[28]

As early as 2013, the OECD claimed that "there is consensus among governments that moving to a system of formulary apportionment of profits is not a viable way forward; it is also unclear that the behavioral changes companies might adopt in response to the use of a formula would lead to investment decisions that are more efficient and tax-neutral than under a separate entity approach".[29]

Although the US and some other states stubbornly defended and insisted on the dysfunctional arm's length principle for transfer pricing adjustments and resisted alternatives,[30] there is no credible evidence to indicate that 34 OECD members have reached clear and concrete agreement on unanimously opposing the system of formulary apportionment of profits based on the single entity principle. Moreover, there are no scientific research findings to indicate that the single entity approach has more weakness and less strength than separate entity approach.

To offer easy, certain, clear and predictable solutions to the BEPS concerns arising from transfer pricing, over the longer term formulary apportionment methodology should be adopted, and the allocation of assets, payroll, sales and other factors need to be restructured and weighted. This will better allocate the tax base of MNE according to the location where economic activities and value creation take place. Needless to say, to make the formulary apportionment approach successful and sustainable, the principle of separate independent entity needs to be replaced by the principle of single unitary entity.

## 2.13 The limits of Action 11

Although the final report of Action 11 conducted in-depth research on measuring and monitoring BEPS and offered recommendations on collecting and disseminating data to facilitate analysis of BEPS, there are some weakness which need to be improved.

For instance, this report emphasizes that analysis of BEPS should not rely on any one indicator, and requires that the indicators should be viewed collectively to determine the scale and scope of BEPS. It is impossible for each of the six indicators to have equal weight in each and every jurisdiction. Unfortunately, this report has not offered a scientific and reliable formula of differentiating the separate weights of the six indicators suitable for the jurisdictions.

This Report offers recommendations concerning data collection and dissemination to facilitate the analysis of BEPS for participating countries,and proposes to collect new data under Action 5, 12 and 13. However, this report has not proposed to publish the CbCRs worlwide, so as to make the

[28] ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING – © OECD 2013, p.20.
[29] ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING – © OECD 2013, p.14.
[30] The BEPS Monitoring Group (BMG), "Overall Evaluation of the G20/OECD Base Erosion and Profit Shifting (BEPS) Project",Available at: https://bepsmonitoringgroup.wordpress.com

transfer pricing information available to all the countries and the public.

We're living in a society of big data. Unfortunately, this report has not offered satisfactory big data solution for the countries to use in a digital society. We believe that it is necessary to develop the big data deployment strategy, and set up a global BEPS data bank as the basic platform for collecting, exchanging, disseminating and analyzing of BEPS information all over the world.

### 2.14 The limits of Action 12

The purpose of Action 12 report is to enable the governments to have early access to information, and to quickly respond to systemic tax risks through informed risk assessment, audits or changes to legislation or tax policies.

However, the recommendations on requirements for taxpayers to disclose their aggressive tax planning arrangements are not minimum standards. Countries are free to decide whether or not to introduce mandatory disclosure regimes. Currently, only seven countries[31] have mandatory disclosure regime in their domestic legislation.

As the recommendations are not universally mandatory, it is easy for the MNEs to avoid the mandatory requirements in certain jurisdictions by incorporation in another jurisdiction without such requirements. It is also possible for the jurisdictions to join the race to the bottom by refusing to adopt mandatory disclosure regime.

In our opinion, mandatory disclosure rules should be introduced to each and every jurisdiction, and the liabilities for violation of the mandatory disclosure rules should be designed and enforced in fair and transparent manner.

### 2.15 The limits of Action 13

The annual CbCR is the most important measure in Action 13 to ensure the minimum transparency of transfer pricing. However, there are some limits with it.

