The Case Against BEPS: Lessons for Tax Coordination

Abstract

In 2013 the OECD, at the behest of the G20, embarked upon an ambitious project of coordinating and harmonizing countries' international tax rules under the guise of curtailing multinational companies' cross-border tax planning, generally referred to as base erosion and profit shifting, or BEPS. The project was finalized with great fanfare in November 2015. But the proclamations of success masked real underlying differences between participant countries. I argue that the project suffered from a number of flaws that largely precluded effective coordination, as a result of which the project's recommendations largely gloss over key differences in participants' goals and commitments while doing nothing to solve the systemic problems it was seeking to address. For example, while a key stated goal of the project was to align the taxation of profits with value creation, there was no attempt made to define the location of value creation, nor to address the fact that this principle is fundamentally at odds with the arm's length principle that serves as the backbone of transfer pricing rules.

The project left in its wake a system even more broken than before, but one papered over with rhetoric suggesting the illusion of consensus and general agreement on new rules. Broadly worded anti-abuse rules allow different countries to go off in their own, preferred directions in interpretation, implementation and enforcement. They thus open the door to unprincipled and aggressive tax agents and an increase in multilateral tax disputes with no clearer path to resolution. Poor outcomes were largely predictable from the project's premises, which merely sought to reinforce the existing rules, but never questioned whether those rules needed updating to adjust for global economic changes and to lead to a fairer allocation of taxing rights. Furthermore, the project failed to acknowledge the bias in the existing system that meant that the outcomes were likely to benefit more powerful countries at the expense of smaller and weaker ones. While the project may have succeeded in its overt goal of limiting multinationals' international tax avoidance, it never addressed the more systemic failures of the system that underpinned the broad consensus it achieved in obtaining initial agreement on its action plan.

The BEPS project thus holds important lessons for the future of international coordination efforts, as efforts to fix a broken international tax system, restore public confidence in multinational corporations, and achieve real agreement on the underlying principles of the rules must continue, if only to minimize the flood of disputes expecting to result from the recent changes in law and policy.

Introduction

International tax rules have a number of goals. They allocate taxing rights between two jurisdictions when goods or services are transferred across borders. They set out guiding principles for when a resident of one country may be taxed by another country on income associated with that country. They may encourage or discourage cross border trade based on the degree to which countries attempt to assess tax on cross border transactions, such as the extent to which countries give relief for taxes paid in another jurisdiction. Finally, they aim to protect individual countries' tax bases by preventing taxable income from escaping national borders.[1]

The rules accomplish these goals through a number of mechanisms. Countries can set their own domestic laws governing cross-border transactions or their residents' foreign earnings. Withholding taxes allow countries to assess taxes earned by foreign residents from cross border sources. Bilateral tax treaties set out agreements between two countries over how to allocate taxing rights for income that could be taxed in one or the other jurisdiction in order to prevent double taxation. Multilateral agreements such as model treaties or OECD transfer pricing guidelines represent commitments from a larger group of countries to a more widely accepted set of principles.

The international tax laws and agreements in existence today are with few major modifications built upon rules that were put in place in the early twentieth century.[2] The belief that they no longer function well in today's global and digital age is widespread.[3] In the U.S., cries for the need to update domestic international tax rules to reflect a different global financial and political order have been getting progressively louder over the past several decades. More recently, this need has been recognized on a global scale.[4] Macro-economic developments, growth in cross-border trade, shifts in global political power, and the increasing sophistication of the world's financial system, have all put increasing pressure on the rules and how they are enforced. At the same time, individual countries' incentives to change their rules to protect their own corporate tax bases are under pressure due to fears over the loss of corporate investment that could result from a tax system being viewed as uncompetitive in a world of mobile capital.

The global financial crisis of the late 2000s provided both an incentive and a means of addressing these concerns. With employment and social services suffering and government budgets under strain, the ability to attract more revenues from corporations presented itself as a useful fix to some of society's most highly visible problems. Countries could avoid the beggar-thyself problem by acting in a coordinated fashion. Corporate tax planning, facilitated by global accounting firms, served as a useful point of attack for pursuing the goal of shoring up domestic revenues. Multinational companies, whose own ties to any particular country were also exceedingly attenuated as revenue sources and manufacturing location shifted from historical

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[1] *See generally* Hugh Ault and Brian Arnold, Comparative Income Taxation – A Structural Analysis (3d ed. 2010).
[2] *See* Michael Graetz and Michael O'Hear, *The 'Original Intent' of U.S. International Taxation*, 46 Duke L.J. 1021 (1997) (hereinafter *Graetz and O'Hear*).
[3] *See* Michael Graetz, *The David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 Tax L. Rev. 261 (2001) (hereinafter Graetz, *Tillinghast Lecture*); Edward D. Kleinbard, *Stateless Income*, 11 FLOR. TAX REV. 699 (2011); Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 Tax L. Rev. 99 (2011); Reuven Avi-Yonah, *Globalization, Tax Competition and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573 (2000).
[4] *See generally* Yariv Brauner, *What the BEPS?* 16 Fl. Tax Rev. 55 (2014).

locales, provided a particularly promising scapegoat for an attack rooted in fears of economic decline and inequality.[5]

Out of this environment was born the base erosion and profit shifting project, or BEPS, mandated by the G20, and managed and implemented by the OECD.[6] Under the guise of cracking down on multinationals' tax planning techniques that enabled them to lower their global tax burdens, in part by moving their profit-generating assets and activities to low tax jurisdictions, the project was intended to facilitate the coordination of international tax rules to ensure higher effective corporate tax rates (an objective implicit but never directly stated in the project's action plan). The coordinated nature of the project was key to make sure that rogue countries did not attract additional corporate investment at the expense of other countries looking to plug the leaks in their own domestic revenue bases.[7]

In the course of two years, the OECD pushed through reports, recommendations and changes in 15 identified areas of international tax rules.[8] But the volume of paper published by the OECD glosses over its poor results. Claims of success in the BEPS project pay lip service to agreements on paper but mask real underlying differences that will cause significant problems going forward. In the area of transfer pricing rules, for example, the OECD introduced a set of rules that lacks the economic coherence necessary to produce the meaningful analysis needed to support cross-border pricing. On the crucial area of determination of when a resident of one country has a permanent establishment in another country – perhaps the fundamental basis for determining the allocation of taxing rights among countries – the project produced a vaguely worded standard with little interpretive guidance. The rules for how to allocate profits to newly found permanent establishments remain unresolved. In the area of treaty abuse, a broadly worded anti-abuse test – the adoption of which is essentially a requirement for all countries signing up to the project – will serve as the basis for litigation and uncertainty for many years to come. Rather than coordinated rules, the project essentially resulted in vague standards that everyone could agree on, because they meant all things to all people.

Most importantly, the project failed in one of its most crucial tasks – to force the U.S. to change its rules to prevent its multinationals from engaging in income shifting activities among other countries. Not only did the U.S. not change its rules to benefit other countries, discussions of U.S. tax reform under a new administration opened up the possibility of even more radical tax reforms that potentially benefit U.S. companies to the detriment of other countries. Finally, the

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[5] *See, e.g.*, *Firms' secret tax avoidance schemes cost UK billions*, THE GUARDIAN (Feb. 1, 2009); Reuters, *Special Report: How Starbucks avoids UK taxes* (Oct. 15, 2012) at http://www.reuters.com/article/us-britain-starbucks-tax-idUSBRE89E0EX20121015 ; Charles Duhigg and David Kocieniewski, *How Apple Sidesteps Billions in Taxes* NYT (Apr 28, 2012) at http://www.nytimes.com/2012/04/29/business/apples-tax-strategy-aims-at-low-tax-states-and-nations.html?action=click&contentCollection=Business%20Day&module=RelatedCoverage&region=EndOfArticle&pgtype=article.
[6] *See* Press Release, *OECD launches Action Plan on Base Erosion and Profit Shifting*, (Jul. 19, 2013), available at http://www.oecd.org/ctp/beps/closing-tax-gaps-oecd-launches-action-plan-on-base-erosion-and-profit-shifting.htm
[7] *Action Plan on Base Erosion and Profit Shifting*, OECD (2013) (OECD Publishing). Available at *http://dx.doi.org/10.1787/9789264202719-en* (hereinafter "BEPS Action Plan").
[8] *See* Stephanie Soong Johnston, *OECD Releases Final BEPS Package*, Tax Notes Today (Oct. 19, 2015).

project resulted in no meaningful consensus for improvement on the mechanism for resolution of cross-border disputes.

The BEPS project may be able to declare success in one of its declared aims: that of ensuring greater tax payments by multinational companies (only time will tell). But proclaiming success for a project that weakens an already fragile international tax system is to no one's benefit, other than those who hope for collapse in order to start from scratch.[9] Vague rules that don't lend themselves to clear interpretation and application don't necessarily benefit tax authorities in the long run.[10]

The poor outcomes of the BEPS project could largely have been largely predicted, because of the nature of the project's undertaking and its underlying premises. Amidst the rhetoric and the declared focus on stopping multinationals' tax avoidance activities, the opportunity for a rigorous examination of the underlying causes of the identified issues was missed. Also hidden behind the rhetoric was any meaningful discussion of real and significant concerns going to the merit and validity of the endeavor. There was no acknowledgement of the various reasons why local politicians offer tax incentives or other (less explicit) tax planning opportunities to multinationals, or the role played by governments in facilitating tax planning opportunities for both domestic and foreign companies. Tensions between emerging economies and OECD member countries – which lay (unacknowledged) at the root of the project, remained unaddressed.

