

8. Corporate tax avoidance: tackling Base Erosion and Profit Shifting

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Summary

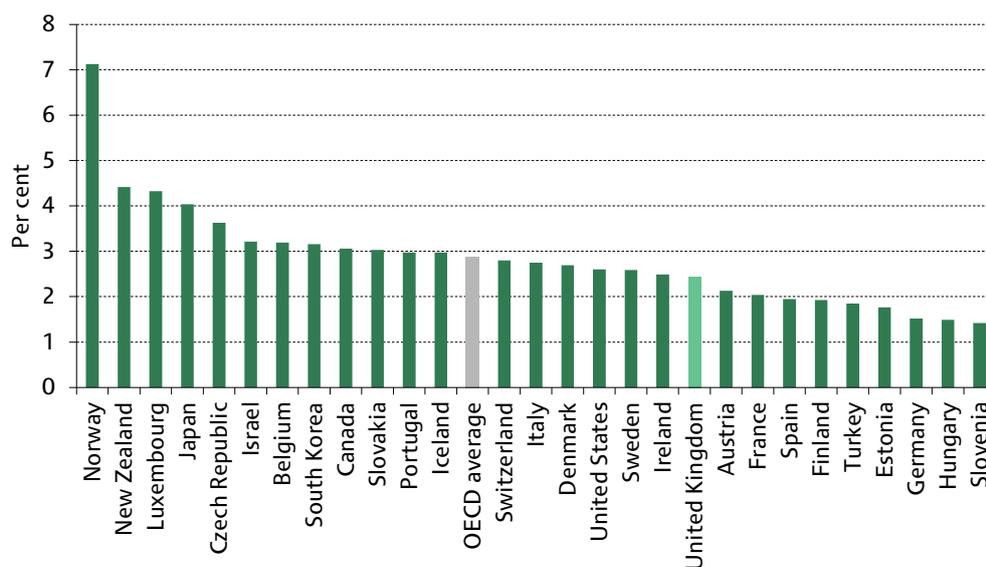
- The OECD Base Erosion and Profit Shifting (BEPS) project aims to foster consensus on how to modify corporate tax rules to prevent multinational tax avoidance. How the proposals are implemented, in the UK and elsewhere, will depend in part on how tensions between maintaining a competitive tax regime and minimising avoidance are traded off against one another.
- The UK has already introduced a new ‘hybrid’ rule to prevent multinationals from taking advantage of cases where an income stream is taxed differently in different jurisdictions. This is a good move. Other countries may follow, but some may continue to allow some hybrid structures because they can advantage domestic multinationals.
- Preferential intellectual property regimes, including the UK patent box (a reduced rate of tax on income from patents), need to be modified in 2016 to install a link between the tax break and the underlying research and development (R&D). This will limit some tax competition and will likely raise UK revenues. However, the UK’s patent box will remain poorly targeted at incentivising additional R&D.
- All countries have committed to aligning taxation rights with real economic substance better by changing the rules on how transfers within companies across borders are priced and the definition of what constitutes a taxable presence. While preventing some avoidance, aligning tax with real activities will sometimes conflict with the principle that the returns to intangible assets are taxed based on the owner’s location.
- The UK (like most countries) does not meet a BEPS best-practice recommendation for the rules that limit interest deductions of multinationals. The UK government has consulted on possible moves to restrict interest deductibility. The decision involves a trade-off: a more stringent rule would prevent some forms of avoidance but also distort genuine commercial decisions of high-debt firms and make the UK less attractive to multinationals.
- All countries have agreed to require multinational companies to produce ‘country-by-country’ reports that provide tax authorities with more information on the location of firms’ activities. This, and other information-sharing moves, will assist authorities in indentifying BEPS risks.
- The BEPS process will result in some important improvements, but is not a silver bullet. Allocating profits across countries and preventing avoidance will always be difficult. A more fundamental change to the system deserves consideration.

8.1 Introduction

It can rarely be said that corporate tax excites the imagination of the public. Over the past several years, however, one aspect has at least piqued their interest: tax avoidance. Against the backdrop of austerity, revelations that companies such as Amazon, Google and Starbucks paid little or no tax in the UK incited widespread upset, though not necessarily accompanied by a great understanding of the often complex issues underlying these outcomes.¹

The UK currently (2014–15) raises £43.0 billion from corporate tax.² This represents 2.4% of national income, which is slightly below the OECD average (see Figure 8.1). UK revenues have fallen substantially in recent years, largely as a result of the financial crisis and associated recession and subsequent deliberate policy changes rather than any increase in avoidance activity.³ Taking a longer-term view, most countries have not seen substantial falls in corporate tax revenues over the last three decades (see Figure 8.2). In many cases, falling tax rates have been offset by a higher share of corporate profits in national income.⁴ Trends in tax avoidance may also have affected these trends in corporate tax revenue, though we lack robust quantitative evidence on the extent to which it has done so. Concerns about growing avoidance are certainly prevalent.

Figure 8.1. Corporate tax receipts as a percentage of national income, 2014



Note: 'OECD average' series is an unweighted average of OECD countries and is for 2013; all other shares are 2014.

Source: 'Tax revenue as percentage of GDP for 1200 corporate', OECD revenue statistics, <http://stats.oecd.org>.

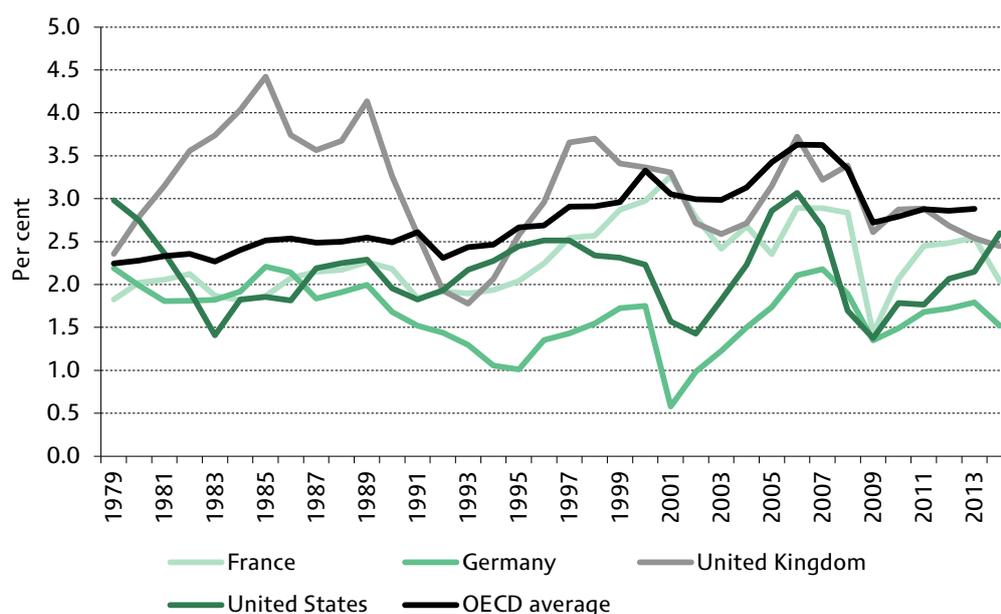
¹ Many media outlets ran large projects to highlight the strategies companies use to shift paper profits. These included Bloomberg's 'The Great Corporate Tax Dodge', the New York Times's 'But Nobody Pays That', the Times's 'Secrets of Tax Avoiders' and the Guardian's 'Tax Gap'.

² Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2015, <http://budgetresponsibility.org.uk/economic-fiscal-outlook-november-2015/>.

³ For a discussion of policy changes under the coalition government, see H. Miller and T. Pope, 'Corporation tax changes and challenges', IFS Briefing Note 163, 2015, <http://www.ifs.org.uk/publications/7590>.

⁴ For a discussion, see R. Griffith and H. Miller, 'Taxable corporate profits', *Fiscal Studies*, 2014, 35, 535–57.

Figure 8.2. Corporate tax receipts as a percentage of national income, 1979–2014



Note: 'OECD average' series is an unweighted average of OECD countries.

Source: 'Tax revenue as percentage of GDP for 1200 corporate', OECD revenue statistics, <http://stats.oecd.org>.

Policymakers in the UK and elsewhere have responded to concerns that large multinational companies are not paying enough tax with unilateral attempts to strengthen anti-avoidance rules. However, many of the opportunities for tax avoidance arise at the boundaries between tax systems in different jurisdictions. In recognition of this, in 2013 the G20 called on the OECD to coordinate a body of work that would provide a blueprint for how to modify domestic and international tax rules to tackle avoidance. The subsequent OECD Action Plan on Base Erosion and Profit Shifting (BEPS) identified 15 areas where there were possible gaps or loopholes in tax laws that facilitated avoidance behaviours, or where improvements in data, transparency and processes could enhance governments' abilities to enforce tax rules.⁵ There was a particular focus on trying to realign taxation with economic substance.

Since the launch of the BEPS project, over 100 countries (including all OECD countries, Brazil, China and India) have been involved in a massive effort to find consensus on how to redesign tax rules. This culminated in October 2015 in a series of recommendations on each of the 15 'action points'.⁶ The next phase of the process is implementation, with countries currently deciding whether and how to revise their tax rules to comply with OECD recommendations.

This chapter sets out the challenges that the BEPS process sought to tackle (Section 8.2) and how the resulting recommendations seek to address these (Section 8.3, with further details in an appendix). In Section 8.4, we consider the main changes in and choices facing the UK.

⁵ OECD, *Action Plan on Base Erosion and Profit Shifting*, 2013, <http://dx.doi.org/10.1787/9789264202719-en>.

⁶ OECD, *BEPS 2015 Final Reports*, <http://www.oecd.org/ctp/beps-2015-final-reports.htm>.

The UK government has engaged in the BEPS process and stated its intention to reduce avoidance opportunities. The previous government introduced anti-avoidance measures, most notably including a new Diverted Profits Tax aimed at changing the behaviour of some large digital-based companies.⁷ One of the aims of the BEPS project is to foster coordinated action so that countries do not introduce a patchwork of unilateral measures that complicate the system and risk fixing avoidance at the cost of taxing the same income more than once (double taxation is something that the OECD has long worked to prevent).

The UK already complies with some of the BEPS recommendations. In other cases, the government has changed or announced that it will change tax policies in order to comply. One such policy is the patent box, which will be adjusted by April 2016 in order to satisfy the new minimum requirement for preferential regimes. Some BEPS action points resulted in recommendations for best-practice rules, with the idea that countries will choose whether they want to adopt them. The most notable of these action points relates to the interest deductions made by multinational groups, where the UK (like most other countries) departs significantly from the recommendations. The UK government has just concluded a consultation on whether to change the treatment of interest expenses and is expected to set out a plan for corporate tax for the remainder of the parliament, including BEPS actions, in a Business Tax Roadmap to be published alongside the March 2016 Budget.

There is much to recommend a multilateral approach that seeks to coordinate a coherent response to avoidance issues and to address directly the gaps and mismatches in tax rules across jurisdictions. The OECD was in a good position to act as the coordinator, having spent the preceding five decades at the forefront of efforts to facilitate agreement on international tax rules.⁸ The OECD has no legal basis upon which to require countries to change their tax rules. It operates by building consensus and seeking voluntary compliance by governments. The majority of developed (and a large number of developing) countries have been at the negotiating table and many have signalled their intention to comply with at least a subset of the BEPS actions. A substantial body of work has been delivered within the ambitious two-year time frame, making it more likely that the BEPS process will benefit from continued political momentum.