First, the threshold of EUR 750 million of annual consolidated group revenue is unreasonably high for the major MNEs in developing countries, although this threshold is tailor made for the need of developed countries. Such threshold will exclude many large MNEs from the CbCR requirement, and deprive developing countries of the access to the information of MNEs below the threshold. In fact, many large MNES have annual consolidated group revenue less than EUR 750 million. Needless to say, some large MNEs will be motivated enough to manipulate their group revenue to a level of less than EUR 750 million. In our opinion, all MNEs should be subject to CbCR requirement.

Second, all the transfer pricing documents are only required to be submitted to the tax authorities, but not to the public and civil society organizations. It seems that the philosophy of this institutional arrangement is to preserve the confidentiality of the information and to ensure the appropriate use by the government. However, the commercial confidentiality is not strong enough to defeat the right of the public to information of BEPS. The relevant stakeholders and the public need to have access to the MNEs' transfer pricing documentation. The reason is very

[31] Ireland, Israel, Korea, Portugal, South Africa, UK and US.

simple, BEPS could hurt other taxpayers and stakeholders in relevant jurisdictions. We believe that the BEPS concerns will be more effectively addressed with the active and informed participation of the stakeholders and the public based on disclosed transfer pricing. Under the public pressure and support, the domestic legislatures and tax authorities will be more diligent and competent in tackling the BEPS issues. Of course, a high level of transparency will also benefit the MNEs, as it will significantly reduce compliance burden, and will improve their public image of credibility in terms of BEPS concerns.

Third, the CbCRs are only required to file with the tax authority of the MNE's ultimate parent entity's jurisdiction, instead of all the tax authorities of the jurisdictions where the MNEs have taxable business presences. To ensure rapid availability of CbCRs, we urge the CbCRs to be shared automatically and simultaneously between and among all the interested jurisdictions which have good reason to believe the existence of taxable presences by MNEs. Of course, if the MNEs' transfer pricing documentation is made available to the public, the double standards will be totally rooted out.

Fourth, although the content of the CbCRs covers the major issues of transfer pricing, it is difficult to exhaust all the data needed by tax authorities to assess the BEPS concerns arising from transfer pricing. Therefore, necessary data should be added into the CbCRs on a regular basis.

### 2.16 The limits of Action 14

The mutual agreement procedure (MAP) is the ideal win-win platform to effectively resolve treaty-related disputes between two countries. However, the MAP does not always work effectively, because any party in the dispute could block the MAP unilaterally. Unfortunately, the Action 14 has not offered remedies for the deadlock of MAP.

In fact, mandatory arbitration is the suitable remedy for the MAP deadlock. However, the Action 14 has not proposed the minimum standard of mandatory arbitration. At most, this Action encourages the inclusion of arbitration as an optional provision in the multilateral instruments. As some jurisdictions might exclude the arbitration clause in their bilateral and multilateral tax treaties, mandatory binding arbitration should be included in all bilateral and multilateral tax treaties.

It is important to note that mandatory binding arbitration should be supported by clear and predictable substantive rules, due process of law, and impartial and competent arbitrators. In our opinion, each party may freely appoint one arbitrator . If the two parties are unable to collaborate in choosing the chief arbitrator, the arbitration body may appoint the chief arbitrator.

### 2.17 The limits of Action 15

The goal of Action 15 is to streamline the implementation of the tax treaty-related BEPS measures by drafting a multilateral instrument.[32] Although this Action represents a significant step towards multilateralism, the proposed multilateral instrument has not been provided for debate. To make the multilateral instrument coherent, inclusive and feasible, the developing process should be open and transparent. Namely, the negotiations should be really on equal

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[32] OECD (2014), Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, P.10. http://dx.doi.org/10.1787/9789264219250-en

footing, the proposals should be published, all relevant stakeholders should be heard, and public debate should be meaningful.

