

combat harmful tax practices



address the challenges of the digital economy

develop a multilateral instrument to aid in the implementation of BEPS

minimize transfer pricing abuse through the use of intangibles

neutralize hybrid mismatches

improve transfer pricing documentation and country-by-country reporting

reduce treaty abuse

BEPS APPRAISAL

Interview with Philip Baker QC

Impressive output so far, but the hardest parts are yet to come.

The OECD/G20¹ BEPS (Base Erosion and Profit Shifting) project grew out of a call by the G20 in June 2012 to combat aggressive tax planning and the shifting of profits to low-tax jurisdictions. Tasked with the project, the OECD issued its BEPS Action Plan on July 19, 2013.² On September 16, 2014, the OECD released the first seven deliverables—on schedule.³ The seven deliverables are the conclusion of a complex process that required extensive comments by government representatives, trade and business associations, non-governmental organizations, multinational corporations, and law and accounting firms. The G20 Finance Ministers endorsed the deliverables at their meeting with the Central Bank Governors⁴ in Cairns, Australia, on September 20-21, 2014.

The approved items represent the first tranche of the 15 Actions described in the Action Plan. The seven deliverables released and approved in September were designed to address the challenges of the digital economy (Action 1), neutralize hybrid mismatches (Action 2),⁵ combat harmful tax

practices (Action 5), reduce treaty abuse (Action 6), minimize transfer pricing abuse through the use of intangibles (Action 8), improve transfer pricing documentation and country-by-country reporting (Action 13), and develop a multilateral instrument to aid in the implementation of BEPS (Action 15).

This is not the first time that the OECD has attempted to reduce profit shifting. In 1998, it launched a multi-year project to limit the use of tax havens.⁶ That effort is widely considered a failure⁷—which raises the question of the likelihood of success of the current endeavor.

To evaluate the prospects for a positive outcome for the BEPS project, the *Journal* spoke with Dr. Philip Baker QC, a Barrister and international tax specialist with Field Court Tax Chambers, Gray's Inn, in London. He is a member of the Permanent Scientific Committee of the International Fiscal Association and a Trustee, International Bureau of Fiscal Documentation (among others), and the author of *Double Taxation Conventions and International Tax Law* (3rd ed., Sweet & Maxwell).

Dr. Baker describes the release of deliverables in September 2014 as “very impressive,” but says that the first batch of deliverables addressed the relatively easy issues and left the more difficult measures for delivery in September 2015. And in the end, he said, the success of the project depends not on how many reports the OECD produces, but on how many countries not only accept but also implement the BEPS Actions. Special features editor Scott Studebaker interviewed Dr. Baker for the *Journal*.

Adoption vs. Implementation

JOIT: Will the OECD countries adopt all 15 Actions in the BEPS project?

Baker: Something will probably be adopted on every Action point, and no country will veto any of the reports. Some countries may ultimately end up expressing a reservation or abstaining.

JOIT: And non-OECD countries?

Baker: I suspect that all non-OECD countries involved in the process will all agree to the final outcomes. Whether they will implement them or not is a different matter.

JOIT: What mechanisms exist to make actual implementation more likely?

Baker: The OECD has not abandoned the idea of making some elements of the BEPS conclusions legally binding through a multilateral instrument. While the multilateral instrument would be primarily intended to amend bilateral tax treaties, it still could be used to give legal effect to some of the other outcomes.

Additionally, the OECD might impose an element of conditionality; this has been suggested to mean that certain outcomes will only apply to country X if that country observes other outcomes. Proposals on hybrid mismatches, for example, encourage countries to implement the suggested solution: if the source country does not deny a deduction because it doesn't have legislation, the recipient country is going to tax the income that it otherwise would not have taxed. So countries



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that don't have primary legislation will be simply giving taxation rights to the other country.

Defining Success and Failure

JOIT: What would constitute failure of the BEPS project? If, in 2016 or 2017, people were to say that the project failed, what would that failure look like?

Baker: Governments are going to announce that BEPS has been a huge success regardless of the outcome. So failure will have to be judged by independent practitioners and academics who will say that, regardless of what the G20 leaders have said, this is, nevertheless, a failure. We already have the first seven sets of reports for this year [released on September 16, 2014, by the OECD and endorsed by the G20 Finance Ministers on September 21-22 in Cairns, Australia] and I assume that sets a precedent for agreeing to the reports on the remaining eight Actions next year.

Despite the progress so far, failure could come in a number of ways. Countries could agree to the reports but five years later there has been no implementation. I personally would say that if five years down the line we have not seen a major reform by the U.S. of its international tax system, then BEPS has been a failure. By major reform, I mean check-the-box has been eliminated, the U.S. CFC legislation is functioning again, and U.S. corporations are actually paying something closer to the U.S. statutory rate on their non-U.S.-source income—which will obviously be much lower by that time.

JOIT: So up to this point has the process been successful?

Baker: We're on the road to completing the outcomes. And that's not quite the same thing as success. It's relatively easy to adopt another eight reports next year. But the basic questions are whether the OECD is dealing with the



right issues and are countries going to implement the outcomes.