The policy actions that result from BEPS are likely to prevent some forms of avoidance behaviour and make others more difficult, although the degree of success will depend in large part on the extent to which governments take action to adopt new rules. The BEPS project has sought to patch up the current system for taxing corporate profit, which has come under increasing strain as firms' activities have become more global, digital and intangible. This approach will produce a more workable but still far from ideal system. In particular, it will remain fundamentally difficult to allocate profits of multinationals to different jurisdictions and countries will continue to have the incentive to compete to attract both real activities and paper profits. A more satisfactory solution to concerns that multinationals are bending the rules to avoid tax may require more radical moves to a different type of tax system. We continue this discussion in the concluding section.

⁷ For more details, see H. Miller and T. Pope, 'Corporation tax changes and challenges', IFS Briefing Note 163, 2015, <http://www.ifs.org.uk/publications/7590>.

⁸ Most notably, the OECD Model Tax Convention launched in the 1960s has provided a framework for eliminating double taxation of multinationals' income streams and the OECD Transfer Pricing Guidelines, formalised in 1979 and regularly revised since, are now used by most countries as the basis for implementing the arm's length principle.

8.2 Avoidance: how and how much?

Most governments seek to tax corporate profits that are created within their jurisdiction. This is a relatively straightforward task for firms that operate in only one country. It is much more challenging when companies operate across borders. In this case, profits must be allocated to different tax jurisdictions. Large companies, many of which are multinational, account for the vast majority of UK tax revenues. In 2007–08, 1% of companies contributed around 80% of revenues.⁹

The rules used to determine profit allocations stem from a set of principles that were put in place in the 1920s. Since then, firms' activities have changed massively. They have become more global: around 60% of trade is in intermediate goods and much of this occurs within companies across country borders.¹⁰ There has also been an increase in the role of the digital economy and a move away from investment in physical machinery towards 'intangible' assets, such as intellectual property (IP). UK investment in intangible assets overtook investment in physical assets in the early 2000s, and continues to increase as a share of total investment.¹¹ These changes make it more difficult to value different activities and to identify where they should be taxed. This in turn puts pressure on tax rules and creates avoidance opportunities. This section discusses what the tax system is currently trying to tax, how multinationals can try to avoid this liability, and the rules in place to try to stop them.

Defining tax liability

Taxable profit is equal to sales revenue minus certain allowable deductions, including for wage costs, material costs and some capital investment (through capital allowances). When a company operates in more than one jurisdiction, more than one country may lay claim to the taxable profit. For example, if a UK company makes sales of a new product through an establishment in France, then both the UK and French governments may wish to tax (at least part) of the resulting profits. A method of allocation between countries is required to ensure that the same profit is not taxed multiple times.

Broadly, countries have agreed on the notion of allocating profit on a source basis, meaning that profits are taxed where the underlying value added was created.¹² In the above example, this means that the profits arising from sales in France should partly be taxed in the UK and partly in France, depending on the relative importance of the UK functions (for example, designing and producing the new product) and those in France (for example, sales activities). The returns to intangible assets – for example, patented technologies – tend to be taxed where the owner of the asset is located. This may, but

⁹ See M. Devereux and S. Loretz, 'Corporation tax in the United Kingdom', Oxford University Centre for Business Taxation, 2011, https://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Reports/corporation-tax-in-the-uk-feb-2011.pdf.

¹⁰ Page 122 of UNCTAD, *Global Value Chains: Investment and Trade for Development*, World Investment Report 2013, http://unctad.org/en/PublicationsLibrary/wir2013_en.pdf.

¹¹ Intangibles are also an important input in other countries. See C. Corrado, J. Haskel, C. Jona-Lasinio and M. Iommi, 'Intangible capital and growth in advanced economies: measurement methods and comparative results', Institute for the Study of Labor (IZA), Discussion Paper 6733, 2012, <http://ftp.iza.org/dp6733.pdf>.

¹² For a fuller discussion of the definition of UK taxable profit and the identification of avoidance, see H. Miller, 'Corporate tax, revenues and avoidance', in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2013*, http://www.ifs.org.uk/budgets/gb2013/GB2013_Ch10.pdf.

need not, be the same location as the real activities that created the asset.¹³ It is this feature of the tax system that often leads to claims of tax avoidance. For example, a commonly-discussed case is that of Starbucks. Starbucks paid no corporation tax in the UK in 2012 in part as a result of significant royalty payments for the use of the Starbucks brand, the intellectual property for which was held in a Dutch subsidiary (i.e. Starbucks claimed that most of the profits it earned came not from the sale of coffee through UK shops but through the exploitation of its brand).¹⁴

Allocating profits can be difficult conceptually because it can be hard to assign profits that are contingent on activities in multiple countries. For example, the 'UK' and 'French' parts of the company may have designed a new product in collaboration – what is the value of one part of the business without the other?

In practice, allocating profits to different countries is achieved by pricing all transactions that happen within a company (between related parties) across a border. A key outcome of OECD efforts in the 1970s was that countries agreed to set these 'transfer prices' according to the arm's length principle: prices must be set as if the transaction occurred between unrelated parties. In our example, there would be a price associated with the UK activities. The higher that price (i.e. the more valuable the UK activities), the higher the taxable UK profits and the lower the taxable French ones. In the Starbucks case, the price refers to the royalty. The idea is that the arm's length principle should ensure that profit is allocated to the value-creating activities.

Opportunities for avoidance

HM Revenue & Customs (HMRC) defines tax avoidance as 'bending the rules of the tax system to gain a tax advantage that Parliament never intended' and 'operating within the letter – but not the spirit – of the law'.¹⁵ However, this definition, resting as it does on an interpretation of the 'spirit of the law', is inherently difficult to apply in practice. It is thus difficult to identify, and so prevent, instances of tax avoidance.

The OECD project considers two broad types of multinational tax avoidance. Base erosion refers to cases where companies take advantage of differences between rules in different jurisdictions to achieve 'double non-taxation' – a situation in which income is not taxed in any country. Profit shifting refers to the artificial transfer of profit from higher- to lower-tax countries. It also identifies tax avoidance that is related to the definition of which types of entities should be deemed to be part of the tax base.

Profit shifting

Conceptually there may be no 'correct' transfer price, and in practice there may be no comparable third-party transaction from which to estimate it. One of the key advantages of operating as a multinational is the ability to make investments and transfers that would not happen between unrelated parties (because, for example, it is difficult to write

¹³ This is often referred to as intangible assets being taxed on a residence basis. See page 12 in Section 8.3 for an example of this.

¹⁴ See 'Special report: how Starbucks avoids UK taxes', Reuters, 15 October 2012, <http://uk.reuters.com/article/us-britain-starbucks-tax-idUKBRE89E0EX20121015>. Starbucks has since restructured some of its business practices.

¹⁵ Page 12 of HM Revenue & Customs, *Measuring Tax Gaps 2015 Edition*, October 2015, <https://www.gov.uk/government/statistics/measuring-tax-gaps>.

complete contracts¹⁶). Firms face incentives to take advantage of ambiguity around the ‘correct’ allocation of taxing rights and to report their activities in such a way as to minimise their tax liabilities. Specifically, firms may seek to charge a higher price for inputs coming from low-tax countries, or a lower price for inputs coming from high-tax countries, in order to reduce the overall tax liability of the multinational group.

Intellectual property (IP) such as patents, trademarks, copyright and trade names can be particularly difficult to value because it is often highly specific and has no third party comparator. It can also make no conceptual sense to value any given piece of IP separately from related IP and other activities. An added difficulty is that the location of IP is highly mobile. For example, firms can, and do, separate the research and development (R&D) activities that create a patent from the ownership and resulting income streams. Unlike with a machine, the use of the knowledge embedded in a patent or of a brand protected by a trademark does not depend on the location of the IP: a patent held in the Netherlands can easily be simultaneously used in many countries. Firms may locate IP in a low-tax country for non-tax-related commercial reasons or with a view to reducing their tax liabilities, and distinguishing between the two motives may be impossible. The size of royalty flows is large. In 2014, the UK received royalties (including those within and between groups) worth \$20 billion and made payments of \$11 billion,¹⁷ making the associated tax liabilities at stake large.

Base erosion

Base erosion can be achieved in a number of ways. There are two areas that received particular attention in the BEPS reports: intra-group debt and hybrid entities.

Interest paid on debt is deductible from taxable profit as a business expense, while interest received is taxable. Firms can shift profit through intra-group loans from a subsidiary in a low-tax country (where the interest payments received will be taxable income) to one in a high-tax country (where interest payments made will get tax relief). This reduces overall tax liability. In a variant of this, companies can also reduce the total tax liability by taking out third-party loans in high-tax countries (where the interest deduction reduces tax liability by more), before transferring these funds to an investing company in a lower tax country. Box 8.1 provides examples.

A further dimension of avoidance risk surrounding debt is hybrid debt instruments and entities. Hybrid debt instruments often look at face value like debt but have some features of equity (an example is ‘convertible bonds’, which are bonds in a company that the holder can choose to exchange for a specific number of the company’s shares). These instruments may be treated differently by different jurisdictions. When one jurisdiction treats an instrument one way – for example, as debt – and another treats it in a different way – for example, as equity – firms can exploit the mismatch in tax rules to achieve double non-taxation (the profit is not taxed anywhere). A multinational can structure its affairs such that the interest in one country is deducted, while the interest paid is not taxed in the other country. This constitutes base erosion – profit is not merely taxed at a lower rate: it is not taxed at all.

¹⁶ A complete contract would specify all parties’ rights and responsibilities for every possible future state of the world. Since a third-party lender cannot perfectly observe how a borrower behaves or dictate behaviour that may affect the probability of default, the lender will require a risk premium.

¹⁷ Source: World Bank, ‘Charges for the use of intellectual property’, receipts and payments, <http://data.worldbank.org/indicator/BX.GSR.ROYL.CD>.

Box 8.1. Interest deductibility and tax avoidance

Example 1: Intra-group loans

Consider a multinational company with two subsidiaries, subsidiary A in a country with a tax rate of 10% and subsidiary B in a country with a tax rate of 20%. Subsidiary A makes a loan to subsidiary B of £100 million at an interest rate of 10%. The interest on the loan is £10 million, which is deducted from subsidiary B's taxable profit and added to subsidiary A's taxable profit. Assuming subsidiary B has other profits against which to offset this payment, tax payable by subsidiary B decreases by £2 million (20% of £10 million) while tax payable by subsidiary A increases by £1 million (10% of £10 million). Overall, therefore, the intra-group loan has reduced the tax liability of the multinational group by £1 million.

Example 2: Location of third-party interest expense

Now consider an investment made by subsidiary A of £100 million with a return of 20%. If subsidiary A takes out a third-party loan of £100 million at an interest rate of 10%, the pre-tax profit of the investment will be £10 million and the post-tax profit will be £9 million.

If, on the other hand, subsidiary B takes out the same loan and provides £100 million in cash to subsidiary A (an untaxed equity purchase), pre-tax profit of subsidiary A will be £20 million and the pre-tax loss in subsidiary B will be £10 million. Assuming subsidiary B can offset this loss against other profits, the post-tax loss is £8 million, while the post-tax profit for subsidiary A is £18 million. The total pre-tax profit is £10 million and the total post-tax profit is also £10 million. By locating interest in the higher-tax country, the multinational has ensured that the investment is not taxed at all.