However, participation in developing the multilateral instrument is voluntary, and participating country are not obligated to sign it.[33] This liberal approach intends to encourage more countries to participate in the development process. However, it is uncertain how many countries will sign it in the end. If the participating countries are obligated to sign the multilateral instrument, many countries will be not interested in participation. This dilemma reflects inadequate multilateralism represented by the OECD. Therefore, we believe that UN is the most qualified multilateralism platform to develop a universally binding multilateral instrument to address BEPS.

## 3. Reconsidering the International Tax Regime: A Multilateral Solution

As stated above, in our opinion it is time to re-evaluate the benefits principle. Most of the current issues can be solved if we taxed active income primarily at residence. About 90% of large multinationals are headquartered in the G20, and none of those countries have a tax rate below 20%, so if they taxed their multinationals currently on a coordinated basis and restricted the ability to move out most of the problem would be resolved.

There are three common critiques of the above approach. First, it is said that it violates certain economic neutrality norms and is therefore less efficient that territoriality (i.e., each country only taxing the income of the multinational earned within it). Second, adopting the proposed global approach is said to harm the competitive position of any given country’s multinationals. Third, adopting the proposed approach will, it is said, provide an incentive for multinationals to shift their residence to tax havens.

### *3.1 Neutrality*

There are three types of neutrality arguments that apply to cross-border investment. The two traditional ones are capital export neutrality (CEN) and capital import neutrality (CIN). CEN requires neutrality in the location of investment between the residence and source jurisdictions, and therefore supports taxing multinationals on a global basis as envisaged above. CIN requires neutrality between two different investors in a third jurisdiction (which is assumed to impose no tax) and therefore requires territoriality if the other jurisdiction taxes on a territorial basis.

It is often said that CEN and CIN are mutually incompatible in a world with different tax rates, and therefore a choice must be made. Traditionally, CEN was regarded as more important than CIN because investment locations were shown to be more sensitive to tax rates than the rate of savings, and CIN was considered to affect the rate of savings in each resident jurisdiction. But in the current environment where the tax rates of most OECD countries have converged, if the above multilateral proposal is adopted it is possible to achieve both CEN and CIN simultaneously.

[33] Joint Committee on Taxation, *Background, Summary, and Implications of the OECD/G20 Base Erosion and Profit Shifting Project* (JCX-139-15), November 30, 2015, p.32.

A new variant of the neutrality argument is capital ownership neutrality (CON), which focuses on the multinational itself and not on its investors. It is said that multinationals exist because of ownership advantages that render them more efficient than their competitors. If one multinational is subject to a higher effective tax rate than a competitor because of global taxation, then it may be forced to forego an investment in a third country even if it is the more efficient one. But if the proposed solution is adopted on a multilateral basis, then all likely competitors will be taxed in the same way and CON can be preserved as well.

### *3.2 Competitiveness*

Historically, the main argument against adopting the Kennedy proposal and similar unilateral proposals is that they would put US-based multinationals at a competitive disadvantage because multinationals from other countries are not subject to the same type of rule. The first author has always found this argument less than persuasive for several reasons: (a) it is not clear that competitiveness is a meaningful economic concept, or that the United States as a country should care particularly about the competitiveness of multinationals resident in it (as opposed to the competitiveness of the US economy as a whole or of its population); (b) the same argument was made in 1961, where US-based multinationals clearly dominated the globe, as in more recent years when their position was less dominant; (c) there is no evidence that current US rules, which deviate from the global norm of territoriality and impose tax on some foreign source income of US-based multinationals, have injured those multinationals in any significant way. In fact, empirical studies suggest that EU-based multinationals and US-based multinationals pay similar effective tax rates even though the former benefit from territoriality and the latter do not (Avi-Yonah and Lahav, 2012).

But even if competitiveness is a valid argument (and it clearly carries weight among politicians), if a multilateral approach is adopted it loses its force. As stated above, about 90 percent of large multinationals are resident in OECD countries, and the others are mostly resident in large developing countries that may also be willing to join a multilateral approach. Under these circumstances, there will be no competitive disadvantage to any residence country that adopts the global approach unless it stems from its domestic corporate tax rate. As suggested above, the United States is an outlier in this regard because its corporate tax rate of 35 percent is significantly above the OECD average. In the context of adopting such a reform the United States can and should reduce its rate on a revenue neutral basis.