Unilateral Changes in Anticipation of BEPS

JOIT: Haven't we already seen some positive changes because of the attention generated by BEPS, such as the recent tax changes adopted by Australia and Canada?

Baker: I suspect that some of the countries would probably have acted in any event. What is interesting is that countries are acting in advance of the BEPS outcomes, which is a bit surprising.

JOIT: Why are countries making these changes now with BEPS measures so close at hand?

Baker: Either the countries have doubts as to whether BEPS will come to a conclusion, or it won't conclude quickly enough. Countries are acting in order to avoid a possible loss of tax

income for the next two or three years. Also, countries that make changes now may be trying to push the BEPS proposals in a particular direction. If three or four countries have adopted positions on an issue, it makes it harder for the BEPS project to adopt a different outcome. Sometimes countries adopt new tax mechanisms to influence other countries to adopt similar measures.

Patent Box Changes

JOIT: How will the patent box regimes of the U.K. in particular, but also of Ireland, Switzerland, and Luxembourg, be viewed under the BEPS proposals?

Baker: In my reading of the 2014 BEPS report [deliverable] on harmful tax practices, the nexus approach has effectively won out and all of those countries will have to change their patent box regimes so that there is a clear nexus between the tax reduction and the research and development carried out by the company. This will require a substantial reduction in the scope of patent box regimes.

EU Implementation

JOIT: Will BEPS be adopted in the EU through an EU Directive procedure?

Baker: I think that's very unlikely. Getting unanimity on a Directive would be nearly impossible and there are countries, like the U.K., that would chafe at the idea of the proposals coming from Europe. The U.K. would say that it agreed on the proposals through the OECD—what does going to the EU add?

ECJ Decisions

JOIT: Recent decisions by the European Court of Justice [ECJ] have held that member states may not restrict cross-border tax schemes if even a slight business purpose exists. Could some of the BEPS measures be found in violation of the EU freedoms?

Baker: In some of the areas, such as reform of CFC rules or treaty abuse, we really don't know how the ECJ might rule. It could well be that one consequence of the BEPS project is that a

number of European countries adopt anti-base erosion legislation and companies that have been adversely affected could then challenge that legislation as contrary to European law.

U.K. Implementation

JOIT: The U.K. government, in particular, has indicated very strong support for the BEPS proposals in various statements. Why such fulsome praise?

Baker: BEPS is fundamentally a political process and the U.K. Parliament's Public Accounts Committee has emphasized the significant loss of revenue through tax avoidance by big multinationals. So the U.K. wants to be seen as doing something to reduce the loss. BEPS is a significant project that is designed to reduce tax avoidance and it is being undertaken in common with many countries, so it answers the political embarrassment caused by the revelation that many companies are paying minimum U.K. tax. It's a way of demonstrating that the government is taking actions to combat tax avoidance.

What's important to the U.K. government [presently controlled by the Conservative Party] is the outcome of the election in May 2015. And tax fairness is an issue that could be a vote loser if the government is not seen to be sufficiently committed to challenging multinationals that avoid tax. That's why the government must be seen to be supportive of BEPS at the moment. Additionally, the U.K. has always been committed to and involved with OECD matters. The U.K. likes the OECD because it counts, realistically, as one of only seven or eight countries that is significantly involved, so it permits the U.K. to "punch above its weight" on international tax matters.

JOIT: What happens to the BEPS process in the U.K. if the May 7, 2015, general election changes the government by electing a Labour majority?

Baker: Well, the current Conservative government is claiming that it should be maintained because it has managed the economy well, and it would probably regard the patent box and the cuts



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in corporate tax rates as some of the things that have helped grow the U.K. economy. If, on the other hand, a Labour government wins in May, it may be very committed to a significant clampdown on multinationals. The U.K. attitude on BEPS could become much more cautious if the Conservative party wins, or much more of a supporter if Labour wins.

U.S. Discord on BEPS

JOIT: Why have officials in the Treasury and the IRS, and trade associations, among others, been so critical of BEPS? After all, with its high statutory corporate tax rate and the recent attention to inversions,⁸ one would assume that the U.S. would be looking for ways to address profit shifting.

Baker: The U.S. business community seems to like the current position, at least those companies that are operating internationally. For such companies, the possibility of driving down their non-U.S. tax rate to single digits is very attractive indeed. But in order for them to do that, they have to be able

to continue to erode the foreign tax base (and the U.S. tax base, for that matter) and keep their profits outside the U.S. What is puzzling is the lack of protest by U.S. corporations with primarily domestic operations. These companies are paying real U.S. tax at the high 20%-to-30% levels; so why do they tolerate the lower taxes on U.S. companies with foreign operations? There's a huge mismatch between the tax rate paid by a corporation that earns 100% of its income within the U.S. territory and one that earns, say, 80% of its income from outside the U.S. If the U.S. is not going to tax this foreign corporate income, there are many other countries that will.