A hybrid entity is a similar concept – a company that is viewed differently by different jurisdictions. An example used by many UK multinationals investing in the US is a 'tower structure'. This could work as follows. A UK parent has a subsidiary in the US, which itself has a subsidiary in the UK. The UK parent makes a loan to the UK subsidiary. This does not affect the UK tax liability: the deduction in the subsidiary effectively cancels out the extra income in the parent. However, from the US perspective, the US company specifies that its UK subsidiary should be treated as a branch. US tax rules allow branches to be 'looked through' and treated as part of the US entity. From the perspective of the US, the UK parent is irrelevant. The interest payments made by the UK subsidiary can therefore be deducted against the company's US tax liability. Because the entity is treated as a UK company by the UK and a foreign branch by the US, the interest is deducted in both jurisdictions. This works to strip tax liability out of the US.

Assigning taxation rights

Tax treaties (which assign taxable rights between two countries) state that a company's profits are taxable in a foreign jurisdiction in as far as it operates a *permanent establishment* (PE) in that jurisdiction. This is an internationally agreed definition of what constitutes a fixed place of business that gives rise to taxable income. The rationale is that if, say, a company performs all of its substantive activity in its home country and simply has a storage or distribution facility in a second country, sales income in that second country should be assigned to the home country. In practice, this creates an incentive for firms to structure themselves to avoid PE status in higher-tax countries so that profits flow to a lower-tax jurisdiction. This concern has often been raised in the case of Amazon, for example, which in recent years has claimed that much of its EU activity is conducted

from Luxembourg and not through a UK PE (i.e. profits from sales are attributable to Luxembourg and not to UK storage and distribution facilities).¹⁸

The taxation rights over certain transactions, such as the payment of interest or dividends, are principally assigned to the jurisdiction of the recipient. However, transactions may also be taxed in the jurisdiction where that payment arose through a withholding tax. Tax treaties between countries limit the withholding tax, often to zero. Not all countries have bilateral treaties with one another, and some treaties are more generous than others in terms of the maximum level of the withholding tax. The limitation of the withholding tax is a 'treaty benefit' and firms may try to benefit from the treaty even when it should not apply to them. For example, if a UK company is making an interest payment to a company in a tax haven (with which the UK has no treaty), the company may limit the withholding tax paid by 'artificially' routing the payment through a country with which the UK does have a treaty. This is called 'treaty shopping' and means income may be subject to low or zero tax when a UK withholding tax should have applied.

How much avoidance?

No one knows how much tax revenue is lost to multinational tax avoidance. This is partly because there is no accepted definition of what constitutes 'avoidance' and partly because we lack full information about the activities of firms. HMRC estimates a UK 'tax gap' – the difference between the amount of tax it estimates it is entitled to and the amount of tax actually collected. In 2013–14 the estimated gap attributable to corporate tax avoidance was £1 billion, 2.5% of that year's corporate tax revenue. However, this measure is not designed to capture the bulk of multinational base erosion and profit shifting so is an underestimate.¹⁹

Much larger estimates have been arrived at. One approach to quantifying profit shifting is to measure the difference between the amount of tax declared on firms' accounts and an estimate of the tax due. For example, a Trades Union Congress (TUC) report estimates that £12 billion is lost each year through avoidance of the 700 largest UK corporations, equivalent to 27.9% of 2014–15 revenues.²⁰ However, such measures can overstate the tax gap (possibly by a wide margin) because, in estimating the tax that 'should' have been paid in the UK, they do not fully account for deliberate features of the tax system that reduce tax liabilities. For example, taxes paid can be legitimately reduced by capital allowances, the R&D tax credit or loss carry-forwards. The TUC estimate may also be an underestimate to the extent that it does not capture UK taxes that are avoided by some foreign multinationals.

It should be noted that observing a firm operating and paying taxes in a low-tax country does not necessarily indicate tax avoidance – firms take tax into consideration when

¹⁸ See 'Amazon: £7bn of sales, no corporation tax', *The Guardian*, 4 April 2012, <http://www.theguardian.com/technology/2012/apr/04/amazon-british-operation-corporation-tax>. Amazon restructured some of its business practices in 2015.

¹⁹ The total tax gap estimate was £34 billion, with £3 billion related to corporate tax (including evasion, predominately by small and medium-sized enterprises). The tax gap calculation is based on cases that HMRC has identified and is litigating against. HM Revenue & Customs, *Measuring Tax Gaps 2015 Edition*, October 2015, <https://www.gov.uk/government/statistics/measuring-tax-gaps>.

²⁰ See Trades Union Congress, 'The missing billions', <https://www.tuc.org.uk/economic-issues/missing-billions-uk-tax-gap>. The Guardian's analysis takes a similar approach (<http://www.guardian.co.uk/business/series/tax-gap>).

making genuine commercial decisions. Distinguishing between legitimate responses to the tax system and avoidance behaviours is very difficult.

Based largely on existing studies, the BEPS project estimated the global revenues lost to BEPS at between \$100 billion and \$240 billion per year, which is between 4% and 10% of total global corporate income tax revenues. This large range reflects the high degree of uncertainty. One of the 15 BEPS action points is devoted to constructing better measures of the scale of avoidance globally.

The widespread perception is that the prevalence and scale (in terms of revenue forgone) of avoidance activity are very large. In reality, the amount lost may be much smaller than imagined. Avoidance may often be overestimated due to the difficulty of defining what counts as avoidance – holding intellectual property in a low-tax country is often thought of as synonymous with tax avoidance, but in many cases may just represent firms responding to tax incentives. Importantly, even if we could precisely estimate the revenue lost to avoidance, it would not be right to assume that, were all avoidance opportunities to be completely removed, the UK's total tax take would increase by that full amount. We would expect reduced avoidance opportunities to lead to higher taxes, which feed through, at least to some degree, to lower investment in the UK and changes in prices such that genuine UK profits may be lower. Raising taxes (including by reducing avoidance opportunities) changes incentives and can deter real economic activity. The overall impact of a tax rise would depend in part on how the resulting revenues were used.

While we cannot confidently quantify how much revenue might be on the table, we do have evidence of specific avoidance channels. Removing avoidance opportunities, especially if done on a coordinated basis across countries, can reduce distortions related to tax planning and protect tax bases.

8.3 The BEPS recommendations

The BEPS project set out to find improvements to tax rules that would reduce avoidance opportunities. Of the project's 15 action points, most are focused on a specific aspect of domestic or international tax rules. The recommendations, which are summarised in Table 8.1, vary by action point and can be broadly categorised into three types: **minimum standards** to which countries have agreed their tax rules must adhere; **revised international standards** that will be incorporated into tax treaties; and recommendations for common approaches and **best practices**. Four actions are concerned either with the **measurement** of BEPS or with the **processes** required to implement changes. The table highlights the UK action required or under way in each area. An appendix explains each of the main issues in more detail. Section 8.4 discusses the main policy changes for the UK.

One area that the project focused on, and where legislative action is already taking place in the UK and elsewhere, is improved transparency and information flows. In particular, countries are legislating to require that multinationals file a country-by-country report detailing certain key statistics for each jurisdiction in which they operate. This information will then be shared between tax authorities and should help authorities identify BEPS risks and target their resources (such as audits) more effectively.

Table 8.1. BEPS recommendations: a summary

Main issue (action point)	Recommendation(s)	UK action
Minimum standards		
IP / patent box regimes (5)	New 'modified nexus approach' to align tax benefit with real activity	UK regime to be modified by July 2016
Treaty benefits (6)	All treaties to incorporate explicit intention (of governments) to prevent treaty abuse	UK adopted a 'main purpose test' in 2012 (the main purpose of an arrangement cannot be to gain a treaty benefit), which already meets the minimum standard
Transfer pricing documentation and country-by-country reporting (13)	Provide tax authorities with more information on transfer pricing policies and location of activities	Required by 2016; UK has begun legislative process; UK firms to start reporting from 2017
Revised international standards		
Transfer pricing guidelines (8–10)	New practice for assessing the value of intangibles and the allocation of risk	New guidelines will be adopted (UK legislation refers directly to OECD guidelines)
Permanent establishment (7)	Broaden definition of a permanent establishment	UK will adjust bilateral treaties
Best-practice approaches		
Interest deductions (4)	New 'fixed ratio' rule for limiting interest deductions	Consultation in UK on whether to adopt ended January 2016
Hybrid mismatches (2)	New two-part hybrids rule to prevent instruments / entities being treated differently across countries	UK has already legislated for new rule to start on 1 January 2017
CFC rules (3)	Framework for designing a rule	UK regime was revised in 2011; it does not adhere to best practice rule, but will not be changed
Mandatory disclosure rule (12)	Require promoters and/or firms taking part in certain schemes to report scheme to tax authority	UK has operated disclosure of tax avoidance schemes (DOTAS), which meets the recommended best practice, since 2004
Measurement and process		
Measuring BEPS (11)	Measures to improve availability and analysis of data	OECD plans to work with countries to improve data availability and analysis
Mutual agreement procedure (MAP) (14)	Mechanism to settle international taxation disputes	All countries adhering to the BEPS outcomes, including the UK, have signed up to ensure the MAP is utilised; more work on how to resolve disputes is under way
Multilateral instrument (15)	Mechanism to adjust all bilateral tax treaties simultaneously	Instrument being designed; UK expected to sign up; outcome expected later in 2016

Note: Action point 1 (not listed) seeks to address 'tax challenges of the digital economy'. The report on this action concluded that the digital economy should not be treated separately for tax purposes. The challenges are address as part of the specific issues in other actions.

Source: Authors' own summary based on OECD, BEPS 2015 Final Reports, <http://www.oecd.org/ctp/beps-2015-final-reports.htm>.

The implementation of BEPS is just as important in determining the success of the project as the work set out to date. The OECD has no power to impose the minimum standards or adherence to new processes. Implementation of BEPS instead relies on pressure and consensus from the international community to ensure the recommendations are implemented. For treaty changes (for example, on PEs and treaty benefits) to be swiftly and successfully implemented, a multilateral instrument must be developed and adopted. The minimum standards on information sharing and preferential regimes require unilateral amendments to domestic legislation.

One of the largest unknowns is how many governments will move to adopt any of the new best-practice rules. A key tension here is that strengthening controlled foreign company (CFC) rules or reducing interest deductibility may make a country a less attractive location and therefore be in conflict with a country's competitive aims. Many countries face an incentive to see what others do before changing their own policies, and no government may be willing to move first.

A new principle

An overarching aim of BEPS was to align taxing rights more closely to economic substance. This may sound innocuous. In some cases, it amounts to reinforcing what the current system is trying to achieve and is therefore desirable. However, in other cases, it represents a new principle being added in such a way that it can conflict with the pre-existing principles.

The desire to realign the taxation of profits with the real activities that created them may appear to be a straightforward and sensible restatement of what the tax system is already trying to achieve. Firms can sometimes organise themselves in egregious ways that involve the complete separation of taxable income from any real activities and are purely motivated by the avoidance of tax. It is desirable to prevent this.

However, the idea that the taxation of profits always be aligned with real economic substance is not a principle that underlies current tax rules. It is often the case that tax liability does arise alongside real activities. For example, if a company is building and selling cars, we would expect a tax liability to arise alongside the car-building factory and the employment of workers. But, as highlighted in Section 8.2, the current system aims to tax the returns to intangible assets in the location of the asset owner. This means that taxable income may arise in a location that is different from that in which the underlying technology was created or sold. There would be benefits to reconsidering the principles of the current tax system, assessing whether they deliver the outcomes that policymakers desire and, if they do not, designing a new set of principles. The BEPS actions do not amount to replacing the old principle (that returns to intangibles are taxed based on ownership) with a new one (that returns are always taxed where economic substance is located), but to having both principles operate at the same time. This may be a form of second-best solution to avoidance. But it means that any benefits come at the cost of a less coherent and more complex system.