### *3.3 Corporate Expatriations*

The last argument against taxing multinationals on a global basis is that the tax can be avoided by shifting the residence of the multinational to a jurisdiction that does not impose such a tax. In fact, we are currently in the midst of another wave of “inversions,” or corporate expatriations, out of the United States because of the high US corporate tax rate.

But this argument assumes that there are other jurisdictions that the multinational can move to. If all OECD countries adopt the proposal, most of the likely destinations disappear (again, assuming this is coupled with a reduction in the US corporate tax rate). There are good business reasons why the headquarters of almost all multinationals are in OECD countries, and those reasons will militate against a move outside the OECD.

A move to a tax haven may be possible if residence is defined as place of incorporation. But as suggested above corporate residence should be defined as location of the corporate headquarters, and those are much less likely to be moveable to tax havens because corporate management are not likely to want to relocate there and other facilities that usually follow the headquarters location, such as research and development, cannot easily be moved there. For the same reasons, it is unlikely that new multinationals can be founded in tax havens outside the OECD and G20 countries.

Thus, it seems that none of the common arguments against taxing multinationals on a current basis is valid if one assumes that this approach can be adopted on a multilateral basis. The key question is therefore whether a multilateral approach is realistic, which is discussed below.

### 3.4 Can the Proposal Be Adopted?

By this point, we hope the reader will be convinced that (a) current taxation of all multinationals on a global basis is the preferred approach, (b) *if* such taxation can be adopted on a multilateral basis, then all the usual arguments against its unilateral adoption by any country disappear. This is an unusual situation because in most tax policy debates there are good arguments on either side. In this case, however, the case in favor of multilateral current taxation would seem to be quite convincing, with no significant drawbacks if it can be achieved.

But, the reader is likely to object, this assumes that a multilateral approach is possible on such a sensitive issue as taxation. What is the evidence that this is in fact the case?

In order to assess whether multilateral action is possible, it is first necessary to establish the interests of the parties involved. Tax competition for FDI typically involves a MNE deciding which countries are possible investment locations from a non-tax point of view, that is, taking into account location, infrastructure, education, political stability, and other factors. Once the MNE has established a list of plausible countries, it then approaches these countries and asks what they would be willing to offer it in return for the investment. The countries then engage in a bidding war to grant tax reductions, culminating in the winner receiving the investment. Frequently, more than one country is able to get the investment.

Under these circumstances it is clear that the investment would be made in any case, whether or not the tax incentive is granted. The tax incentives are therefore a pure windfall for the MNE. If the countries could find a way to coordinate their approaches, they would still get the investment but without the tax cost.

Thus, it is in the interest of most countries to coordinate their approaches to prevent this type of tax competition. The same rationale obtains for capital exporting jurisdictions like the large countries in OECD. They would prefer to tax their MNEs on a current basis, but are constrained from doing so because of the competitiveness and expatriation concerns outlined above.

Thus, in our opinion all OECD member countries would benefit from a multilateral approach. Capital exporting countries could obtain revenues from their MNEs without concerns about harming their competitiveness or MNEs migrating to other OECD countries. Capital importing countries could obtain FDI without concern that if they do not grant tax holidays the investment would end up in other countries. In the latter case, if all OECD and G20 countries were on board, the limits on tax competition would apply outside the OECD as well since almost all MNEs are based in these countries. Countries outside the OECD/G20 would have no incentive to grant tax holidays against their own interest if the income were taxed in the residence country of the MNE, since in that case there would be no benefit to the MNE from the tax holiday.