The project also failed to address another set of broader, more philosophical questions, rooted in economics but also in concerns over fairness in the context of global economic development. The tools that public finance economists have developed for analyzing what constitutes sound policy in a domestic setting are not easily transportable when the questions morph from those having to do with maximizing economic welfare within a particular set of borders, to maximizing welfare globally. No country has signed on to such a concept as the basis for international tax rules that may lead to the diminishing of its own revenue intake.[11] In a coordination setting, larger countries can and likely will act to negotiate and implement rules that may work to their best advantage, potentially to the disadvantage of smaller and less powerful countries, and the BEPS project largely failed to assuage such concerns.[12]

These concerns provide lessons for international tax coordination efforts more broadly, and prompt the question as to whether there are alternative mechanisms for improving the existing system. Greater scrutiny of the systemic issues that prompted the BEPS project – rather than a narrow focus on corporate tax avoidance -- could have resulted in a more substantive project, rather than the flawed endeavor that BEPS became.

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[9] *See* Mindy Herzfeld, *Whither the International Tax System*, 85 TAX NOTES INT'L 22 (Jan. 2, 2017).
[10] *See* Alex Raskolnikov, *From Deterrence to Compliance: Legal Uncertainty Reexamined* (2016).
[11] *See* Graetz, *Tillinghast Lecture*.
[12] *See* Tsilly Dagan, INTERNATIONAL TAX POLICY: BETWEEN COMPETITION AND COOPERATION (forthcoming Cambridge University Press 2018).

This paper proceeds as follows. Part I provides a background on the BEPS project. It begins with a brief outline of the project and then steps back in time to review the historical framework of international tax rules, followed by an analysis of the immediate factors giving rise to the project. Part II explores the issues that underlay and proved problematic for successful outcomes of the BEPS project, and pose challenges for future international coordination efforts as well. Part III describes how the underlying issues resulted in poor outcomes in the BEPS project. Part IV concludes.

I BEPS in Perspective

A. What is BEPS?

In 2012, the G-20 tasked the OECD with developing an action plan to combat base erosion and profit shifting by multinational enterprises.[13] The G-20's mandate to the OECD was to fix aspects of the current international tax system that were facilitating base erosion and profit shifting by multinationals.[14] The OECD was supposed to prevent large amounts of multinationals' corporate profits from not being subject to tax in any jurisdiction, often referred to as "double non-taxation," or "stateless income."[15]

The OECD responded by publishing a 15 point action plan (the "BEPS Action Plan") in June 2013.[16] To some critics the action plan represented far more than a targeted attack on specific abusive practices involved in profit shifting and instead suggested that the OECD would be undertaking a re-examination of many of the fundamental building blocks of the international tax regime.[17] To others, however, the BEPS action plan failed to go far enough – because it

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[13] G-20 Leaders' Declaration (Jun. 19, 2012) ("We reiterate the need to prevent base erosion and profit shifting and we will follow with attention the ongoing work of the OECD in this area."). Available at www.g20mexico.org/images/stories/docs/g20/conclu/G20_Leaders_Declaration_2012.pdf. The G20, an informal group of the largest economies, is an outgrowth of the G7 that has become more active in the years since the 2008 financial crisis. The BEPS project represents the G-20's first foray into directing substantive international tax policy. Itai Grinberg, *The New International Tax Diplomacy*, 104 Geo. L.J. 1137 (2016) (describing the transition of the G20 from a role as setting financial regulatory policy into the international tax policy arena). As Grinberg notes, although the G20 operates under no administrative rulebook, and without any entrenched bureaucracy, its power and influence over international financial regulation has increased markedly over the past few years.

[14] Involvement of the G20 in international tax affairs has increased the politicians' engagement in global tax policy. *See* Grinberg, *supra*. *See also* Mindy Herzfeld, *Why BEPS is Just the Beginning*, 79 TAX NOTES INT'L 983 (Sept. 21, 2015).

[15] *See* Kleinbard, *Stateless Income*.

[16] BEPS Action Plan; *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15-2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, Par. 3 Available at *http://dx.doi.org/10.1787/9789264241688-en* .

[17] *See, e.g.*, Avi-Yonah, Reuven S. and Xu, Haiyan, *Evaluating BEPS* (Jan. 15, 2016). U of Michigan Public Law Research Paper No. 493. Available at https://ssrn.com/abstract=2716125 (arguing that "[t]he primary problem with the BEPS project is that . . . new principles and new rules have not been truly established for the new direction, and the old principles have been strengthened by a patch up of current rules"); Swapneshwar Goutam, *Critical account of the OECD's Action Plan on Base Erosion and Profit Shifting*, 8 Madras L. J. 9 (2014) (questioning whether the action plan will go far enough from a developing country perspective). For example, in action 7, the OECD undertook to review the rules of permanent establishment, stating that it would "Develop changes to the definition of

claimed adherence to the core principles of the international tax system, those who advocated a wholesale revamp of the international tax rules to accommodate a more globally connected economy were disappointed.[18]

In the 15 BEPS action items, the OECD addressed a wide range of topics. These can be grouped into several broad categories: recommended actions for changes in domestic laws; revisions to treaties; modifications to the OECD transfer pricing guidelines; and transparency and exchange of information initiatives. Also included in the action plan were a number of studies and reports relevant to the overall project but not recommending particular rule changes.[19] Changes to the OECD model treaty are one of the most important parts of the project, and are addressed in a number of action items. Action 6, for example, includes language to ensure that treaties aren't used to facilitate treaty abuse and double non-taxation.[20] Action 7 provides revised language for the model treaty standard for a permanent establishment.[21] The BEPS action plan also included a proposal for a multilateral instrument that would incorporate proposed changes to the model treaty into bilateral treaties in a single stroke.[22]

BEPS action items 8-10 includes revisions to the OECD transfer pricing guidelines.[23] These rules govern how related parties price goods and services in cross-border transactions. Many OECD member countries, as well as a number of non-OECD members, have incorporated these guidelines into domestic law. Changes to the guidelines thus have immediate effect. Indeed, anecdotal evidence suggests that many tax administrations are already applying the new principles on audit. One aspect of BEPS that has seen widespread take-up is the new transfer

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PE to prevent the artificial avoidance of PE status in relation to BEPS." The action plan said that in action 6, the OECD would be looking to "[d]evelop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances." BEPS Action Plan. *See also* The BEPS Monitoring Group, *Explanation and Analysis of The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MC-BEPS)* (Mar. 2017). Available at https://bepsmonitoringgroup.files.wordpress.com/2017/03/explanation-and-analysis-of-mc-beps.pdf.

[18] *See* Stephanie Johnston, Kristen Parillo and David Stewart, *OECD BEPS Action Plan Draws Praise, Criticism*, 140 TAX NOTES 437 (Jul. 29, 2013); Sol Picciotto, *Can the OECD Mend the International Tax System?* 71 TAX NOTES INT'L 1105 (Sept. 16, 2013) (describing the project as having "much more radical aims: to remodel the international tax system to ensure that TNCs are taxed according to where they actually do business").

[19] The OECD has generally described the work included in the BEPS project as falling into three categories, namely transparency efforts to improve tax administrations' knowledge of multinationals' structures and taxable profits, substantive efforts to align tax with economic substance and value creation, and coherence, or coordination of international tax rules to avoid tax arbitrage. According to its schema, each of the 15 action items fits within one of these categories. *See, e.g.*, OECD Policy Brief, BEPS Update No. 3 (Oct. 2015). Available at http://www.oecd.org/ctp/policy-brief-beps-2015.pdf .

[20] OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report*, OECD Publishing (2015) DOI: http://dx.doi.org/10.1787/9789264241695-en [hereinafter BEPS Action 6 Report].

[21] OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report* OECD Publishing (2015). DOI: http://dx.doi.org/10.1787/9789264241220-en [hereinafter BEPS Action 7 Report].

[22] *See* OECD, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 - 2015 Final Report*, OECD (2015), DOI: http://dx.doi.org/10.1787/9789264241688-en; OECD/G20 Base Erosion and Profit Shifting Project *Action 15: A Mandate for the Development of a Multilateral Instrument on Tax Treaty Measures to Tackle BEPS* (2015) available at http://www.oecd.org/ctp/beps-action-15-mandate-for-development-of-multilateral-instrument.pdf.

[23] *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*, OECD (2015) DOI: http://dx.doi.org/10.1787/9789264241244-en [hereinafter "BEPS Transfer Pricing Report"]

pricing documentation requirements – the country by country report -- included in action 13. This is the one area in which the U.S. has taken action on BEPS to date.

Action 13 is referred to as a "minimum standard" by the OECD. Other 'minimum standards' include transparency initiatives under action 5, which appears as a reincarnation of an earlier OECD project. What started out in the 1990s as an attempt to shut down harmful tax regimes has through the BEPS project morphed into something else altogether. In its review of harmful tax practices, action 5 started with patent boxes, and in the process developed guidelines for when patent boxes should be considered not harmful (having met substantial nexus requirements). Also contained in action 5 are recommendations for automatic exchange of cross-border tax rulings.[24]

Even in areas where the BEPS reports include consensus-based recommendations, not all participating countries are fully on board. For example, action 2 contains recommendations on hybrid instruments, while action 4 has recommendations for interest expense limitations. Both action items attempt to address excessive interest expense deductions in the cross border context. While some countries have evidenced an intention to incorporate the BEPS recommendations legislatively, others such as the U.S. are not likely to move as quickly, if at all, in this area.[25]

Not all the BEPS reports prescribe recommended law changes. Due to lack of agreement among participants, a number simply take the form of reports or a recitation of best practices. The digital economy report (action 1) outlines a series of options countries could take to ensure better taxation on profits from digital transactions, while a report on controlled foreign corporations (action 3) merely provides guidelines based on what different countries are doing as best practices. The report on mandatory disclosures (action 12), describes different approaches to requiring taxpayers to disclose information about aggressive tax transactions to respective governments.