Consider the following example. A UK multinational decides it wants to move into the driverless car market. It contracts a US subsidiary to research the new technology required to do this. The US subsidiary creates a new technology and gets a patent which is held by a Dutch subsidiary that is involved with managing the IP. The US subsidiary will earn (taxable) income (i.e. a payment from the UK firm) that reflects the value of the R&D activity (commonly the cost of conducting the R&D plus a markup). The UK firm will earn

income by selling cars that incorporate the new technology. The UK firm will also make royalty payments to the Dutch subsidiary reflecting the value of the patent (possibly including any economic rents that accrue as the result of the market power bestowed by the new technology). The more valuable the patent (i.e. the more of the value of the cars that results from the new technology), the higher the taxable income in the Netherlands and the lower the taxable income in the UK. This is a case where a large amount of income may accrue in a location (the Netherlands) without there being a great deal of 'economic substance' (possibly just a small team of people to manage the IP). This is effectively the choice that was made about how to run the international tax rules.

However, firms can sometimes abuse the fact that intangibles are taxed according to the location of ownership to avoid taxes. We already have transfer pricing rules that aim to deal with this by ensuring, for example, that the income received in the Netherlands only reflects the value of the real economic activities (i.e. the US subsidiary gets the correct price for the value of the R&D, the UK gets the correct price for the value of integrating the technology and selling cars, and the Netherlands only receives a payment for managing services). In practice, as discussed above, it is difficult to price all transactions correctly (and in many cases there will be no 'correct' answer on how to divvy up profits). And because the income streams associated with intangible assets are large, the location of the associated tax revenues is of much interest to companies and governments. The BEPS approach is effectively seeking to override current outcomes when they are deemed undesirable.

A number of the actions have adopted the new substance requirement.²¹ For example, modifications will be made to the transfer pricing guidelines to clarify that ownership of intangible assets alone does not give a company the right to any or all of the profit flows associated with that asset (see the appendix for further details). The basic idea is that, in examples such as the above, more weight will be placed on the real activities of the IP owner (for example, what they are contributing to the management of the asset) in determining the correct transfer price. Again, this may help prevent avoidance. But it may also conflict with the outcome that would be expected under the current rules even absent avoidance. For example, the new rules could mean that the arm's length price received by the Dutch subsidiary is lower than if it licensed the technology to a third party. Changes to IP boxes are also driven by the desire to align taxing rights with real activities and we give an example in Section 8.4 of where this may override current principles.

In summary, adding a new principle provides a way for governments to move taxing rights towards something that they think more accurately reflects where value is created. In some cases, this will prevent tax avoidance. But it does come at the cost of having a tax system that embeds two principles that sometimes conflict and that is therefore less coherent and more complex. It may also distort genuine activities in some cases. It will still be difficult to assess the correct transfer price and the new approach opens the door for disputes over whether passive income (such as royalty flows to a patent) should be taxed based on the residence of the owner or under the new substance requirement. Further, many firms will face an incentive to adjust their activities by just enough to meet the minimum substance requirement rather than to restructure their activities completely.

²¹ Most notably, actions on harmful tax practices (5) and transfer pricing (8–10).

The BEPS process could have done much more to acknowledge that the substance requirement can be at odds with current principles and to consider explicitly how the interaction will work.

8.4 Main implications for UK policy

Table 8.1 highlighted the actions that the UK is undertaking (or has undertaken) as a result of the BEPS process. Here we consider four of these in more detail and discuss the likely overall effect for UK tax revenues.

Redefining permanent establishment status

The BEPS process sought to deal with concerns that companies are avoiding tax by structuring themselves such that they do not have a taxable presence (a PE) in a foreign jurisdiction by broadening the definition of PEs in international tax rules. The revisions are particularly focused on tackling issues related to the digital economy. Notably, entities are currently exempt from PE status if they undertake only activities of a 'preparatory or auxiliary character', such as storage and distribution.²² This means that a UK consumer may purchase a good via the website of a foreign company (such as Amazon) that is then delivered from a UK distribution centre, and that transaction will not lead to a UK corporate tax liability because there was no UK PE involved. This is the correct outcome under current law. But it leads to concerns that some activities are being undervalued and countries therefore missing out on taxable income. Storage and distribution facilities may actually constitute core business activities that contribute to the creation of value added (for example, by providing quick distribution or high levels of customer service).

To operate the current rules, we require a definition of what constitutes a taxable presence and what does not. There is no clear answer. The rules dictating PE status will be revised to move where the dividing line is drawn. In particular, the revised rules will specify that storage and distribution activities will constitute the operation of a PE unless the activities are genuinely only preparatory and auxiliary in nature, which is, of course, still somewhat subjective. There will also be clarifications to prevent some forms of 'commissionaire' arrangements, whereby a good is sold by one company on behalf of one in another country, such that the sales go directly to the other company. Relatedly, there will be clarifications to address situations where a seller avoids having a PE where sales take place and instead formally concludes sales in a lower-tax jurisdiction. Google has used the latter form of arrangement: substantial negotiation of sales happens in the UK but Google sales are booked in Ireland.²³

Redefining PE status should result in taxing rights that better reflect the source of profits if countries find a way to adjust bilateral treaties to implement a new PE definition, and if that works to redefine some activities that are currently deemed auxiliary.

It is worth noting that this change may work in both directions for the UK. For example, more income (and therefore tax) could be received from the UK storage and distribution

²² Article 5(4) of OECD, 'Model convention with respect to taxes on income and on capital', 2014, <http://www.oecd.org/ctp/treaties/2014-model-tax-convention-articles.pdf>.

²³ See 'Google avoided \$2bn tax by funnelling profits through Bermuda', *Daily Telegraph*, 10 December 2012, <http://www.telegraph.co.uk/finance/personalfinance/tax/9735448/Google-avoided-2bn-tax-by-funnelling-profits-through-Bermunda.html>.

facilities of foreign multinationals (such as Amazon) – although some companies may choose to adjust their activities to avoid becoming a PE. At the same time, some UK multinationals may receive less foreign income if their foreign storage and distribution facilities are given PE status.

Preventing hybrid mismatches

The longest BEPS report set out a best-practice framework for hybrid debt structures (such as tower structures – see Section 8.2). The recommendation was a set of rules to ensure companies could not benefit from instruments (or entities) being treated differently in different jurisdictions. The new rule specifies new rules for instruments and entities, each with two parts. For instruments, the rule is:

1. A transaction that generates a deduction from tax in one country (for example, an interest payment) should only be allowed if the corresponding income (for example, interest received) is taxed in another country.
2. If part 1 is breached (i.e. the transfer and deduction go ahead), a defensive rule can be applied and the transfer will be included as taxable income in the second jurisdiction.

For entities, the rule operates a little differently:

1. When a hybrid entity would achieve a ‘double deduction’ of a payment, the deduction in the parent jurisdiction (the country in which the multinational parent is based) is disallowed.
2. If part 1 is breached, a defensive rule is applied and the deduction will be disallowed in the subsidiary jurisdiction instead.

By linking the tax treatment in one jurisdiction to the tax treatment in another, this rule prevents hybrid mismatches from occurring. The UK is among a group of countries that has already legislated for this rule (Australia is another). It will be in place in the UK from 1 January 2017.²⁴ This is a positive move that will prevent some forms of avoidance, including the much-used tower structure cited above (UK companies have already started the process of unwinding such structures). In this specific case, the UK is the parent jurisdiction and, under the new hybrid entities rule, the interest deduction would be disallowed in the UK while taxable income in the US would be unaffected.

One of the nice features of this type of rule is that it is designed to encourage take-up among countries. The inclusion of the defensive rule means that, if one country has the rule, other countries in which the same multinational firms operate and use hybrid arrangements may be forgoing tax revenue by not having it. From the perspective of the multinational, it makes no difference whether one or both countries have the rule as either way the use of the mismatch is prevented. A country therefore gains a competitive advantage only so long as other countries within which its firms operate do not have a rule. Otherwise, the defensive rule employed by other countries would simply reduce tax revenues (with no corresponding competitive advantage). However, since many countries do not currently have the rule, many may be reluctant to introduce it and thereby reduce the competitive advantage to domestic multinationals. This new hybrid rule will be most effective if a significant number of large countries implement it. A

²⁴ HM Treasury, *Autumn Statement 2014: Policy Costings*, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/384071/AS2014_policy_costings_final.pdf.

disadvantage of a best-practice rule rather than a minimum standard is that countries may struggle to coordinate on the introduction of hybrid rules.

Patent box

The UK's patent box – its own version of an IP box – offers a reduced corporate tax rate of 10% on the income derived from patents, compared with the main rate which is currently 20% and will fall to 18% by 2020.²⁵ By the end of 2015, the policy had been used by 639 companies, representing a cost to the exchequer in terms of forgone tax revenue of £335 million to date.²⁶ This is forecast to rise to £740 million in 2016–17.²⁷

The UK patent box, like all similar regimes operating in Europe, does not currently meet the minimum standard for preferential regimes set out by BEPS. In particular, it does not require that the research underlying a new patent took place in the UK.²⁸ The current scheme will be closed to new entrants from April 2016 (with grandfathering of existing patents until 2020–21) and replaced by new rules that follow a 'modified nexus approach'. At the end of 2015, the government ran a consultation on exactly how the policy will be changed.²⁹

The aim of the new 'modified nexus approach' is to ensure that the granting of a tax benefit aligns more closely with the location of real activities. The policy change required will be larger in some other countries than in the UK (because their policies are further away from the minimum standard). The new approach will make the policy better at attracting R&D activity to a country, although how attractive any one country is depends on the actions of others and this is an area where governments face an incentive to compete. However, the new UK rules will be substantially more complex and will require detailed tracking between R&D and resulting income streams. The patent box remains a policy that is poorly targeted at incentivising firms to undertake additional R&D investments. For this, an R&D tax credit is better targeted and much simpler.

The modified nexus approach

One of the features of the UK patent box that has been previously highlighted is that the real innovative activity underlying the creation of a patent need not be located in the same country as the IP and therefore the taxable income.³⁰ The modified nexus approach seeks to stop a preferential regime being applied in this scenario. Instead, it sets out a framework in which preferential IP regimes can only be used when there is real substance in the jurisdiction in which the tax relief is granted. The BEPS plan is effectively

²⁵ The regime was phased in from 2013, starting with smaller reductions in the tax burden (because only a fraction of the tax break was allowed). It will reach its steady-state level of generosity (a 10% rate) in 2017.

²⁶ HM Revenue & Customs and HM Treasury, *Patent Box: Substantial Activities*, Consultation Document, 22 October 2015, <https://www.gov.uk/government/consultations/patent-box-substantial-activities>.

²⁷ HM Treasury, *Budget 2013*, March 2013, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221885/budget2013_complete.pdf.

²⁸ The new minimum standard also places restrictions on the types of IP that can be included in a preferential regime. This does not affect the UK but will require changes in other countries' policies.

²⁹ See HM Revenue & Customs and HM Treasury, *Patent Box: Substantial Activities*, Consultation Document, 22 October 2015, <https://www.gov.uk/government/consultations/patent-box-substantial-activities>.