In addition, if the proposal above were adopted, this would also help alleviate the current opposition by MNEs and some countries to country-by-country reporting, which is being considered by OECD as part of the BEPS project. Since MNEs would obtain credit for taxes levied by source countries under the proposal, they should be less hostile to country-by-country reporting, which is designed to aid source countries collect their fair share of taxes.

If the interests of the countries are aligned, what has prevented multilateral action so far? In my opinion, it is primarily because of lobbying by the MNEs themselves. They are the primary beneficiaries from the status quo and they have successfully lobbied both countries and the OECD against meaningful reform.

A useful contrast is to examine a case in which the countries and MNEs were aligned. Prior to 1977, there were no domestic limits on MNEs paying bribes overseas to obtain contracts from corrupt government officials. In 1977, following several scandals, the United States enacted the Foreign Corrupt Practices Act, which imposed criminal sanctions on such bribes by United States-based MNEs and their executives. Predictably, US MNEs complained that this ban put them at a competitive disadvantage, especially when other countries like Germany permitted foreign bribes to be deducted for domestic tax purposes.

Somewhat surprisingly, the outcome was not relaxation of the US law. Instead, the Clinton administration successfully pushed the OECD to adopt the same provisions as part of a binding, multilateral treaty, which eliminated the competitive disadvantage issue.

The key reason for this success is that not only were the interests of the countries aligned; the MNEs did not like paying bribes either and therefore lobbied in favor of the provision. This will not be the case for tax, where the MNEs are already pushing back against the OECD BEPS project. However, there have been instances in the past where resistance by MNEs has been overcome.

In the case of corporate tax avoidance, we think the best way forward is unilateral US action. The precedent is the adoption of the CFC rules, which proves (among other examples) that such action can be both possible and effective in pushing other countries to adopt similar rules.[34]

Before 1961, no country taxed the foreign source income of subsidiaries of its multinationals, because residence countries believed they lacked both source and residence jurisdiction over foreign source income of foreign corporations. However, in 1961 the Kennedy Administration proposed taxing all income of "controlled foreign corporations" (CFCs) by using a deemed dividend mechanism that was copied from the FPHC rules.

While this proposal was rejected, the resulting compromise (Subpart F, 1962) aimed at taxing income of CFCs that was unlikely to be taxed by source countries either because it was mobile and could be earned anywhere (passive income) or because it was structured to be earned in low-tax jurisdictions (base company income).

Initially, the adoption of Subpart F seemed to have put US-based multinationals at a competitive disadvantage, because no other country had such rules. But gradually this picture changed. The US was followed by Germany (1972), Canada (1975), Japan (1978), France (1980), United Kingdom (1984), New Zealand (1988), Australia (1990), Sweden (1990), Norway (1992), Denmark (1995), Finland (1995), Indonesia (1995), Portugal (1995), Spain (1995), Hungary (1997), Mexico (1997), South Africa (1997), South Korea (1997), Argentina (1999), Brazil (2000), Italy (2000), Estonia (2000), Israel (2003), Turkey (2006), and China (2008). Many other countries, such as India, are considering adopting such rules. As a result, most of our trading partners now have CFC rules.

Moreover, the later adopters improved on the US in two principal ways. First, they rejected the deemed dividend mechanism, which can lead to many unforeseen complications, in favor of taxing the shareholders on a pass-through basis. Second, they generally explicitly incorporate the effective foreign tax rate into the determination whether a CFC will be subject to current tax. This is better than the US rule that is based solely on the type of income, because after 1980 it became quite easy to earn active income that is not subject to tax.

The result is that the CFCs of EU-based multinationals are currently generally subject to tax at similar or higher rates than US-based ones, despite the non-taxation of dividends from active income under territoriality. This is therefore a classic example of constructive unilateralism. The US led and others followed, and the end result is that most multinationals are subject to similar effective tax rates, with no competitive disadvantage or advantage. The result is a world in which there is much less double non-taxation than in the absence of CFC rules.