A number of other items included in the BEPS action plan are of great interest to international tax practitioners, taxpayers and tax administrations, but not immediately relevant to the task of limiting base erosion and profit shifting practices. These include action 11, which tries to quantify revenues lost to governments from BEPS practices and develop a methodology for monitoring the effectiveness of BEPS recommendations, and action 14, intended to improve

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[24] *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 - 2015 Final Report*, OECD (2015) DOI: http://dx.doi.org/10.1787/9789264241190-en [hereinafter "BEPS Action 5 Report"].

[25] *See* Ryan Finley, *U.K. Seeks Public Comment on BEPS Interest Deductibility Rules*, WORLDWIDE TAX DAILY (Oct. 23, 2015), 2015 WTD 205-2; Ryan Finley, *HM Treasury Issues Proposals to Modify U.K. Patent Box*, WORLDWIDE TAX DAILY (Oct. 26, 2015) 2015 WTD 206-3; Mindy Herzfeld, *U.K. Leads on BEPS While the U.S. Dither*s, 80 TAX NOTES INT'L 727 (NOV. 30, 2015); Mindy Herzfeld, *The U.K. Embraces Tax Competition and BEPS*, 75 TAX NOTES INT'L 85 (JULY 14, 2014); Mindy Herzfeld, *Will the United States Take Action on the BEPS Action Plan*? 79 TAX NOTES INT'L 817 (Sept. 7, 2015). *See also* European Commission anti-tax avoidance directive (ATAD I and ATAD II). EU COUNCIL DIRECTIVE 2016/1164 (Jul.12 2016) at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2016.193.01.0001.01.ENG&toc=OJ:L:2016:193:TOC
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multilateral dispute resolution procedures. Like actions 5, 6 and 13, commitments to improved dispute resolution procedures is a BEPS minimum standard.

The OECD surprised most tax professionals and political observers by meeting its timelines and producing reports on each of the action items within the proscribed two-year timeline. It released a package of final BEPS reports in October 2015. It maintains that the coordination of international tax rules reflects a new global consensus that will result in a crackdown on tax havens and curb abuses in international tax arbitrage.[26]

B. Origin of current system

1. Colonialism and the development of international tax rules

The current international tax system has its roots in the years before and after World War I.[27] The rules hashed on in the early twentieth century by European nations and the U.S. set the parameters for a system which mostly remained in place for the next century. Key to the development of the current system was agreement on a model bilateral tax treaty.[28] The terms of that treaty, which currently exists in the form of the OECD model treaty, has served as the basis for the negotiation and terms of thousands of bilateral tax treaties since.[29] All OECD member countries have bilateral tax treaties in place that in their general format follow the original 1928 model treaty developed by the League of Nations.[30] The OECD model treaty is regularly updated along with its extensive commentary. The OECD's role with regard to the model treaty has allowed it to play a key position in the development and ongoing modification of international tax rules. Through its Committee of Fiscal Affairs, the OECD has played a significant function in coordinating international tax policy among its members, and setting the rules under which cross-border trade is taxed globally.

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[26] *See Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project*, OECD (2015) available at www.oecd.org/tax/beps-explanatory-statement-2015.pdf (stating that "[o]nce the [BEPS] measures are implemented, many schemes facilitating double nontaxation will be curtailed" because the "implementation of the BEPS package will better align the location of taxable profits with the location of economic activities and value creation, and improve the information available to tax authorities to apply their tax laws effectively").

[27] *See* Graetz, *Tillinghast Lecture* at 262-3 (noting that "not only the fundamental structure of the system for taxing international income today, but also many of the core concepts used to implement that structure--concepts such as permanent establishment, corporate residence, and arm's length pricing-date from a time when airplanes were first becoming a regular means of travel, and when the "wireless" was a relatively new instrument of communication …").

[28] *See* Graetz and O'Hear at 1023 (arguing that "the fundamental structure for international taxation of income announced nearly seven decades ago in the 1928 League of Nations Model Treaty forms the common basis for more than twelve hundred bilateral tax treaties now in force throughout the world.").

[29] On the development of tax treaties, s*ee generally* Klaus Vogel, *Double Tax Treaties and Their Interpretation*, 4 Int'l Tax & Bus. Law. 1 (1986), available at: http://scholarship.law.berkeley.edu/bjil/vol4/iss1/1. *See also* Wei Cui, *Minimalism about Residence and Source*, 38 Mich. J. Int'l L __ (2016) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2677429 (arguing that "[b]oth critics and defenders of the current international tax regime trace the 'traditional principles' of international taxation to a small group of elite academics and policymakers working for the League of Nations in the 1920s and 1930s.") (hereinafter Cui, *Minimalism*).

[30] Graetz and O'Hear at 1023.

Bilateral tax treaties govern the taxation of cross-border transactions by allocating taxing rights among and between its signatory countries.[31] The rules operate by first categorizing and classifying items of income into different categories. The treaty then assigns primary rights to tax different categories of income to one or the other of the treaty partners.[32] In general, treaties divide up taxing rights between source countries (the country where the business operations take place) and residence countries (the country where the owner or investor is tax resident). The current allocation of taxing rights is generally considered to favor residence countries at the expense of source countries (although the issue is the matter of some dispute).[33] Treaties also provide a set of rules for determining when a person's activity in another jurisdiction (in which it is non-resident) may be subject to tax by that jurisdiction. Generally speaking, activity must give rise to a permanent establishment in another jurisdiction in order to be taxed there. The permanent establishment threshold sets a bar for source countries to overcome before being able to assert taxing rights.[34]

Some argue that the rules developed in the aftermath of World War I for the allocation of taxing rights favored rich capital exporting countries at the expense of poorer nations, former colonies in particular. This narrative assumes that the countries that negotiated the principles of tax treaties were acting primarily in their own self-interest.[35] Under this narrative, the countries that developed the international tax rules that were then accepted by the rest of the world did so at others' expense. This perspective, still very much in evidence at meetings of the United Nations tax committee today,[36] assumes that much of the developing world was disadvantaged by the treaty rules laid out in the formative tax treaties. This account gives credence to and emphasizes the importance of the U.N. tax committee, which is supposed to act as a counterweight to the OECD and the international tax policy interests of its member countries.[37] The U.N. tax committee has developed its own version of a model treaty, the provisions of which are generally

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[31] *See* Dan Throop Smith, *The Functions of Tax Treaties*, 12 NAT'L TAX. J. 317 (1959); David S. Foster, *The Importance of Tax Treaties*, 5 HASTINGS INT'L & COMP. L. REV. 565 (1981-1982).
[32] *See* Cui, *Minimalism* at 17.
[33] *See generally Graetz & O'Hear;* Michael Lang and Jeffrey Owens, *The Role of Tax Treaties in Facilitating Development and Protecting the Tax Base*, WU Int'l Tax'n Rsch Paper Series No. 2014-03 (2014) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2398438 ; Veronika Daurer, *Tax Treaties and Developing Countries*, 42 *Intertax* 695–701 (2014); Cym Lowell & Bret Wells, *Income Tax Treaty Policy in the 21st Century: Residence vs. Source*, 5 Colum. J. Tax L. 1, 30 (2014) (arguing that "the 1935 Revised Draft Model Treaty shifted the balance of power away from source countries and toward the country of residence.") (hereinafter Lowell & Wells).
[34] *See, e.g.*, Richard Vann, I*nternational Aspects of Income Tax* 10 in TAX LAW DESIGN AND DRAFTING vol. 2 (Victor Thuronyi, ed., 1998).
[35] For example, Lowell and Wells argue that the organizing principles of the original model treaty policies involved "base erod[ing] colony countries for the benefit of imperial countries." Lowell & Wells at 22. They posit that the 1920s framework was based on the mercantilist belief that imperial countries were crucial providers of capital and know-how while colonies were passive suppliers of goods and services with little value added. As a result, the right to tax residual income belonged to the residence countries of the imperial companies. Source countries were allocated only routine profits. Lowell & Wells at 10.
[36] *See* discussion *infra* [].
[37] The U.N. committee of experts lacks the status of an intergovernmental agency, and it has a skeletal budget with only a few employees. *See* Mindy Herzfeld, *The U.N. Rewrites International Tax Rules*, 76 TAX NOTES INT'l 477 (Nov. 10, 2014); Mindy Herzfeld, *Implementing BEPS (or Not) in the Developing World* 80 TAX NOTES INT'L 475 (Nov. 9, 2015).

considered more favorable to developing countries because they provide for greater taxing rights for source countries.[38]

The principle that tax treaties are needed to alleviate double taxation is embedded in the development of the bilateral treaty network.[39] But over the past decades, academic commentators have adopted a more critical perspective. Tsilly Dagan of Bar Ilan University argues that treaties are not necessarily needed to reach the goal of alleviating double taxation because they "often just replicate the mechanism that countries unilaterally use to alleviate double taxation."[40] Instead, she argues that they "serve much less heroic goals, such as easing bureaucratic hassles and coordinating tax terms between the contracting countries, and much more cynical goals, particularly redistributing tax revenues from the poorer to the richer signatory countries."[41] According to Dagan, the current international tax system results in a shift of taxable revenues from poorer to richer countries.[42] This view receives support in recent papers by international organizations such as the International Monetary Fund (IMF), which notes that "the network of bilateral double taxation treaties based on the OECD model significantly constrain the source country's rights."[43] As a result, the IMF has suggested that developing countries "would be well-advised to sign treaties only with considerable caution."[44]

2. <u>A More Benign View</u>

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[38] The U.N. also has a transfer pricing manual to assist developing countries in applying transfer pricing rule. *See* UNITED NATIONS PRACTICAL MANUAL ON TRANSFER PRICING FOR DEVELOPING COUNTRIES (United Nations 2d ed. 2017) http://www.un.org/esa/ffd/wp-content/uploads/2017/04/Manual-TP-2017.pdf .