³⁰ See section 5 of L. Evers, H. Miller and C. Spengel, 'Intellectual property box regimes: effective tax rates and tax policy considerations', *International Tax and Public Finance*, 2015, 22, 502–30, <http://dx.doi.org/10.1007/s10797-014-9328-x> and R. Griffith and H. Miller, 'Corporate taxes and intellectual property', in M. Brewer, C. Emmerson and H. Miller (eds), *The IFS Green Budget: February 2011*, <http://www.ifs.org.uk/budgets/gb2011/11chap10.pdf>.

to try to limit the potential for preferential IP regimes to erode countries' tax bases (by encouraging firms to locate IP income but not real activities in a country with a regime) while continuing to allow countries to compete for the associated real activities.

As highlighted in Section 8.3, this is an example of where the new substance requirement (i.e. that taxing rights align with real activities) is being used. This can be seen by following the example, introduced in Section 8.3, of a UK multinational that developed a new technology in the US and holds the related patent in the Netherlands. Under current rules, the income earned in the Netherlands (i.e. the royalty payments sent from the UK) would be eligible for the Dutch IP regime. The UK company could not use the UK patent box. If, instead, the patent had been filed in the UK, then all of the net revenue that accrued in the UK (i.e. profits from the sale of cars minus the payment to the US subsidiary for the R&D) would currently be eligible for the reduced patent box rate. This will not be the case under the new rules. That is, even though the tax system says that the income (from the use of the technology in the new cars) should be taxed in the UK, the income will not qualify under the new patent box regime because the underlying R&D activity took place in the US. In order to qualify, the R&D would need to take place in the UK (if only some of the R&D took place in the UK, only some of the tax benefit would be granted; more on this below). This is a case where the desire to align tax with real activities (which underlies the modified nexus approach) deviates from the principle currently used in the international tax system that income from intangibles is taxed where the owner is located.

Is the change a good one?

Effectively, the aim of the new minimum standard on preferential regimes is to ensure that they can only be used to attract real activities and not to try to attract footloose revenue streams. There is merit to this. The move should help to prevent 'harmful' tax competition – broadly, this is competition that shifts the location of taxable income such that overall revenues are reduced without affecting the location of real activities.

Regimes vary in how easily they can be used for tax avoidance purposes. Some countries already operate rules aimed at preventing the use of IP regimes for pure profit shifting. For example, acquired IP (i.e. IP purchased from another company or acquired in a merger or acquisition) is eligible under the Belgian and Dutch regimes, but a tax benefit is only granted for that part of value added that is created through further development by the taxpayer. Others operate IP boxes that are clearly targeted at attracting income, with less concern for the real activity. This is clearly the case in Malta, for example, where there is a 0% rate that only applies to acquired IP where no domestic R&D expenses are claimed (i.e. the reduced rate would apply if a company transferred their IP to Malta). Cyprus, France, Hungary and the Swiss canton of Nidwalden also stand out because their regimes neither require acquired IP to be further developed in order to qualify nor allow internal use of IP to benefit from the relief (i.e. only royalty and capital gains income qualifies).³¹ These are the kinds of regime that are of most concern as they may act to erode other countries' tax bases. The UK regime is not targeted purely at attracting income, and many firms that use the regime are likely to be doing some real activity in the UK. However, as is the case with all IP box regimes, there is currently no requirement that

³¹ For a description of European IP regimes and discussion of the surrounding policy issues, see L. Evers, H. Miller and C. Spengel, 'Intellectual property box regimes: effective tax rates and tax policy considerations', *International Tax and Public Finance*, 2015, 22, 502–30, <http://dx.doi.org/10.1007/s10797-014-9328-x>.

the underlying innovative activity be carried out domestically.³² Modifying patent box policies will change this. It will work to prevent some forms of avoidance (for example, where a patent is shifted to a low-tax country purely to take advantage of a tax break). However, it will also affect some genuine commercial decisions (for example, in the above example, the UK firm will face a tax disadvantage to conducting R&D in the US).

Conditional on having a patent box, the BEPS changes should place a cap on some forms of tax competition. However, there is still a question of whether having a patent box at all is a good idea. The BEPS report states that the idea of a substantial activity requirement builds on the principle that 'IP regimes are designed to encourage R&D activities'.³³ If the aim is to incentivise R&D activities, then a better policy would be an R&D tax credit. This has the key benefit of being given in proportion to the amount of investment activity undertaken, and is well targeted at the externalities created from R&D – the fact that one firm's innovation may have spillover benefits for the rest of the economy that are not factored into that firm's decision when deciding how much innovation to do is what justifies a subsidy. Where an IP box will be more effective than an R&D tax credit is in attracting highly profitable activities (because in these cases the level of the tax rate will be more important than the tax base). If the aim is to be a more competitive location for this kind of activity, then only granting the IP tax break when there is associated real activity makes sense. A preferential rate could also allow tax competition to be isolated in one part of the tax system (taking pressure off the main rate, for example). However, competitiveness is a moving target, as evidenced by the sequential introduction of IP boxes across Europe. Therefore, as with other elements of corporate tax, there is an open question as to whether all countries could be better off if they agreed not to operate IP boxes.

There are other possible aims behind the introduction of IP boxes. For example, a preferential regime could be used to provide a lower rate on a mobile form of income (effectively accepting that high levels of tax cannot be raised from a certain kind of income). In this case, the location of the real activity is less important and adding a restriction on the location of R&D and thereby distorting some commercial decisions is an unwelcome step. Another aim could be to encourage further commercialisation of IP, yet there is no clear justification for subsidising commercialisation activities.³⁴ If it is an aim, it does not require a link to R&D expenditure.

Achieving the new minimum standard

The BEPS minimum standard sets out a framework for applying the 'modified nexus approach' to preferential regimes. It stipulates that a tax reduction can only be granted to the extent that there is a direct link ('nexus') between the IP income and the expenditures on real activities that created the IP. As a proxy for real 'substantial' activity, the approach will use expenditures on R&D. Specifically, the calculation of qualifying income will comprise the income from an IP asset multiplied by the 'nexus fraction'. The nexus

³² This is in line with the fundamental freedoms codified in the Treaty on the Functioning of the European Union.

³³ See page 9 of the Final Report on action point 5 (*Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*), available at <http://www.oecd.org/ctp/beps-2015-final-reports.htm>.

³⁴ There may be some specific market failures around getting technologies to the market in the UK. For example, there may be less than efficient information sharing between university research departments and the private sector or financial market frictions that limit commercialisation. However, there is no evidence of large spillovers from commercialisation activities (such as branding and advertising).

fraction is the share of total R&D expenditures that went into the creation of the IP that were carried out by the taxpayer. If all R&D is carried out in the same country, the nexus fraction is likely to be 1 (such that all income qualifies). There are two notable categories of expenditure that are explicitly excluded from qualifying (and that will therefore reduce the nexus fraction and the tax benefit). One is expenditure on acquired IP, which is currently allowed in many regimes. Under the new rules, such income will only be eligible to the extent that the taxpayer has undertaken additional R&D expenditures. The other is expenditure on R&D that is outsourced to a related party (expenditure on outsourcing to third parties is allowed as it is not deemed to be associated with BEPS risk). It is this latter restriction that will prevent a tax benefit in examples, such as the one above, where a UK firm holds a patent created from R&D conducted by a related subsidiary located offshore.

Within the minimum standard, jurisdictions are free to define qualifying income and expenditure for IP regimes as they wish, so long as they adhere to the nexus fraction. The UK completed a consultation on exactly how to achieve this in December 2015. More information on the new patent box is expected at Budget 2016. New rules will be introduced in Finance Bill 2016 and come into effect on 1 July 2016 for patents applied for after that date.³⁵ Importantly, applying the new method will require firms to track R&D expenditures through to resulting income and to document the relationship (this is referred to as the 'streaming' approach). In most cases, this will lead to a significant increase in complexity and compliance burden. At present, the patent box applies to a company's IP proceeds as a whole, with no regard for associated R&D expenditures. In future, firms will have to provide data at the level of an individual patent or product such that R&D expenditures can be traced to resulting income. This will be administratively burdensome and difficult in practice, especially for large firms that hold many related patents. It may be hard to identify exactly which spending contributed to the creation of a patent, and the spending may be ongoing such that the calculation has to be regularly updated.

For many UK firms, notably including domestic firms, the new rule may not lead to a change in the UK tax treatment (i.e. 100% of their patent income will still be deemed eligible). Those firms that conduct a large share of the related R&D offshore (either for legitimate commercial purposes or because IP is held in the UK for tax avoidance purposes) will see a reduced tax advantage under the new regime.

The new minimum standard has a number of other restrictions, including that the allowable scope of IP regimes be limited to patents (and equivalents) and copyrighted software. This will not affect the UK regime (which applies only to patents), but will have a significant effect on many other regimes that allow income from a broader set of IP, often including trademarks and copyrights and in some cases secret formulas and business know-how.

Interest deductibility

Multinational companies can use intra-group loans to shift interest expenses (and therefore taxable profits) from one member of the group to another. These arrangements

³⁵ Most patents filed (but not necessarily granted) before July will continue to receive the benefit of the existing patent box until 30 June 2021. Draft clauses of the legislation are available at <https://www.gov.uk/government/publications/corporation-tax-patent-box-compliance-with-new-international-rules>.

can result in low, or even zero, taxation for certain projects. The BEPS goal was to produce an anti-avoidance rule that could be used to prevent multinationals from artificially shifting income expenses. In designing such a rule, it specifically targeted 'excessive' intra-group lending and the location of third-party debt in high-tax countries, both of which can result in the use of interest expense to shield other income from tax (see Box 8.1 earlier).

It is worth noting that it is not desirable to simply disallow all interest deductions arising from intra-group loans or third-party loans from high-tax countries. There are legitimate reasons for such arrangements. For example, some members of a multinational group may be more capital intensive and require more investment and an intra-group loan may be preferable (i.e. lower cost and more available) to a loan from a third party because the group has more information about its own operation. Most corporate tax regimes allow interest payments on loans to be fully deductible from taxable income as a business expense and, in general, this is sensible as it helps ensure that only the net return (to debt-financed projects) is subject to tax.³⁶

Most governments aim to deal with avoidance by operating rules that prevent or restrict interest deductions in certain circumstances. It is not possible to identify cases of avoidance perfectly, so any rule can only hope to define situations that are correlated with avoidance. In designing such rules, there is always a trade-off: a more stringent rule that severely restricts interest deductions does a better job of limiting avoidance but also places a greater tax burden on genuine commercial activities.

The UK operates a worldwide debt cap that is generous relative to rules in other developed countries: it rarely limits interest deductions as most companies are below the cap. The UK rule does not meet the BEPS best-practice recommendation; the current UK approach is compared with the new best-practice rule below. The UK has consulted on possible changes to interest relief, including whether or not to implement the new 'fixed ratio' rule and what the surrounding provisions could look like were it to be implemented.³⁷ More information about the government's decision is expected in the 2016 Business Tax Roadmap. Were the UK to adopt the proposed new 'fixed ratio' rule, which would likely be in place no earlier than April 2017, it would be a substantial change that would restrict interest deductions in the UK and raise UK revenues.