JOIT: Do you expect that the U.S. will adopt the BEPS proposals?

Baker: Yes. The Obama administration will still be in place through the end of the BEPS project; that's something the OECD probably foresaw when it established the timeline. It seems unlikely that the Obama government would block the U.S. signing up to any of these outcomes that are agreed by all participants.

JOIT: So we would have a situation where the U.S. would sign on to BEPS but maintain the current Subpart F regime?

Baker: Conceivably, yes, though I would say that that is probably an example of BEPS having not really succeeded. One of the big questions is whether the U.S. is going to make the Subpart F rules operational again.

Check-the-Box

JOIT: The White House says that the check-the-box loophole costs the U.S. treasury \$10 billion a year. Will the check-the-box rules be maintained in their current form?

Baker: No rational tax system would have check-the-box. I know that historically companies could often decide through the structure they adopted whether their foreign entity was going to be opaque or not, but introducing a system where the taxpayer can decide whether foreign entities are opaque or transparent simply by checking a box—well, the government is going to be a loser on that one. Unless companies are badly advised, they are always going to check the box to their advantage. I find it amazing that the U.S. maintains the check-the-box rules.

¹ The Group of Twenty (G20) comprises 19 countries with major economies and the EU.

² See Anson, Urse, Nauheim, Dewar, and Lubkin, "BEPS: OECD and Ways & Means Start Talking Action," 24 JOIT 45 (October 2013).

³ See PwC, "OECD Recommendations on BEPS 2014 Deliverables: Few Surprises but No Let Up," 25 JOIT 24 (December 2014).

⁴ See www.centralbanknews.info/p/central-bank-governors.html.

⁵ See PwC, "OECD Report on BEPS Action 2—Hybrid Mismatches," 25 JOIT 30 (December 2014).

⁶ See OECD, "Harmful Tax Competition: An Emerging Global Issue," www.oecd.org/tax/transparency/44430243.pdf.

⁷ See Avi-Yonah, "The OECD Harmful Tax Competition Report: A Tenth Anniversary Retrospective," 34 Brook. J. Int'l L. no. 3 (2009), pages 783-95; Kudrle, "The OECD's Harmful Tax Competition Initiative and the Tax Havens: From Bombshell to Damp Squib," 8 Global Economy J. (2008), Issue 1, Article 1 (Berkeley Electronic Press), <https://www2.hhh.umn.edu/publications/7102/document.pdf>.

⁸ See McClure, "Corporate Inversions, Stateless Income, and Transfer Pricing," 25 JOIT 29 (November 2014).



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Tax Havens and Real Substance

JOIT: Under BEPS Action 10 [Other high-risk transactions], corporate substance would be measured by real activities and real assets. Would tax havens still be a useful planning option?

Baker: The answer depends on what one regards as tax havens. There are lots of low-tax jurisdictions where companies can have plenty of real activities. When one walks out of certain European airports—I’m speaking about low-tax jurisdictions—one will see U.S. multinationals with big offices, and there are many employees and lots of activities, and the companies are paying very low tax rates. However, I can’t see a huge amount of substance going into Nauru or Vanuatu or Tuvalu or other places in the Pacific.

Most Difficult Actions Yet to Come

JOIT: Did the OECD’s presentation of the deliverables on September 16 inspire confidence or uncertainty in terms of the ultimate success of the BEPS program?

Baker: I thought it was very impressive. To produce that number of reports,

to produce summaries, hold press conferences, takes a large amount of organization. At the same time, we must guard against being carried away with the presentation and forgetting about the substance.

When you actually step back from the fact that there are 700 pages of reports—all of which have been through the OECD and the G20 process and all of which have been approved—and see what has actually been agreed to, many of the issues addressed in this first year were the easy items. These are, for the most part, the low-hanging fruit. The intangibles work was already well underway before BEPS started. There wasn’t going to be too much difficulty with country-by-country reporting once multinationals accepted that more reporting was inevitable.

It’s not difficult for governments to agree on the idea of countering treaty abuse, particularly when they can have both the U.S. option of a limitation-on-benefits provision and the U.K. option of the principal purpose test. Most countries will come onboard if they have the option of one or both of those.

There are areas where not much progress has been made, such as the

digital economy (Action 1). Let’s see how the OECD does with the difficult issues next year.

JOIT: Which BEPS Actions will multinationals find most objectionable or threatening?

Baker: Multinationals don’t like aggressive audits and extensive engagement with foreign revenue authorities where negotiations and disputes often are long and difficult to conclude. And a significant danger with a number of the BEPS elements is that they could well encourage a massive increase in disputes with foreign tax authorities. There are going to be many more disputes, for example, where local tax authorities claim that a company has created a permanent establishment. Similarly there will be more disputes about the attribution of profits, and we don’t have a very good method for resolving those disputes. This is why improving the process for resolving international tax disputes (Action 14) is really critical. The work on multilateral instruments (Action 15) is also very important because it provides a way to update tax treaties and move toward greater uniformity in the wording of tax treaties. ●