[39] The commentary to the introduction to the OECD model treaty states that: "The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons." Commentary to Article 1 of 2014 OECD Model Treaty. *See also* PREFACE TO THE UNITED NATIONS HANDBOOK ON SELECTED ISSUES IN ADMINISTRATION OF DOUBLE TAX TREATIES FOR DEVELOPING COUNTRIES iii (A. Trepelkov, H. Tonino and D. Halka eds. 2013) (noting the important role played by tax treaties in "encourag[ing] international investment and, consequently, global economic growth, by reducing or eliminating international double taxation over cross-border income)"; Brian Arnold, *An Introduction to Tax Treaties* 5 available at http://www.un.org/esa/ffd////wp-content/uploads/2015/10/TT_Introduction_Eng.pdf (noting that the wide acceptance of the U.N. and OECD model conventions has been important in reducing double taxation).

[40] Tsilly Dagan, *The Tax Treaties Myth*, 32 NYU J. INT'L L. & POL 939 [at *3]. *See also* Elisabeth Owens, *United States Income Tax Treaties: Their Role in Relieving Double Taxation*, 17 RUTGERS L. REV. 428 (1963); Julie Roin, *Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems*, 81 VA. L. REV. 1753 (1995).

[41] Dagan, *Tax Treaties Myth* at [*4]. Dagan argues that because "treaties have generally been constructed by and for developed countries with mutual interests and ideology", they provide residence countries with a larger slice of the revenue pie than do" unilateral mechanisms. Similarly, Lowell and Wells claim that "the existing model treaties, and the original TP rules to implement those treaties, were purposefully skewed" in favor of richer imperial nations. Lowell & Wells at 34.

[42] *See* Dagan, *Tax Treaties Myth* at 40 (arguing that "treaties tend to limit the tax rate a host country can impose on passive income," and that "[e]xcept in cases where tax sparing is granted, such a reduction in host country taxation does not translate into a larger volume of foreign investment, but rather amounts to no more than a revenue shift."). *See also* Lowell & Wells at 34.

[43] IMF Policy Paper, *Spillovers in International Corporate Taxation* (May 9, 2014) (available at https://www.imf.org/external/np/pp/eng/2014/050914.pdf) at 12 (hereinafter IMF SPILLOVER PAPER).

[44] *See* IMF SPILLOVER PAPER; OPTIONS FOR LOW INCOME COUNTRIES' EFFECTIVE AND EFFICIENT USE OF TAX INCENTIVES FOR INVESTMENT, A REPORT TO THE G-20 DEVELOPMENT WORKING GROUP BY THE IMF, OECD, UN AND WORLD BANK (Oct. 15, 2015) [hereinafter IMF INCENTIVES PAPER]. *See* Mindy Herzfeld, *The Backlash Against Tax Treaties and Free Trade*, 84 TAX NOTES INT'L 438 (Oct. 31, 2016).

An alternative version of this history exists, which instead of emphasizing how the foundations of the current international tax system rest on an imperial world, describe a more nuanced picture based on the history of the enactment of the U.S. foreign tax credit. Enactment of this credit means that the U.S. gives primary taxing rights to the source country rather than the residence (investor) country. Graetz and O'Hear have characterized enactment of the foreign tax credit by the U.S. as an example of a country acting in a selfless manner,[45]and as "an extraordinarily generous measure for its time." Its enactment meant that the U.S. assumed "sole responsibility for the costs of reducing the double taxation of its residents and citizens."[46]

In making this argument, Graetz and O'Hear are not trying to claim that U.S. international tax policy has been driven primarily by altruism; they point out that the credit was viewed "as a method to encourage foreign trade and to prevent revenue loss."[47] The fact that the U.S. was the world's creditor after World War I also may have motivated it to develop international tax rules which favored "generosity in source rules to capital importers."[48]

C. Why BEPS Now?

Calls for a revamp of the international tax system are not new. Scholars, policy makers, practitioners and taxpayers have for several decades been referring to the system as broken.[49] Yet it was not until directed by the G20 to address the issues of base erosion and profit shifting that the OECD began to seriously undertake a major effort of reform. As with any significant policy change, the impetus for the BEPS project was a confluence of factors, outlined below.

1. <u>Inequity and the Financial Crisis</u>

The international tax system muddled along in its basic form throughout most of the twentieth century was increasingly being called into question by the 1990s.[50] But little was done until the immediate aftermath of the financial crisis of 2008, as a direct result of which many governments undertook austerity programs.[51] The public discontent with crackdowns in social welfare spending also prompted NGOs and the press to question why many corporations reported tax rates far below statutory rates. The fact that multinationals' corporate tax payments in a given

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[45] Graetz & O'Hear at 1040, 1059 (1997) (arguing that the foreign tax credit was "a rejection of the primacy of residence based taxation, and that it "effectively gave priority to source-based taxation, while retaining residence-based taxation as a backstop.").
[46] Graetz and O'Hear note that "[s]uch generosity was virtually unprecedented." Graetz & O'Hear at 1045-46.
[47] Graetz & O'Hear n. 106 (quoting from Roswell Magill & William C. Schaab, *American Taxation of Income Earned Abroad*, 13 TAX L. REV. 115, 118 (1958).
[48] Graetz & O'Hear at 1072.
[49] *See* Graetz, *Tillinghast Lecture* (noting in 2000 that it was "a propitious time for a fundamental reexamination of the system of international income taxation and the principles and concepts on which it is based" due to changes in the world economy including advances in trade; increased global capital flows; and more sophisticated financial products). *See also* Reuven Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573 (2000).
[50] *See* Graetz, *Tillinghast Lecture*.
[51] *See* Brauner, *What the BEPS?* at 64.

country rarely matched, and often were significantly less than, statutory corporate income tax rates was an easy target for claims of inequity. Corporate international tax planning became headline news as never before.[52] The BEPS project was fueled by public perceptions of lack of fairness,[53] a perception evident overseas much more than in the U.S.[54]

In official OECD documents, notions of fairness and equity dominate as rationales for the BEPS project. For example, in presenting the BEPS action plan to the G20, OECD Secretary-General Angel Gurria noted that "*The joint challenges of tax evasion and tax base erosion lie at the heart of the social contract.*"[55] Similarly, in its statement endorsing the OECD's action plan, the G20 said:

> *In a context of severe fiscal consolidation and social hardship, in many countries ensuring that all taxpayers pay their fair share of taxes is more than ever a priority.*[56]

In an interview soon after the release of the BEPs action plan, Gurría claimed that "[t]he perception that individuals are getting away with not paying taxes because they hide that money away in a tax haven, or that multinationals are not paying taxes when they make billions in profits, is becoming politically untenable."[57]

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[52] *See, e.g.*, Nick Somerlad**,** *Six firms including Google and Facebook made £14 BILLION last year but paid just 0.3% UK tax,* MIRROR (Jan. 31, 2015) http://www.mirror.co.uk/news/business/six-firms-including-google-facebook-5081824http://www.mirror.co.uk/news/business/six-firms-including-google-facebook-5081824 ; *Starbucks: No UK Tax Paid Since 2009,* SKYNEWS (Oct. 16, 2012) http://news.sky.com/story/998230/starbucks-no-uk-tax-paid-since-2009 ; Bonnie Kavoussi, *Google Avoids $2 Billion In Taxes By Offshoring Profits In Bermuda*, Huffington Post (Dec. 10, 2012); Lisa O'Carroll, *If Google is in Ireland for tax reasons, why are most of its profits in Bermuda?*, THE GUARDIAN (Mar. 24, 2011); Matt Warman, *Google's £6 billion Bermuda tax shelter*, The Telegraph (Jan. 2, 2013) http://www.telegraph.co.uk/technology/google/9775216/Googles-6billion-Bermuda-tax-shelter.html ; Renai LeMay, *Australian Govt pledges action on Google tax avoidance*, DELIMITER (Nov. 23, 2012) https://delimiter.com.au/2012/11/23/australian-govt-pledges-action-on-google-tax-avoidance/ . A BBC News article noted how "a recent spate of stories has highlighted a number of tax-avoiding firms that are not seen to be playing their part." *See* Vanessa Barford & Gerry Holt, *Google, Amazon, Starbucks: The rise of 'tax shaming'*" BBC NEWS MAGAZINE (May 21, 2013). http://www.bbc.com/news/magazine-20560359

[53] *See* Brauner, *What the BEPS?* (arguing that "the substantive rules of the international tax regime were beside the point; it was the media exposure of these tax-planning schemes that mattered."); *see also* Andrew Morriss and Lotta Moberg, *Cartelizing Taxes: Understanding the OECD's Campaign Against 'Harmful Tax Competition,'*" 4 COLUMB. J. TAX L. 1, 52 (2012) (noting that "[d]omestic politics in several EU nations also increased interest in demonstrating that governments were "tough" on tax evasion.") [hereinafter *Cartelizing Taxes*].