In the run-up to the 2010 election, the Conservative Party floated the idea of restricting interest deductions and 'reducing the dependence of our corporate sector on debt'.³⁸ Before the 2015 election, the Liberal Democrats also pledged to restrict interest deductions.³⁹ Despite these statements and the consultation, it is far from certain that the UK will adopt a new approach, not least because to do so would directly conflict with previous statements that generous interest deductibility rules are one of a number of aspects of the UK corporate tax system (the CFC rules are another) that make the UK an attractive location for multinationals' headquarters: 'The UK's current interest rules,

³⁶ In a closed economy with capital allowances that perfectly reflect depreciation, allowing interest deductibility should mean that the tax does not distort investment at all.

³⁷ The consultation closed in January this year. See <https://www.gov.uk/government/consultations/tax-deductibility-of-corporate-interest-expense/tax-deductibility-of-corporate-interest-expense-consultation>.

³⁸ <http://conservative-speeches.sayit.mysociety.org/speech/601394>.

³⁹ See S. Adam, J. Browne, C. Emmerson, A. Hood, P. Johnson, R. Joyce, D. Phillips, H. Miller, T. Pope and B. Roantree, 'Taxes and benefits: the parties' plans', IFS Briefing Note BN172, 2015, <http://www.ifs.org.uk/uploads/publications/bns/BN172.pdf>.

which do not significantly restrict relief for interest, are considered by businesses as a competitive advantage'.⁴⁰ The consultation document notes that 'consideration will need to be given to if and when other countries act upon the recommendations in the OECD report', an indication that the UK would not want to make a unilateral move that put it at a disadvantage. Given this, a likely outcome is that the UK decides not to introduce a BEPS best-practice recommendation (and therefore not prevent some forms of avoidance) because it places a higher value on the perceived competitive advantage and the associated real activity that encourages.

The UK would not be alone in such calculations. Many face an incentive to wait to see whether others will adjust their rules. The new rule is not a minimum standard because there is no cross-country consensus on where to draw the line on interest deductions. Coordinating implementation of a new rule, even among a subset of countries, would be difficult. Some countries may decide on a different approach altogether.

Current UK rule: worldwide debt cap

The UK's worldwide debt cap (WWDC) applies only to large companies that are part of a multinational group, and applies at the UK sub-group level (the UK sub-group is all of the members of a multinational group located in the UK). In effect, it caps the total amount of net interest that the UK sub-group can deduct from taxable profit at the gross external interest payments of the worldwide group.⁴¹ This means that the net interest (interest paid minus interest received) deducted in the UK must be less than the total amount of interest paid by the group as a whole to third parties. Under this regime, interest deductibility will be limited only if the net interest payments of the UK sub-group are larger than the total amount of interest that the worldwide group pays on debt from third parties. Recall, such rules are effectively designed to prevent situations that are highly likely to signal tax avoidance. The WWDC targets cases where very high levels of debt are held in the UK and defines high debt based on how much debt is held in the multinational as a whole.

BEPS outcome: fixed ratio rule

The recommended rule would limit interest deductions to a fixed proportion of what is known as EBITDA. This is a measure of Earnings (profit after deducting labour costs) Before deductions for Interest paid, Tax paid, Depreciation of tangible assets and Amortisation of intangible assets. For example, if the allowable fixed ratio of net interest to EBITDA were set at 10%, a company that had net interest equal to 20% of EBITDA could only deduct half of its interest when calculating taxable profit. The OECD suggests a 'corridor' of 10% to 30% within which each country's ratio might fall. A rule that compares the level of interest deductions with a measure of firm size provides a way to link the degree of interest deductions to real activity and can be used to combat both excessive third-party and intra-group loans.

⁴⁰ Paragraph 3.8 of HM Treasury and HM Revenue & Customs, *Corporate Tax Reform: Delivering a More Competitive System*, 2010, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81303/corporate_tax_reform_complete_document.pdf.

⁴¹ The WWDC mechanism is actually slightly more complicated. Initially, the 'tested expense amount' is calculated as the aggregate net interest payments of all those companies in the UK sub-group with positive net interest payments. If this exceeds the 'available amount' (the gross external interest of the worldwide group), the difference between the tested expense amount and the available amount is called the 'disallowed amount'. The UK sub-group can then disregard net interest income (for those companies in the sub-group with negative net interest payments) up to the disallowed amount. While the mechanism has implications for the distribution of interest deductions over the UK sub-group, interest deductibility will only be limited if the net interest deduction of the UK sub-group is greater than the external interest payments of the worldwide group.

The OECD sets out several other aspects that jurisdictions may wish to incorporate into their rule. Principal among them is a supplementary ‘group rule’. The idea is to allow interest to be deducted above the fixed ratio as long as the worldwide group’s net external interest to EBITDA ratio was higher than the fixed ratio. In that case, interest could be deducted up to the group ratio (plus an optional uplift of 10%). Other optional elements include the carry forward or back of spare interest capacity or disallowed interest and a de minimis threshold that limits the application of the rule to firms larger than the given threshold. Consultation is ongoing on the precise design of the group rule, other options, and the application of the fixed ratio rule to certain industries, such as finance and insurance.

The two rules compared

As highlighted above, it is not possible to discriminate perfectly between structures motivated by tax avoidance and those motivated by other, ‘legitimate’ considerations, so any anti-avoidance rule faces an inevitable trade-off between two types of error. An excessively lenient rule will do little to prevent tax-avoiding structures. An excessively stringent rule will distort legitimate firm behaviour, either not allowing full interest deductions (distorting investment) or forcing firms to modify their debt structure (which is itself costly).

The WWDC is a lenient rule that is more likely to succumb to the first type of error (permitting avoidance activities) than the second (distorting legitimate behaviour). It will only restrict interest if the amount deducted by the UK sub-group is greater than the total third-party interest of the world group. This is an extremely high bar. It is poorly targeted in particular at preventing firms locating third-party debt in the UK. If there is no intra-group lending, the WWDC allows all third-party interest expense (subject to thin capitalisation rules) to be held in the UK.⁴² It places some limited restrictions on intra-group lending.

The fixed ratio is far more likely to limit interest deductibility.⁴³ Even at the upper bound of the OECD corridor (30%), it would affect some firms’ decisions. Based on firm accounts data for 2009–13, the OECD estimates that 13% of multinational groups had an average net third-party interest to EBITDA ratio over 30%. This rises to 38% of multinationals for a 10% ratio.⁴⁴ That is, a net interest to EBITDA ratio of greater than 30%, let alone 10%, is not particularly exceptional or unusual. Therefore the rule may be innocuous for low-debt firms, but it will bind for higher-debt business models.

The UK could choose to relax the rule for high-debt firms by also operating the suggested group rule that would allow each subsidiary of a multinational to deduct up to the overall group ratio (possibly with 10% uplift). However, debt in multinational groups is rarely spread evenly, and for good reasons. For example, a parent firm may use its reputation and collateral to secure external debt finance to be used for new foreign ventures and, in

⁴² In this case, the interest deduction made by the UK sub-group would be equal to the total deduction of the world group (and so would abide by the WWDC). If there were also intra-group loans to the UK company, however, the WWDC would not allow all third-party interest to also be deducted in the UK.

⁴³ The application of the fixed ratio rule is potentially much broader than that of the WWDC (which applies only to multinationals) because it could apply to domestic firms. However, the operation of an appropriately-designed group rule could be used to effectively ensure that the rule only applied to multinational firms. As these are the firms that pose the vast majority of the BEPS risk, such a restriction seems appropriate.

⁴⁴ Among firms that are not parts of multinational groups, 19% were above a 30% threshold and 45% above a 10% threshold.

so doing, have a higher interest to EBITDA ratio than the overall group. The WWDC allows for more flexibility in the distribution of debt between companies.

If the UK were one of only a few countries to implement the fixed ratio rule, firms may be able to limit the impact by restructuring their activities and/or debt. Reflecting the trade-off highlighted above, if many countries implemented the rule, the likely consequence would be less avoidance and less than full interest deductibility (even for some entirely legitimate activities and corporate structures) for high-debt business models that were not able to spread debt evenly across the business.

Another side effect of the fixed ratio rule is that it would discriminate between similar companies in possibly undesirable ways. Two firms could have identical debt structures, with a fixed ratio above the fixed ratio rule. If one was part of a multinational group that happened to have a very high group ratio, that firm could deduct more interest than the other (by using a group rule). The implementation of the fixed ratio rule could therefore even have the unintended consequence of inducing multinationals to take on more third-party debt, at least in jurisdictions where debt rules were more flexible.

However it is designed, the fixed ratio rule would limit multinationals' use of debt (for both legitimate and tax-motivated reasons) more than the WWDC. The merits of moving to a rule that prevents more avoidance activity but would likely also distort more legitimate firm behaviour depending on how the government values the trade-off between these two kinds of error.

A further complication in evaluating these errors is that interest deductibility, while reducing the distortion to debt-financed investment, also generates a debt–equity distortion as equity-financed investment is treated differently. This in turn distorts the level and financing of investments and creates opportunities for multinational avoidance (for example, hybrid debt instruments; see Section 8.2). A rule that limited interest deductions could reduce the debt bias. However, this would only arbitrarily remove the distortion in some cases. The debt–equity distortion could be better solved by correcting the treatment of equity.⁴⁵

What effect will the BEPS outcomes have on UK tax revenue?

The initial motivation for the BEPS project was a perception of insufficient tax payments by multinationals. It is therefore natural to expect the policy responses to mean higher UK revenues. Some measures already announced are expected to be small revenue raisers for the UK. The new hybrid rule is expected to raise £90 million in 2019–20, while country-by-country reporting is forecast to boost receipts by £15 million.⁴⁶ Changes to transfer pricing rules may also operate in the UK's favour. If implemented, limits on interest deductibility in the UK would lead to a (possibly substantial) increase in revenue. It is not clear to what extent changes to the PE definition will lead to a net increase in the UK tax take.

⁴⁵ For a discussion of the debt–equity bias and possible solutions (including an allowance for corporate equity (ACE)), see A. Auerbach, M. Devereux and H. Simpson, 'Taxing corporate income', in J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba (eds), *Dimensions of Tax Design: The Mirrlees Review*, Oxford University Press for Institute for Fiscal Studies, Oxford, 2010, <http://www.ifs.org.uk/publications/7184>.

⁴⁶ HM Treasury, *Autumn Statement 2014: Policy Costings*, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/384071/AS2014_policy_costings_final.pdf.

Taken together, the BEPS actions specify different ways for income to be distributed between jurisdictions. While some outcomes from BEPS may mean the allocation of income to the UK from elsewhere, profit shifting goes both ways. Underlining countries' incentive to compete, UK firms and the UK tax base may be impacted by the legislative action of others. For example, the UK could increase revenues by reducing interest deductibility. But if the US restricted interest relief, it could impact the profits (and taxable income) of some UK multinationals holding US debt. If a number of OECD countries restricted interest relief and the UK did not, firms may move debt to the UK and the increased interest deductions would lower revenue.

Further uncertainty arises from the likely behavioural response to any policy changes. If the outcomes really are successful at linking income more closely to real activity, firms may make large changes to the organisation of those real activities between countries.⁴⁷ In particular, higher-tax countries may become less attractive as a location for real activity. The UK has a low tax rate relative to its competitors, but it also has an uncompetitive tax base. If there were substantial increases in taxes across countries as a result of the BEPS actions, the UK may become more attractive for some companies and less attractive for others. Overall, it is unclear whether the UK will see a significant increase in revenues as a result of the BEPS project.

8.5 Conclusion

The BEPS process was an ambitious attempt to patch up an international tax system creaking under the pressure of increased multinational activity. It has largely met its equally ambitious two-year time frame and, in so doing, should be able to capitalise on the political momentum behind anti-avoidance initiatives.