Unfortunately, in the US Subpart F has been critically undermined by the adoption of check the box and the CFC to CFC exception, resulting in $2 trillion of low-taxed accumulated earnings offshore by US multinationals. This cannot happen in other countries with tougher CFC rules, and is a major part of the explanation why despite rampant tax competition most OECD members did not see the sharp drops in overall corporate tax revenues that are seen in developing countries.

The main argument in favor of territoriality (i.e, exempting dividends paid by US CFCs from tax upon receipt by their parents) is the lock-out problem. About $2 trillion in low-taxed foreign source income are in CFCs that cannot repatriate them because of the 35% tax on repatriations and the absence of foreign tax credits. We know this is a real problem because of the effectiveness of the 2004-5 amnesty and because of various attempts by multinationals to avoid the rule (e.g., via inversions, "killer Bs", short-term loans, etc.).

[34] We do not think unilateral action is possible on the evasion front, but as explained above coordinated withholding taxes by the US and the EU should work.

But it is less clear that the solution is a participation exemption. Why not abolish deferral and let the dividends flow back tax-free?

We would argue that this is a good opportunity for "constructive unilateralism". No G20 country has a corporate tax rate below 20%.[i] If we reduced the corporate tax to, say, 28%, and at the same time abolished deferral, the likely response by other G20 members like Germany or France would be to follow suit. They need the extra revenue more than we do, and concerns about competitiveness would be alleviated by the US move, like they were in the original CFC context.

It should be remembered that the other G20 have more effective CFC rules than we do, and those CFC rules already act as a de fact worldwide system with a minimum tax: If the foreign tax is below a set level (e.g., 25% in Germany or 20% in Japan), the CFC rules kick in to tax the income. The result is that there is much less lock out because most low-taxed foreign income is taxed by the CFC rules. The change to a worldwide system would be much less radical than usually envisaged. This is why for both the UK and Japan there was no significant increase in repatriations after they adopted territoriality in 2009.

But should the US not adopt a minimum but lower tax on foreign source income for competitiveness reasons? This is what both the Obama and Camp proposals envisage. Obama suggests a 28% corporate tax on domestic profits and a 19% tax on foreign income, while Camp proposed a 25% tax on domestic profits and a 12.5-15% tax on foreign income.

The problem, of course, is that such a gap would still encourage US-based MNEs to shift profits overseas, with no repatriation tax to deter them. We can always fall back to such a system if needed. But for now we would suggest taxing all income at the same rate, and if that rate has to be lower, so be it. As long as it is above 20% we do not think we will be outside G20 norms, and a rate in the 20-25% range will not put our MNEs at a significant competitive disadvantage given the effective minimum tax imposed by the CFC rules of our trading partners.

It is impossible to predict what will happen, but the history described above suggests that there is a good chance that other G20 countries will follow us if we abolish deferral at a lower rate.[35] And if that happens, all the usual objections to worldwide taxation (competitiveness, inversions, and the various neutralities) lose their force. We do not think there is a significant risk involved in this move, and the potential upside is quite large.

## 4. Conclusion

The benefits principle should be reconsidered in light of the reality of globalization. We should tax active income primarily at residence. This will enable the large economies to address corporate tax avoidance.

If nothing is done, multinationals will avoid the corporate tax. If that happens, ordinary middle class Americans will be reluctant to pay their taxes. Our tax system is built around voluntary cooperation; if most Americans refused to cooperate, the IRS could not force them to do so. As

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[35] See the most recent proposal of the EU Commission to tax currently CFC profits that are subject to an effective tax rate below 40% of the residence country rate if over 50% of the CFC's income is either passive or derived from sales to related parties. Council of the European Union Doc. 14544/15 (Dec 2, 2015) and Dec 14544/15 Add 1 (Dec 2, 2015), Art. 9.

the Greek experience has recently demonstrated, once a tax culture of non-payment is established, it is very hard to change. We need to do something about avoidance before it is too late.