[54] A scandal in which hundreds of private letter rulings granted by the Duchy of Luxembourg was leaked to the press (LuxLeaks) was front page news all over the world, but received much less coverage in the United States. In the UK, the need to "do something" about multinationals' corporate tax planning was a 2015 election issue, with the government's introduction of a new diverted profits tax on multinationals characterized as a political imperative by the Tory government. *See* Vanessa Houlder, *Business Leaders Attack UK 'Google Tax,'* FT (Dec. 10, 2014) (describing how the diverted profits tax was "greeted as politically astute ahead of an election campaign.").

[55] Remarks by Angel Gurría, Secretary-General of the OECD (Jul. 20, 2013) (available at 2013 TNT 141-19).

[56] G20 Leaders' Declaration par. 50 (Sept. 2013). https://g20.org/wp-content/uploads/2014/12/Saint_Petersburg_Declaration_ENG_0.pdf *See also* statement by European Union Tax Commissioner Algirdas Šemeta (Jul. 20, 2013) (MEMO/13/711, available at 2013 WTD 141-16 (stating that the BEPS action plan "fully supports our common objectives to ensure that everyone pays their fair share of tax.").

[57] *See* Stephanie Soong Johnston, *Tax Evasion and Avoidance Now Politically Untenable, OECD Chief Says*, 72 TAX NOTES INT'L 814 (DEC. 2, 2013).

Along with rhetoric over fairness and equity, comments made by officials from intergovernmental organizations on the need for the BEPS project also hint at populist concerns over globalization. The BEPS Action Plan notes that "globalization has opened up opportunities for MNEs to greatly minimise their tax burden,"[58] [sic] and that "as globalisation has changed the way business is done, the gaps and frictions that were always present" in the international tax system have become more of a concern.[59] Concerns with the fairness of international tax rules are part of a larger set of concerns over a new global order in which the old rules no longer function well. Non-governmental organizations have also played a significant role in shaping the international tax policy debate to focus on issues of inequality and equity. The influence of these organizations has grown significantly over the past decade, and their advocacy was part of the stimulus that led to development of the BEPS agenda.[60]

2. Digital Economy

As originally conceived, the BEPS project focused primarily on making changes to international tax rules to address disruption to business patterns resulting from e-commerce and what was referred to as the digital economy. The G20 leaders noted in their 2013 declaration that the growth of the digital economy posed challenges for international taxation,[61] and it is no accident that the first of the BEPS action items deals with the digital economy. According to the BEPS Action Plan, the digital economy poses challenges for international taxation because "it raises fundamental questions as to how enterprises in the digital economy add value and make their profits, and how the digital economy relates to the concepts of source and residence or the characterisation [sic] of income for tax purposes."[62] It is hard enough to figure out taxing rights as between two countries when the products being sold are physical goods and the processes that give rise to making the goods involve machines and tools. When the processes and products are invisible or ephemeral, it is harder to determine where activity is taking place and where to tax the profit.

The idea that modifications to the international tax rules were needed in order to address changes in business models caused by the rise of digital commerce was not new to BEPS. The OECD had been wrestling with these issues for years.[63] But the rise of U.S. tech companies that

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[58] BEPS Action Plan at 8.
[59] *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15-2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015) *http://dx.doi.org/10.1787/9789264241688-en* .
[60] *See* Alexander Lewis, *U.S. Multinationals Losing Tax Reform Debate*, *Stack Says*, 81 TAX NOTES INT'L 756 (Feb. 29, 2016); Mindy Herzfeld, *Bursting Global Tax Bubbles*, 82 TAX NOTES INT'L 315 (Apr. 25, 2016).
[61] G20 LEADERS' DECLARATION (Sept. 2013), available at http://www.g20.utoronto.ca/2013/2013-0906-declaration.html.
[62] BEPS Action Plan at 10. In endorsing the BEPS action plan in July 2013, EU Tax Commissioner Algirdas Šemeta said that he "particularly welcome[d] the commitment to examine ways to overcome the tax challenges of the digital economy" and that he expected to "be working closely both within the EU and with the OECD to find answers to the complex questions that taxing the digital economy poses." European Comm'n Memo (Jul. 20, 2013) available at http://europa.eu/rapid/press-release_MEMO-13-711_en.htm.
[63] In the late 1990s, the OECD issued an Action Plan for Electronic Commerce, with Taxation Framework Conditions for e-commerce. *A Report by the Committee on Fiscal Affairs* (Oct. 8, 1998), available at http://www.oecd.org/ctp/consumption/1923256.pdf . Subsequent reports on the topic were published in 2001. *See*

accumulated cash hoards of tens or hundreds of billions of dollars of low-taxed profits exacerbated the situation.

3. Political cover for politicians

Another political dynamic also played a role in the development of the BEPS action plan. The public furor over multinationals' tax planning provided politicians cover, or incentive, to undertake reforms that could not have been accomplished politically on their own. Some parts of the BEPS action plans require international coordination to accomplish. For example, changes to the OECD model treaty require consensus agreement to modify the document.[64] And changes to the OECD transfer pricing guidelines also require coordinated action.[65] So do modification to the dispute resolution process for cross-border tax disputes requires coordinated action.

But much of the BEPS action plan involves recommended changes to domestic law that countries could have passed on their own. Thus, one reason for the BEPS project was to force individual governments to pass laws and shut down tax breaks that either they preferred to leave open, or that would have been politically too difficult to accomplish without the cover of an international obligation. In that sense, the BEPS project was partly driven by the fact that finance ministries wanted to undertake revenue raising reforms that might be politically impossible for elected officials to achieve otherwise. Elected leaders needed the OECD and the G20 to drive the effort to reform international tax rules because signing up for international obligations allowed politicians to counteract business lobbying efforts that opposed reform, or political factions that saw tax breaks as a way to encourage investment. It also solved the first mover problem.

The G20 statements make clear that the G20 and the OECD believed that a coordinated international approach was needed because politicians lacked the moral courage or the will to undertake necessary action on their own. Similar approaches are evident in hearings conducted by the EU TAXE committee, formed by the European parliament to investigate tax rulings issued by EU member states.[66]

4. Global power shifts

Just as the dynamics of cross-border business has changed, so has the balance of power among eastern and western countries. While at the time the international tax rules were

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TAXATION AND ELECTRONIC COMMERCE: IMPLEMENTING THE OTTAWA TAXATION FRAMEWORK CONDITIONS (2001), available at http://www.oecd.org/tax/consumption/Taxation%20and%20eCommerce%202001.pdf

[64] Actions 6 and 7 of the BEPS Action Plan recommend changes to the OECD model treaty.

[65] The U.S., with its own model treaty is an exception here. The U.S. also has its own transfer pricing guidelines which while in many respects are consistent with OECD guidelines, in other aspects are unique. *See* U.S. Model Income Tax Convention (Feb. 27, 2016), available at https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US%20Model-2016.pdf ; *see also* IRC § 482 and accompanying regulations.

[66] *See also* Eric Zolt, *Tax Incentives: Protecting the Tax Base*, Paper for U.N. Workshop on Tax Incentives and Base Protection (Apr. 2015), available at http://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015TIBP_PaperZolt.pdf; U.N. Conf. on Trade and Dvlp't, WORLD INVESTMENT REPORT 2015: REFORMING INTERNATIONAL INVESTMENT GOVERNANCE, Chapter V, UN Publ. No. E.15.II.D.5, available at http://unctad.org/en/PublicationsLibrary/wir2015_en.pdf [hereinafter UNCTAD paper].

developed in the early twentieth century, many countries could be neatly categorized as either capital exporting or importing countries, the lines are now blurred, making it harder to identify which particular country would be benefitted by a given rule.[67] In contrast to publicly voiced concerns over fairness and globalization, these other macro-political trends, while also a driving force for the BEPS project, were rarely spoken of publicly.[68]

Nevertheless, these global power shifts are evident in the role the OECD adopted for itself in the BEPS project. While historically the OECD was organized to address the concerns of its member countries, primarily drawn from the wealthier countries in Western Europe and North America, it expanded its agenda as part of the BEPS project to make its work more relevant to emerging market economies.[69] At the same time, its primary allegiance remains to its member countries, who fund the organization.

Although the OECD repeatedly stressed that the BEPS project did not involve a re-examination of the principles forming the basis of the international tax system[70] and was focused on eliminating tax avoidance practices, numerous statements made by emerging market countries and NGOs suggest they had alternative perceptions of the project.[71] Their comments indicate how pressure from large emerging economies put pressure on the OECD to adopt a broad scope for the BEPS project, involving implicit reconsideration of principles that were supposedly inviolate.[72]

The BRICS countries in particular have been vocal in articulating opposition to the existing treaty system as detrimental to their economies.[73] Comments submitted by India's representative to the U.N. tax committee reflect the view of some emerging market countries that the international tax rules do not work to their benefit. In comments submitted to the U.N. in 2012 in opposition to a point of contention in the U.N. model treaty, the Indian delegate noted that:

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[67] *See* Lowell & Wells at 33 (highlighting how former source-colony countries have become residence-imperial countries). In 2015, the U.S. was the largest location for inbound foreign direct investment in the world. See SelectUSA statistics at https://www.selectusa.gov/servlet/servlet.FileDownload?file=015t0000000LKSn.

[68] *See* BRICS AND THE EMERGENCE OF INTERNATIONAL TAX COORDINATION (Yariv Brauner, Pasquale Pistone, eds. 2015); Amanda Athanasiou, *Source Versus Residence Debate Sparks Candid Comments on BEPS*, 81 TAX NOTES INT'L 44 (Jan. 4, 2016).

[69] *See* Stephanie Soong Johnston, *OECD Proposes 'Striking' Inclusive Framework for BEPS Implementation*, 81 TAX NOTES INT'L 727 (Feb. 29, 2016); Stephanie Soong Johnston, *OECD Inclusive Framework Gets Moving on BEPS Implementation Efforts*, 83 TAX NOTES INT'L 32 (Jul. 4, 2016). *See also* Lowell & Wells at 39.