The success or otherwise of the process will be hard to evaluate comprehensively for several years, but the likely result is a reduction in at least some forms of avoidance behaviour. If implemented, the following should represent improvements in the suitability and operation of the international tax system:

- changes to the PE definition and new hybrid rules;
- the information sharing initiatives (including country-by-country reporting) and the move toward mandatory disclosure of avoidance schemes, which should make it easier for tax authorities to identify BEPS risks;
- measures to prevent treaty abuse;
- a modified patent box better targeted at attracting R&D activities to a country and that will limit some forms of government tax competition. But this comes at the cost of a substantially more complex policy and one that is fundamentally not well designed to incentivise additional R&D activity.

Other changes represent choices over how to deal with trade-offs, which are unavoidable given the current structures of corporate taxes, and their benefits will need to be weighed up against potential costs:

⁴⁷ There is a large literature on the ways in which firms respond to taxes. For a review, see R. de Mooij and S. Ederveen, 'Corporate tax elasticities: a reader's guide to empirical findings', *Oxford Review of Economic Policy*, 2008, 24, 680–97.

- The changes to transfer pricing rules offer the possibility to prevent some forms of avoidance related to risk allocation and intangibles, but it remains difficult to price the related transactions accurately and it is not clear that the treatment will be any more coherent than at present.
- Curbs to interest deductibility could have substantial effects both in terms of preventing some forms of avoidance and in terms of raising revenues, but the proposed rule could also distort genuine commercial activities and seems unlikely to be implemented by many countries.

The implementation of BEPS is just as important in determining the success of the project as the work set out to date. It is yet to be seen how much real policy change there will be.

One of the key constraints on both the BEPS outcomes (which required extensive negotiation to reach a consensus) and the subsequent implementation is the desire that countries have to operate competitive tax systems. BEPS does not remove countries' incentives to compete to attract activity and income (firms are still taxed differently depending on where they locate and where they declare income). This creates a tension: there are areas where cooperation cannot be achieved, and best practices will not be followed, because countries want to maintain a competitive advantage. The UK (current and previous) government has explicitly pursued the aim to have 'the most competitive tax regime in the G20'. Achieving this has included substantial cuts to the headline rate, a patent box and generous interest deductibility.⁴⁸ As noted earlier, the UK will be reluctant to adopt a rule that limits interest deductibility precisely because it would reduce the competitive edge that it has explicitly pursued. Similarly, the new recommended hybrid rule would be more effective if a significant number of countries implement it, but many may be wary of doing so if they think others will not follow suit. The final report on CFC rules acknowledges a concern that CFC rules that are too stringent will put a country at a competitive disadvantage and notes that 'another way to maintain competitiveness would be to ensure that more countries implement similar CFC rules'.⁴⁹ Yet agreement on a common approach was not reached.⁵⁰

The BEPS exercise, valuable though it may be, has inevitable limitations. BEPS does not offer a silver bullet that 'solves' the problem of tax avoidance and even if all recommendations were enacted we would still be operating a system that required profit allocation between jurisdictions (using the arm's length principle). This will always be difficult to administer and be open to avoidance opportunities.

There are real economic trade-offs embedded in the BEPS approach. We cannot perfectly identify what is legitimate behaviour and what is tax avoidance. Rules are being adjusted to capture more avoidance, but in some cases will do so at the expense of increasing the tax burden on genuine activities. The key 'patch' used by the BEPS system is a new principle that says that taxing rights should be aligned with economic substance. In many cases, this will not conflict with the current principles (effectively that trading income is

⁴⁸ See H. Miller and T. Pope, 'Corporation tax changes and challenges', IFS Briefing Note BN163, February 2015, <http://www.ifs.org.uk/publications/7590>. Part of the trend towards lower tax rates in developed countries over the past 35 years can be attributed to tax competition (see M. Devereux, B. Lockwood and M. Redoano, 'Do countries compete over corporate tax rates?', *Journal of Public Economics*, 2008, 92, 1210–35).

⁴⁹ Page 16 of Final Report on action point 3 (*Designing Effective Controlled Foreign Company Rules*), available at <http://www.oecd.org/ctp/beps-2015-final-reports.htm>.

⁵⁰ The report also notes practical reasons, such as the balance between territorial and source income in different countries, why CFC rules may need to vary across countries.

taxed at source and the returns to intangible assets are taxed where the owner resides). But in some cases, it will conflict: some forms of passive income will be taxed based on the location of economic activity rather than on a residence basis. By layering a new principle on top of the current system, we get a more complex and less coherent tax system that will distort some genuine commercial decisions.⁵¹

Modifications to the source-based system were probably the only politically feasible option on the table. Yet other systems with different features are possible and deserve consideration.⁵² One possibility is to move to a system that is able to consider the whole of a multinational company's activities (rather than looking at its activities in each country separately). The basic idea is to require firms to produce an account of their total activities (profits and costs) in all (or a subset of) countries they operate in and to use information on the location of real activities (sales, assets and employment, for example) to allocate taxing rights to individual jurisdictions. This is similar to how profits are allocated across individual states in the US. The European Commission, having long supported more harmonised corporate taxation in Europe, has recently relaunched proposals for a common consolidated corporate tax base (CCCTB).⁵³

Another, more radical solution would be to move towards a destination basis for the corporate income tax. The idea would be to tax income where the final purchaser of a good or service resides (i.e. where the sale was made) and to deduct costs where they are incurred. The place of sale is visible, limiting firms' opportunities to avoid taxes and removing complexity associated with identifying the source of profit. Moreover, a destination-based system does not distort firm location decisions.⁵⁴

A destination-based tax would represent a substantial departure from the current approach to corporate tax. However, unlike the outcomes arising from the BEPS process, it poses solutions to the fundamental problems of taxing mobile companies. The system would also have the nice feature that, once some countries began to implement it, there would be an incentive for others to follow. While this is a radical suggestion, at the very least it merits further investigation and consideration.

⁵¹ For further discussion of this issue, and of the competition incentives, see M. Devereux and J. Vella, 'Are we heading towards a corporate tax system fit for the 21st century?', *Fiscal Studies*, 2014, 35, 449–75.

⁵² For a discussion of other alternative tax systems, see A. Auerbach, M. Devereux and H. Simpson, 'Taxing corporate income', in J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba (eds), *Dimensions of Tax Design: The Mirrlees Review*, Oxford University Press for Institute for Fiscal Studies, Oxford, 2010, <http://www.ifs.org.uk/publications/7184>.

⁵³ http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm.

⁵⁴ A destination-based system would operate in a similar way to a value added tax (VAT) with an additional deduction for labour costs. Exports would be exempt from tax in the exporting country and imports taxed in the importing country. For a detailed discussion of the implementation of this tax, see M. Devereux and R. de la Faria, 'Designing and implementing a destination-based corporate tax', Oxford University Centre for Business Taxation, Working Paper 14/07, May 2014, <http://eureka.sbs.ox.ac.uk/5081/1/WP1407.pdf>.

Appendix 8.1 The BEPS recommendations

The following subsections discuss the BEPS outcomes according, where appropriate, to the types of avoidance risk addressed (as set out in Section 8.2).

Profit shifting⁵⁵

Three of the BEPS action points were devoted to **transfer pricing**. In two areas in particular – the value of intangibles and the allocation of risk – the OECD deemed the current rules insufficient to prevent profit shifting.

Transfer pricing guidelines will be changed to clarify that ownership of intangible assets alone does not give a company the right to any or all of the profit flows associated with that asset. Instead, revenue should flow to the companies ‘performing important functions, controlling economically significant risks and contributing assets’. This clarification is designed to ensure that a company in a low-tax country cannot receive the revenues associated with IP merely through passive ownership of that asset. However, as discussed in Section 8.3, this represents a new principle that is being layered onto, and may be at odds with, principles underlying the current tax system.

The transfer pricing revisions also clarify the treatment of risk. Higher economic risk is associated with higher expected returns; a firm genuinely taking on risk can expect this to be reflected in the (transfer) price charged for its services. However, multinationals can institute risk-sharing contracts, with an associated transfer price, that shift the reported risk (to a low-tax country) without changing real activity or the true underlying distribution of economic risk. The new guidelines seek to clarify that risk should be allocated to the companies that have ‘meaningful and specifically defined control’ over the risks and have the financial capacity to bear those risks. These rules are intended to move closer to an economic interpretation of risk rather than a legal interpretation, a welcome idea given that the rationale for higher returns to riskier activities is inherently an economic one.

However, it is conceptually very difficult to work out how risk is allocated within a multinational group. For example, a parent and a wholly-owned subsidiary may have a legal contract stipulating that the subsidiary will bear the risk for a new investment (i.e. its profits will be reduced if there are losses). However, in what sense can the subsidiary actually bear any risk if any gains or losses are ultimately borne by the parent company (through lower dividends, for example)? No matter what kinds of rules are in place, it will always be difficult to assess how to place a value on (and therefore determine the taxable income from) risk taking.⁵⁶

The OECD transfer pricing guidelines will now be modified.⁵⁷ For these to come into effect, they must be enshrined in countries’ legislation. Some countries, including the UK, subscribe fully to the OECD interpretation of the arm’s length principle and have transfer pricing legislation that refers directly to the OECD guidelines. In such cases, OECD

⁵⁵ This section refers to BEPS action points 8–10 (*Aligning Transfer Pricing Outcomes with Value Creation*). All BEPS reports can be found at <http://www.oecd.org/ctp/beeps-2015-final-reports.htm>.

⁵⁶ For further discussion of issues around risk, see M. Devereux and J. Vella, ‘Are we heading towards a corporate tax system fit for the 21st century?’, *Fiscal Studies*, 2014, 35, 449–75.

⁵⁷ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2010, <http://www.oecd.org/tax/transfer-pricing/transfer-pricing-guidelines.htm>.

changes (when confirmed in early 2016) will be instituted automatically. Other countries will receive revised guidance on acceptable interpretations and will need to change their legislation accordingly.

Base erosion⁵⁸

Limiting interest deductions

Loan agreements were identified as a significant BEPS risk. In part, these are dealt with by transfer pricing regulations. The 'price' that must be consistent with the arm's length principle is the rate of interest charged. There is also a further layer of transfer pricing regulation – thin capitalisation rules – which require that a company cannot take on more debt than would be permitted if it were a stand-alone entity.

However, these rules leave considerable scope for avoidance. Many countries therefore operate a further layer of rules to limit interest deductibility under certain circumstances. There is diversity in the type of rule applied across countries and in how restrictive it is for companies. The BEPS process provides a recommendation for best practice (*not* a minimum standard). The new '**fixed ratio**' rule, which would limit interest deductions, is discussed in Section 8.4.

Preventing hybrid mismatches

BEPS set out a best practice rule for preventing the use of hybrid debt structures to avoid tax. The new **hybrid rule** comes in two parts and aims to ensure that a hybrid mismatch between two countries is prevented even if only one of the countries operates the rule. Further discussion can be found in Section 8.4.

Assigning taxation rights

Several BEPS action points are devoted to the assignment of taxable rights between countries, either by addressing the avoidance of permanent establishment status, tackling the abuse of treaty benefits or recommendations for appropriate CFC rules.

*Permanent establishment status*⁵⁹

There will be revisions to the international standard on **permanent establishments** that will broaden the definition and stipulate that distribution activities will constitute the operation of a PE unless the activities are genuinely only preparatory and auxiliary in nature (see Section 8.4 for further details).

The implementation of this change (along with other definitional clarifications) requires changes to bilateral tax treaties (in which PE definitions are stated) and not legislative change. The aim is for these changes to be implemented using a new multilateral instrument (see below).

*Treaty benefits*⁶⁰

As outlined in Section 8.2, multinationals may organise their activity so as to benefit from **treaty benefits** (such as lower withholding taxes) when they are not entitled to those

⁵⁸ This section refers to BEPS action points 2 (*Neutralising the Effects of Hybrid Mismatch Arrangements*) and 4 (*Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*).

⁵⁹ This subsection refers to action point 7 (*Preventing the Artificial Avoidance of Permanent Establishment Status*).

⁶⁰ This subsection refers to action point 6 (*Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*).

benefits. The outcome from the BEPS process is a (flexible) minimum standard to be incorporated into tax treaties through the multilateral instrument (see below). This requires that every tax treaty incorporate an explicit stated intention from all countries that they intend to prevent abuse of treaty benefits. The minimum standard also requires that countries operate some kind of rule to ensure that treaty benefits can only be allowed in certain circumstances and not when activities have been arranged in order to avoid tax. There is some flexibility on how such a rule can be designed. In 2012, the UK implemented legislation that applies to all of its tax treaties that specifies a 'main purpose test'; this sets out that one of the main purposes of the arrangement or scheme cannot be to gain the treaty benefit. This conforms to the OECD minimum standard. Other countries, such as the US, have also incorporated rules into their tax treaties that conform to the OECD minimum standard. The US uses a 'limitation on benefits' rule, which grants benefits only if a company meets certain conditions.

CFC rules⁶¹

A number of countries, including the UK, operate anti-avoidance **controlled foreign company (CFC) rules**. A CFC is a subsidiary of a multinational that, while a permanent establishment in another country, will be taxed as if it resides in the home country. CFC rules are targeted at identifying subsidiaries residing in low-tax countries and deemed to be avoiding taxes in the home country. The UK rules apply to companies resident in countries with a tax rate below 75% of the UK rate earning solely or predominantly 'passive' income. Passive income is income, such as royalty flows to a patent, that is not associated with substantial real activities.

The OECD has now set out a best-practice framework for CFC rules. This includes clarification over the appropriate definition of a CFC and computation of taxable income, as well as provisions to guard against double taxation (the same income being taxed in two different jurisdictions). There is scope for many rule designs within the framework. It is unlikely that many countries will add or modify CFC rules as a result (the rule is a best practice, not a minimum requirement), such that this recommendation seems likely to have only a limited effect.

Countries may choose not to operate a CFC regime, or to operate a weaker version than the OECD recommends, in order to gain a competitive advantage. The UK regime was revised in 2011 and is considered generous, particularly in its treatment of financial income. This provides an incentive for multinationals to locate their headquarters in the UK. As with interest deductions, there is a trade-off between tighter CFC rules (that prevent more avoidance) and looser ones that are seen as part of a competitive strategy.

Harmful tax competition⁶²

The scope of the BEPS process was not confined to preventing certain firm behaviours, but also covered preventing the kinds of government policies that are deemed to constitute 'harmful tax competition'. The OECD and EU both have forums that seek to identify harmful tax policies, which, broadly, can be defined as policies that lead a tax base to be artificially shifted between countries or that facilitate the avoidance of other

⁶¹ This subsection refers to action point 3 (*Designing Effective Controlled Foreign Company Rules*).

⁶² This subsection refers to action point 5 (*Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*).

countries' taxes.⁶³ In practice, what constitutes harmful tax competition is somewhat arbitrary and thus a grey area. But the idea behind the OECD and EU efforts is to encourage countries to agree multilaterally not to operate certain kinds of policies in order that they may all benefit from the coordination.

The BEPS process singled out '**preferential regimes**' – tax rules that provide a lower tax liability if companies meet certain conditions – as a type of instrument that may be harmful. A key and long-running concern with preferential regimes is that they may be used for artificial profit shifting. The outcome of the BEPS approach is a new methodology that can be used to ensure that preferential tax treatment is only granted where there is substantial real activity in the same country as the tax benefit.

The main focus of the work was on **IP or patent boxes**, which grant a lower tax rate for income arising from the exploitation of some forms of intellectual property.⁶⁴ There had already been work at the European level considering the role of IP regimes in promoting harmful conduct. For many years no action was taken, but in 2013 the EU Commission concluded that the British regime meets two of the criteria used to identify harmful tax measures.⁶⁵ The BEPS outcome arising on IP boxes was a minimum standard that specifies a new 'modified nexus' approach to the calculation of applicable income. This approach seeks to link the benefits from the regimes to the R&D (the 'substantial activity') underlying the IP. All IP boxes need to be modified to comply with this principle.

A number of countries, including the UK, the Netherlands and Spain, have acknowledged the need to adjust their legislation. It is anticipated that other countries will contest the idea that their regime is harmful and encourages BEPS. The modified nexus approach and implications for the UK patent box are considered in more detail in Section 8.4.

Transparency and implementation

As well as changes to tax rules, the BEPS process devoted five action points to information gathering, information sharing and the implementation of new rules.

*Information gathering and sharing*⁶⁶

When tackling avoidance, tax authorities face several constraints. One of these is a limitation of resources; authorities must choose how many and which cases they can feasibly investigate. The BEPS process seeks to assist authorities by improving information flows that will help them better target their resources.

One aspect of this is a minimum standard requiring that all countries implement legislation on **transfer pricing documentation** and **country-by-country reporting**. The

⁶³ See OECD, *Harmful Tax Competition: An Emerging Global Issue*, 1998, <http://www.oecd.org/tax/transparency/44430243.pdf> and http://ec.europa.eu/taxation_customs/taxation/company_tax/harmful_tax_practices/index_en.htm.

⁶⁴ Sixteen of the 43 regimes examined were IP boxes. The majority of others were either judged not harmful or are already being phased out. This eclectic group includes, for example, regimes for the Brazilian semiconductor, Canadian life insurance and Turkish shipping industries. A minority of non-IP schemes are under review.

⁶⁵ European Commission, Room Document No. 2 prepared for the Code of Conduct Group (Business Taxation), 22 October 2013, *Tax Notes International*, Doc. 2013-24148. For discussion, see <http://www.ifs.org.uk/publications/6899> and the introduction to L. Evers, H. Miller and C. Spengel, 'Intellectual property box regimes: effective tax rates and tax policy considerations', *International Tax and Public Finance*, 2015, 22, 502–30, <http://dx.doi.org/10.1007/s10797-014-9328-x>.

⁶⁶ This subsection refers to action points 11 (*Measuring and Monitoring BEPS*), 12 (*Mandatory Disclosure Rules*) and 13 (*Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*).

new country-by-country reporting requires large multinationals to report certain key statistics from their operations in each jurisdiction (turnover, profit before tax, tax paid, number of employees etc.), which will be made available to the tax authority of every jurisdiction in which they operate.⁶⁷ On transfer pricing, companies must provide a 'master file' containing information on their global activities and transfer pricing policies, which will be shared with every relevant tax authority, and a 'local file' with more detailed transfer pricing policies for each individual jurisdiction. The legislation requiring documentation to be produced must be in place for all countries for accounting periods that begin on or after 1 January 2016, with the report due no later than 12 months after the end of the accounting period. The UK (as well as others) has begun the legislative process. The tight time frame is a likely challenge for the 'implementation' phase of the BEPS process, especially because the OECD has no power to impose the minimum standards. Country-by-country reporting may prove to be the first test of how binding the BEPS recommendations will be in practice.

The aim is that the increased information on transfer prices and the location of activities will help authorities to target resources (such as audits) at the highest BEPS risks. This should be the case: authorities should be able to find a way to use the information to improve their tax-raising abilities, although there are areas in which they would probably like even more information. (Some less developed governments may find that they lack the resources required to make use of the large amount of information.)

The move will represent an increased burden for firms, although the extent of this will vary according to how close firms' current recording of their own activities is to the new reporting templates. During the BEPS process, many firms raised concerns that the information will be misused by tax authorities to produce quick but inaccurate proxies to identify BEPS. The UK tax authority has set out that it plans to use the information in risk assessments and not to target firms based on simple indicators. Another often-raised concern was that higher disclosure to authorities could be the first step towards the public disclosure of information on firms' activities. Under the BEPS recommendation, all information will remain confidential. There would be costs and benefits to making information on firms' activities public. More information would allow a range of parties to put more pressure on firms that were deemed to be avoiding tax, although this would be difficult to determine and could lead to many false accusations (as discussed in the main text, there is often ambiguity about what counts as avoidance and it is difficult to identify even for fully-informed tax authorities). It would also be a move away from taxpayer confidentiality, which protects information that may be deemed competitively sensitive (i.e. some firms do not want their competitors, and perhaps not even other parts of the same firm, to have detailed information on their costs and profits).

A further BEPS outcome pursues information sharing of a different kind. There is a recommended best practice for countries to implement a **mandatory disclosure rule** requiring that promoters and/or firms taking part in schemes with certain hallmarks (related to BEPS risk) report the scheme to the relevant tax authority. This will help authorities and policymakers close loopholes quickly as well as discouraging firms from entering suspect schemes. The UK has, since 2004, had a mandatory disclosure scheme in the form of DOTAS (disclosure of tax avoidance schemes), so this outcome will not

⁶⁷ The OECD has set up a Multilateral Competent Authority Agreement to facilitate automatic exchange of country-by-country information between tax authorities and to enable businesses to file information once centrally rather than via all tax offices.

require a legislative response from the UK but may encourage countries without such a regime to implement one.

The final aspect of information gathering that the BEPS process addressed was the measuring and monitoring of the scale of BEPS internationally. In addition to providing an estimate of global revenues forgone as a result of BEPS (see the final section of 8.4), the report also provided recommendations to improve the precision of this task going forwards. Specifically, the report recommended that the OECD work with countries to report corporate tax statistics in a more consistent way and to improve the availability and analysis of existing data.

Implementing BEPS outcomes and handling teething issues⁶⁸

Three aspects of the OECD BEPS outcomes – changes to transfer pricing rules, permanent establishment status and rules surrounding the granting of treaty benefits – require changes to bilateral tax treaties. The renegotiation of hundreds of treaties would take many years, and each would require domestic ratification. Instead, the OECD proposes a single **multilateral instrument** that would simultaneously adjust all tax treaties between those countries that signed (subject to domestic ratification). Work is ongoing, including in the UK, on the precise design of this ‘multilateral instrument’, with an outcome expected later in 2016. This endeavour involves considerable legal complexity, especially when it comes to the limitation of treaty benefits where the minimum standard has considerable flexibility, meaning the precise rule will vary by treaty.

The BEPS outcomes also entail considerable change beyond those incorporated into the multilateral instrument. Legislative changes will likely occur at different rates in different countries, and this is widely expected to lead to an increase in the number of disputes – for example, over instances of double taxation or perceived unfair tax treatment. The BEPS process addresses ‘making dispute resolution mechanisms more effective’. There is more work to come on this action in 2016. So far, countries have signed up to certain minimum requirements relating to the **mutual agreement procedure** (MAP), which is a mechanism by which countries can settle international taxation disputes. Broadly, these minimum standards require that countries ensure the MAP is utilised effectively and appropriately.

⁶⁸ This subsection refers to action points 14 (*Making Dispute Resolution Mechanisms More Effective*) and 15 (*Developing a Multilateral Instrument to Modify Bilateral Tax Treaties*).