[70] The BEPS Action Plan specifically states that the action plan "*is focused on addressing BEPS" and is "not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income.*

[71] *See* Lowell & Wells at 39 ("it appears that the BRICS and source countries have planted their stake in the sand, rejecting the existing order and declaring an intention to update the rules that apply to their own tax base defense."); Sol Picciotto, *Can the OECD Mend the International Tax System?* 71 Tax Notes Int'l 1105 (Sept. 16, 2013); India Responses to U.N. Questionnaire on Countries' experiences regarding base erosion and profit shifting issues, available at http://www.un.org/esa/ffd/tax/Beps/CommentsIndia_BEPS.pdf.

[72] *See* Lowell & Wells at 35 (noting that India, "[l]ike the other BRICS and many source countries of today, … is a serious economic power intent upon defending its own tax base, just as were the original residence countries in the 1920s," and that "[t]his emergence is a transformative element of the treaty policy dialogue.").

[73] Lowell & Wells at 4; Dagan, BETWEEN COMPETITION AND COOPERATION. *See also* Mindy Herzfeld, *Who Will Control the Future of International Tax Policy?* 78 TAX NOTES INT'L 419 (May 4, 2015).

> *The OECD principles have evolved from the perspective of only developed countries since they were prepared by the OECD countries, and many issues relating to developing countries have not been taken into consideration.*

The comments state that reliance on OECD developed standards "has resulted in serious curtailment of the taxing powers of the developing countries in relation to international transactions," and that they therefore "should not be taken as internationally agreed 'standards.'"[74]

The debate over whether the current allocation of taxing rights under the OECD model treaty reflects the interests of developing countries was percolating prior to the start of the BEPS project. But it became more pronounced because the G20 mandated that the OECD process be opened up to take the views of emerging BRICS economies into account as full participants in the OECD consensus process. This process allowed the OECD to segue into a role that includes rule-setting not just for OECD member countries, but for a larger group of nations as well. Its new inclusive framework – an outgrowth of the BEPS project that includes many countries outside of the OECD in the consensual process for making policy decisions relating to global tax issues – highlights how the OECD's role has expanded.[75]

An initiative launched by BRICS countries for coordination and cooperation of tax policy and tax administration[76] is not so different from the increasingly assertive stance being taken by a number of these countries on other issues of international economic policy.[77] The fact that that in the BEPS project the OECD was forced to take account of the political and revenue goals of emerging market countries is part of the context of a larger debate over the need for change in global financial institutions which have retained post-World War II power balances.[78] Another example of this flexing of muscles by emerging markets is the New Development Bank formed by the BRICS countries[79] and the Asian Infrastructure Investment Bank, an infrastructure bank

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[74] Letter from M.S. Puri to H.E. Mr. Milos Koterec, President of the Economic and Social Council, United Nations (Aug. 13, 2012) http://www.un.org/esa/ffd/wp-content/uploads/2014/10/ta-unmodel-LetterIndia_13aug12.pdf . *See* Mindy Herzfeld, *India and the United States – Half a World Apart on Tax*, 84 TAX NOTES INT'L 953 (Dec. 12, 2016).
[75] *See* Stephanie Soong Johnston, *G-20 Finance Ministers Approve BEPS Framework*, 81 TAX NOTES INT'L 819 (Mar. 7, 2016).
[76] *See* Joint Communique issued after Two Day meeting of the heads of Revenue of Brics Countries, January 18, 2013 (announcing the cooperation agreement between Brazil, Russia, India, China, and South Africa), reprinted at 2013 WTD 15-27, Tax Doc. 2013-1498 ("We [BRICS countries] agree to extend the cooperation on the following issues of tax policy and tax administration: (i) contribute to development of International Standards on International Taxation and Transfer Pricing taking into account the aspirations of developing countries in general and BRICS Countries in particular.").
[77] *See* Yariv Brauner & Pasquale Pistone, Eds., BRICS AND THE INTERNATIONAL TAX REGIME (IBFD 2014).
[78] As the U.S. 2016 election illustrated, such pressures are coming from the U.S. as well.
[79] *See, e.g., BRICS Countries Launch New Development Bank International Centre for Trade and Sustainable Development, 1*8 Bridges 26 (Jul. 17, 2014) http://www.ictsd.org/bridges-news/bridges/news/brics-countries-launch-new-development-bank. This new development bank was launched by the BRICS countries in direct response to the failure of the World Bank and the International Monetary Fund to revise their system of decision making process to give more of a voice to developing countries.

led by China. In announcing the launch of the New Development Bank, the Chinese Finance minister said:

> *This bank will place greater emphasis on the needs of developing countries, have greater respect for developing countries' national situation, and more fully embody the values of developing countries.*[80]

These trends highlighted the risks to the OECD of not bending its own tax rule-making process to accommodate the participation and positions of developing countries. The OECD needed to make the BEPS project broader rather than narrower to prevent the possibility that an alternative international rule-making body would develop. In that respect, BEPS was partly a test case for the OECD as to whether it could accommodate the policy goals of the BRICS and other countries as part of the BEPS mandate. The reform agendas of these countries go far beyond those of restricting base erosion and profit shifting practices. As discussed further below, China and India in particular viewed the project as a way to revisit fundamental principles of the international tax system.

There is another aspect to the story of how global power shifts prompted large developed countries to advocate for the BEPS project. As financial markets opened up and trade barriers fell, international trade forced developed countries to become more competitive to sustain their welfare states. Restricting tax competition was one way for them to continue to survive while providing the same benefits to their populations.[81] It presented the opportunity to muscle smaller (developed) countries which had developed into financial centers out of the picture.[82]

5. The OECD's Role

Historically, the OECD's tax agenda has formed a subset of its broader mission which is to facilitate economic development and cross-border trade.[83] Decision making at the OECD is by consensus, meaning that any one country can effectively block a reform from moving forward.

[80] As quoted in Gabriel Wildau, *New Brics bank in Shanghai to challenge major institutions*, FT (Jul. 21, 2015) http://www.ft.com/intl/cms/s/0/d8e26216-2f8d-11e5-8873-775ba7c2ea3d.html#axzz3q4SpN4DZ . *See also* Gabriel Wildau and Charles Clover, *AIIB launch signal China's new ambition*, FT (Jun. 29, 2015).
[81] *See Cartelizing Taxes* at 4 (noting that "[u]ntil relatively recently, larger developed economies have been sheltered from some of the competition to attract economic activity by the combination of the costs of conducting international transactions and the barriers to such transactions" but that as "these barriers declined and investors grew more sophisticated at using international financial structures to reduce tax burdens on international transactions, states whose economies' size had previously been sufficient to make them attractive locations for investment found themselves struggling to capture revenue from increasingly internationalized transactions").
[82] *See generally Cartelizing Taxes*.
[83] The OECD is the successor of a body (the Organization for European Economic Cooperation) formed after World War II to promote economic development, including facilitation of free trade, beginning with the implementation of the Marshall plan. For a brief history of the origins of the OECD, *see* Joint Committee on Taxation, *Background, Summary, and Implications of the OECD/G20 Base Erosion and Profit Shifting Project* (JCX-139-15) (Nov. 30, 2015).

The OECD's tax function has traditionally moved slowly, and modifications to the language of the OECD model treaty have often taken years if not decades to finalize.[84]

However, the leadership of the tax organization responded eagerly to the G20's invitation to expand and shift its traditional role in international tax policy, making attacking tax avoidance – with a necessary ancillary attack on global companies' actions -- a focus of its work. In the BEPS project, the OECD learned its lessons from prior unsuccessful efforts in this area. The BEPS project provided a vehicle for the OECD tax committee, arguably becoming less relevant in a world where economic power was shifting to the east, to take on a role as key arbiter of global tax rules.[85] In so doing, it strengthened its organization, and the careers of its bureaucrats.[86]

II Weak Foundations

While countries and international organizations in 2012 could point to many different reasons why a coordinated effort to reform international tax rules made sense, particularly in the case of minimizing revenues lost to governments as a result of multinationals' base erosion and profit shifting activities, as the BEPS project swept forward with a momentum of its own, the coordinated effort mostly ignored the underlying issues that gave rise to the challenges that the project was supposed to address. In this section I show how the underlying premises for the coordination efforts undertaken in the BEPS project were flawed, necessarily leading to problematic outcomes. In highlighting progress in coordination efforts, policy makers and government officials were able to paint over major policy differences.

A. Global politics

1. No Agreement on Allocation

The BEPS action items required technical revisions to existing domestic tax rules and international agreements such as bilateral tax treaties. But while an implicit assumption embedded in the agreement to change a law is that there is agreement on the principle and policy behind the changes, such agreement never existed in the case in the BEPS project. To the extent countries in the 1920s had reached a general agreement over how multinationals' global profits should be allocated, such consensus no longer exists. The BEPS project never acknowledged this lack of

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[84] The committee is led by technical experts acting as representatives of the developed economies, which provides for a technocratic, bureaucratic, bottom-up procedure. *See* Grinberg, *Breaking BEPS* at 9.
[85] *See* Philip Baker, *Is There a Cure for BEPS?* 5 BRIT. TAX. REV. 605 (2013).
[86] *See Cartelizing Taxes* at 57. The significant role played by individual leadership in the effectuation of the BEPS action plan must be mentioned. In Pascal Saint-Amans, Director, Center for Tax Policy and Administration at the OECD from the start of the BEPS project, the international coordination project found someone with the skills and motivation to move the project from conception to completion. *See* Stephanie Soong Johnston, *Pascal Saint-Amans – The Face of BEPS,* 2014 WTD 245-1 (Dec. 22, 2014). The G20 may have desired international tax reform, but without someone in the leadership capacity with Saint-Amans' skills and motivation, the BEPS action plan may have ended up as little more than a footnote in a G20 letter. See introduction by David Rosenbloom to the 2015 Tillinghast lecture presented by Saint-Amans, noting that Saint-Amans had accomplished "what is pretty close to a miracle, steering the BEPS project through a three year process to completion" and capturing the attention of millions of people in the process. (available at https://www.youtube.com/watch?v=qUy-_gHe-Mg).

agreement, highlighted in comments from countries such as China and India on various aspects of the project. The lack of agreement on principles meant that it was practically impossible to reach meaningful consensus on the details of rules.[87]

Achieving consensus is challenging because the different roles that countries play in the world economy mandate that they advocate for competing international tax policies. Consider, for example, a vastly simplified characterization of the different roles the U.S., France, China, and Brazil play within the world economy. The U.S. economy thrives on innovation, and the intellectual property developed by its resident multinationals is one of the biggest drivers of growth and source of profits for its resident companies.[88] France, in contrast, supports employment in its jurisdiction by charging higher prices for products produced, and sold, within the jurisdiction. While China has been a global engine of growth for much of the past decade, this growth has been to a large extent driven by its ability to promote low-cost manufacturing through the capacity of its very large population to work for low wages and through exports. Brazil, like many other developing economies, relies to a large extent on the export value of its commodities. While these are gross generalizations that gloss over many of the different facets of the different economies, they also illustrate why countries take different positions on how international tax rules should be designed to allocate multinationals' profits among different countries.

Because the U.S. economy derives significant value from its corporate residents' development of intellectual property, it in theory should have a strong interest in an international tax system which allocates taxable profits in accordance with the development of "value" as defined relative to intellectual property.[89] France, which lacks a strong base of profitable and innovative companies in high tech industries, instead advocates for international tax rules to be revised to allow greater possibility for assessing corporate income tax at point of sale (where the market is).[90] Countries such as Brazil that rely heavily on the export of natural resources want greater emphasis on withholding taxes. China, a country whose economic strength has historically depending on its large labor force, would like to see the allocation principles place more stress on human capital factors (including its market) than other types of capital.[91]

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[87] *See* discussion *supra* pp. [].

[88] *See* Kevin Rivett, Henry Nothhaft and David Kline, *Discovering New Value in Intellectual Property*, HBR (2000) at https://hbr.org/2000/01/discovering-new-value-in-intellectual-property.

[89] In reality, the U.S. position is muddled due to the fact that unlike most of the rest of the world, it taxes the worldwide income of its resident taxpayers. In practice, this worldwide system provides its multinationals with significant incentives to keep their profits out of reach of the U.S. tax net and move high-valueintangibles overseas into low tax jurisdictions. *See* Edward Kleinbard, *Stateless Income's Challenge to Tax Policy* (arguing that "[t]t is more accurate to say that in practice and as used by sophisticated multinational firms, the U.S. tax system operates as an ersatz territorial tax regime"). But as the negotiating positions of the U.S. Treasury in the BEPS project show, the U.S. still retains a strong interest in ensuring that the value derived from U.S. developed intellectual property is not taxed elsewhere, because it retains the possibility of being repatriated to the U.S. *See* Robert Stack, *The Progress and Future of BEPS* (Remarks delivered to the OECD/U.S. Council for International Business tax conference (Jun. 10, 2015)), reprinted at 147 TAX NOTES 1593 (Jun. 29, 2015).

[90] The U.S. and France were co-leaders of the digital economy project and had very different views. *See* Ryan Finley, *Stack Reflects on Turbulent Days at Treasury, Future of the OECD*, 85 TAX NOTES INT'L 1045 (Mar. 20, 2017).

[91] *See* discussion *infra*.

As part of the revision to transfer pricing guidelines in the BEPS project, the OECD undertook a revision of guidelines for the profit split method, a controversial method of transfer pricing.[92] Comments submitted by Chinese academic institutions on the first version of the profit split draft illustrate the extent to which the Chinese authorities viewed the BEPS project as an opportunity to revisit international tax principles.[93] These comments stated that while "[i]n the past, the [transfer pricing] mechanism focuses on only the supplier side of enterprises with no emphasis of the market and no mentioning of the government," such old-fashioned concepts needed to be "upgraded." The Chinese comments stated that "the transfer pricing outcomes shall be in line with not only value creation, but also value realization."[94] They also argued that the arm's length standard should be combined with a new principle, the "fair-share-principle," because the arm's length principle fails to reflect the "exterior contributions from the markets and the governments."[95] The Chinese comments thus illustrates a vision for a more radical rewrite of international tax rules than that stated in the OECD's agenda.

The BEPS project charted new territory in focusing on value creation as the determinant for profit allocation.[96] But value creation is an incoherent and ill-defined notion, and not all countries were aligned on this idea. For example, China argued for a rejection of the concept of value creation in favor of an alternative notion of value realization, an idea that gave the market relevance as a factor in the pricing of goods transferred across borders. Relying on market realization as an allocation factor would likely mean that China would be allocated a greater share of a global company's profits. And China does not necessarily agree that a company's profits are solely attributable to the arm's length factors of assets, functions and risks,[97] but highlight the market and the government as two additional value contributors that must be considered in the

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[92] The U.S., the OECD, and the U.N have each expressed concerns as to the choice of the profit-split method and how it will be used. For example, the BEPS final report on actions 8-10 cautioned countries against using the profit-split method too proactively. *See* BEPS Transfer Pricing Report. In its discussion draft on the profit split method issued in July 2016, the OECD cautioned that "lack of comparables alone is insufficient to warrant the use of a transactional profit split of actual profits under the arm's length principle." https://www.oecd.org/tax/transfer-pricing/BEPS-discussion-draft-on-the-revised-guidance-on-profit-splits.pdf

[93] See Comments on Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains, China International Tax Center / IFA China Branch (Feb. 6, 2015), *available at* http://www.oecd.org/tax/transfer-pricing/public-comments-action-10-profit-splits-global-value-chains.pdf [hereinafter China IFA Comments]; Mindy Herzfeld, *Splitting Profits with Communists*, 79 TAX NOTES INT'L 467 (Aug. 10, 2015).

[94] See China IFA Comments. The comments state that: "Both value creation and value realization enable a value becomes a value. In this way, the role of the enterprises and markets are clearer and their contribution to the value will be easier to be identified and differentiated."

[95] The Chinese comments advocate adoption of a formulary apportionment system to replace the arm's length standard, arguing that, "the simpler Formulary Method which takes care of all important contributing elements will better illustrate the Fair-Share-Principle." *Id*.

[96] The BEPS Action Plan mandate for revision of the transfer pricing guidelines is to "assure that transfer pricing outcomes are in line with value creation." *See* BEPS Action Plan Actions 8, 9 and 10. *See* Michael Devereaux and John Vella, *Are We Heading Towards a Corporate Tax System Fit for the 21st Century*? 35 FISCAL STUDIES 449 (2014).

[97] China IFA Comments.

arm's length analysis.[98] The theory of value realization advocated by the China Comments suggest that because it is ultimately the consumers who provide value to a business, a country with more consumers deserves to be credited with a greater share of business profits.

The fact that Chinese institutions submitted as comments on a BEPS discussion draft suggestions for rewriting the rules in accordance with principles that diverge from the arm's length principle, while simultaneously participating on a consensus basis in a project that endorsed that principle, illustrates the wide split on fundamental principles of the international tax system among BEPS participants. Such differences exist not just between the developing and the developed world. Significant disagreements over the proper basis for assessing the income tax were evident over the course of the BEPS debate between the U.S. and many European countries. These differences played out in the BEPS report on the digital economy, which was co-led by two countries with widely conflicting views on the question of how profit derived from the digital economy should be taxed.[99]

In addition to disagreements among countries, the NGOs whose voices were instrumental in getting OECD to undertake the project consistently questioned its parameters. Throughout the project, for example, the BEPS Monitoring Group argued that the fundamental problem with the current international tax rules was that they respected legal entities as separate persons.[100]

Simply put, there was no agreement among the parties negotiating changes to the international tax rules as to the appropriate balance between taxation based on source versus residence.[101] Generally speaking, a system which gives priority to residence as a means of taxation is likely to favor richer countries, whose residents channel capital to developing countries, while giving greater priority to source may favor developing countries whose only

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[98] The comments from IFA's China Branch and the China International Tax Center are written on the letterhead of Beijing's Central University of Finance and Economics which is supported by the Chinese government. The comments suggest that the unique role of the Chinese government warrants a greater allocation of profits to China, stating that:

> *Especially in the case of the Chinese government, it is not only an expenditure unit in compensation for passive public service of security, but also an active investing party in the economy who then shall enjoy the surplus of the out-puts; the Chinese government undertakes more functions than other 'market economy governments*.'

Furthermore, the comments state that while the government has not been recognized "as a producing unit in the past; in the modern economy, its macro productive force is increasing [sic] accepted by the society."

[99] The U.S., which continues to adhere to the principle that profits should be taxed where the value producing assets reside, while France and some other countries profess to favor a tax base that looks to the market for digital products. While concerns over whether the existing tax system adequately captured profits from the digital economy were at the root of the BEPS project, action 1 of the project, which was supposed to "identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties," did not produce any detailed recommendations due to lack of consensus. See OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, (2015). Available at: http://dx.doi.org/10.1787/9789264241046-en [hereinafter ACTION 1 REPORT].

[100] See BEPS Monitoring Group, *Overall Evaluation of the G20/OECD Base Erosion and Profit Shifting (BEPS) Project* (Oct. 5, 2015), available at 2015 WTD 193-33 (Oct. 6, 2015).

[101] *See* Amanda Athanasiou, *Source versus Residence Debate Sparks Candid Comments on BEPS*, 150 TAX NOTES 67 (JAN. 4, 2016).

basis for tax may be the activities being conducted within their jurisdiction. But even those demarcations are no longer necessarily valid in an age when capital flows both ways.[102]

Lack of agreement about the principles on which global profits will be allocated poses challenges to an international effort of coordination premised on the goal of strengthening the operating rules that implement those principles.

2. Global politics – shifts in balance of power

An international tax system that was developed by, and arguably in the interest of, richer developed countries to the disadvantage of developing countries was the basis for the international tax system for close to a century. But shifts in the global balance of power mean that inequalities resulting from such a system -- whether perceived or real -- are no longer sustainable.[103] As emerging markets that are becoming ever more dominant in the global economy assert their interests in international tax policy more aggressively, this perception of an unequal system poses an additional constraint on the ability to reach consensus on modifications to current rules. Shifts in global power balances mean that some countries no longer feel that the status quo is advantageous to them, and are willing to express their positions. This too creates challenges for reaching agreement on a set of rules.

Comments from India on the U.N. model tax convention are relevant here. India's representative to the U.N. tax committee objected to what it described as the U.N. tax committee rubber stamping the OECD's tax guidelines:

> *The Committee of Experts and its predecessor Ad Hoc Group of Experts have not been able to appropriately reflect all the concerns of developing countries, as the proceedings in the Committee and its sub-Committees tend to be dominated by experts from the OECD countries, low tax jurisdictions and- non-governmental observer-representatives. An inter-Governmental Commission with balanced representation from countries at various stages of development would be a preferred organization to develop international standards for adoption by the countries. Only a commission of such nature can play a crucial role in fostering dialogue and cooperation between national tax authorities and ensure that the views of the developing countries do not get ignored, particularly when the positions of the developed countries on issues on which they have a consensus, are challenged.*[104]

When agreement was hashed out over a model tax agreement that became the OECD model convention in the early twentieth century, it was among countries with relatively equal economic clout. As the international tax rulemaking process expanded in BEPS to include the

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[102] *See* Reuters, *China's outbound investment jumps, catching up with FDI* (Jun. 18, 2015), available at http://uk.reuters.com/article/uk-china-investment-fdi-idUKKBN0OY07420150618.
[103] *See generally* Yariv Brauner & Pasquale Pistone, Eds., BRICS AND THE INTERNATIONAL TAX REGIME (IBFD 2014).
[104] Letter from M.S. Puri, Ambassador/Deputy Permanent Representative from India to the United Nations, to Milos Koterec President of the U.N. Economic and Social Council (Aug. 13, 2012), accessible at http://www.un.org/esa/ffd/wp-content/uploads/2014/10/ta-unmodel-LetterIndia_13aug12.pdf

larger emerging economies in addition to historical OECD members, parties' divergent interests made it harder to coordinate a single set of rules. If emerging countries see the international tax rules as a way to assert their growing global economic power, it becomes harder to agree on the rules that should apply to all.[105]

In addition, the least developed countries, which were not part of the BEPS project initially but now have a role within the BEPS inclusive framework,[106] also believe that the current system is inherently biased against them. As a result, they resist changes to the model treaty that enforce existing principles. Such protests against the existing system are made clear in the outputs of the U.N. tax committee.[107]

B. Domestic politics

1. Power to Tax Means Political Power

Any effort to coordinate international tax rules necessarily involves a loss of sovereignty and hence of domestic political power. The compromise necessary to reach international agreement consequentially dilutes the local politician's ability to be responsive to constituents.[108] Julie Roin of University of Chicago, in her paper on *Taxation without Coordination* argues that "[t]ax base harmonization reduces legislative control over national tax policy without creating a corresponding increase in control over world-wide tax policy."[109] The fact that the U.S. may have lots of influence to shape international tax rules at the OECD doesn't help individual congressmen trying to secure advantages for their constituents. With the ability to write tax laws and give tax breaks comes political power, and, according to Roin, legislators are keenly aware of the loss to their own power that accompanies significant attempts to assign such power to an international organization, such as loss of opportunity to grant special favors, while "receiving accompanying recompense." The more power an international organization charged with harmonizing tax laws accrues, the more political opportunities are potentially lost to local politicians.[110]

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[105] *See* Mindy Herzfeld, *India and the United States: Half a World Apart on Tax*, 84 TAX NOTES INT'L 953 (DEC. 12, 2016).
[106] *See* OECD Background Brief: Inclusive Framework on BEPS (Jan. 2017), available at http://www.oecd.org/tax/beps/background-brief-inclusive-framework-for-beps-implementation.pdf.
[107] The 2017 version of the U.N. model treaty includes a new article that greatly expands taxation at source. *See* U.N. Comm. of Experts on Int'l Cooperation in Tax Matters Seventh Session, *Taxation of Services Report of the Coordinator* E/C.18/2016/CRP.1. Available at http://www.un.org/esa/ffd/wp-content/uploads/2016/10/12STM_CRP1_Services.pdf ; Andrés Báez Moreno, *The Taxation of Technical Services under the United Nations Model Double Taxation Convention: A Rushed – Yet Appropriate – Proposal for (Developing) Countries?* 7 WORLD TAX J. 3 (2015).
[108] On the importance of political responses to local needs in setting domestic tax policy, see James Hines, *High Tax Heresy* [working paper Jan. 2016], available at http://www.law.georgetown.edu/faculty/symposia-lectures/tax-law-public-finance/upload/High-Tax-Heresy-Jan-2016.pdf (arguing that "[i]n well-run democratic societies the legislatures choose tax policies, thereby implicitly or explicitly attaching weights to equity, efficiency, administrability, and possibly other considerations).
[109] Julie Roin, *Taxation without Coordination*, 31 J. LEGAL STUDIES 61, [xx]. Roin further notes that "[n]ational legislators thus would lose a significant element of political power, power that generates benefits in the form of campaign donations, honoraria and other inkind benefits." *Id*.
[110] Roin, *Taxation without Coordination* at [xx].

While G20 finance ministers have lauded the BEPS project as providing the opportunity to recoup a missing $200 billion from the global economy in the form of stateless income, locally elected politicians may see less benefit. Roin's point that "tax base harmonization will not necessarily provide governments with enough additional revenue to fully compensate their politicians for the concomitant losses of political control" is particularly salient in the context of the BEPS project.[111] Local politicians' interests are not necessarily in sync with those of tax technocrats who negotiate international rules in a technical body.

International coordination also may conflict with domestic policy goals. Robert Stack, who as U.S. Treasury deputy assistant secretary (international tax affairs), during the time period when most of the negotiation over the BEPS project took place, had a unique vantage point on the various viewpoints of the participants, repeatedly reflected on how the possibility of significant change in international tax rules resulting from BEPS ultimately ran head-on into nationalist interests.[112] The fact that international coordination efforts may play out at the expense of a loss of power to domestic politicians is relevant because it motivates them to impose roadblocks to successful conclusion of the effort.

2. <u>The need to encourage investment (e.g., patent box)</u>

The views of tax experts as to optimal tax policy often runs head on into the domestic politics around tax incentives. Economists generally disfavor tax incentives designed to attract foreign investment, consistently questioning whether tax incentives geared towards encouraging foreign investment produce a net economic benefit. There is widespread consensus among academic economists that developing countries, and in particular the least developed countries, suffer from an overuse of tax incentives.[113] The concern also exists in developed countries but is less acute because corporate tax revenues represent a smaller share of their budgets.

In 2015, the IMF released a working paper examining the costs and benefits of tax incentives that aim to encourage investment.[114] The paper concluded that:

> *"IOs [international organizations] and many other observers have often found tax incentives to be ineffective, inefficient and associated with abuse and corruption. As a result, they have frequently advised countries to remove them or to improve their design, transparency and administration. Yet, this advice has often had limited effect. The common reluctance to scale back incentives – perhaps even, . . . a tendency for them to*

[111] Roin, *Taxation without Coordination* at [xx].
[112] *See* Amanda Athanasiou, *Competitive Interests Preventing Consensus on CFCs, Stack Says*, 2015 WTD 96-3 (May 19, 2015); Robert Stack, *Remarks delivered at OECD/USCIB tax conference* (June 2015), *available at* 2015 WTD 124-14. *See also* Graetz & O'Hear at 1042 (noting that "it is hard to convince a U.S. President or members of Congress to put aside "narrow" national interests to fashion U.S. tax policy in a manner that is indifferent to whether taxes flow into U.S. coffers or the treasury of some foreign nation").
[113] *See, for example*, Alexander Klemm and Stefan Van Parys, *Empirical Evidence on the effects of Tax Incentives*, 19 INT'L TAX & PUBL. FIN. 393 (2012)).
[114] IMF Incentives Paper, supra n. [xx].

> *proliferate – may reflect vested interests, political inertia, and tax competition with other countries."*[115]

The IMF paper noted the challenges inherent in persuading politicians on this point, acknowledging that "reform of tax incentive regimes has proven difficult."[116] The IMF paper says that "politicians may find it attractive to introduce new tax incentives to reveal their proactive stance in addressing weak economic performance, or to favor particular regions."[117]

The increasing prevalence of the patent box – simultaneously with countries' commitment to the BEPS project -- highlights the tensions between sound economic policy, coordination of tax rules, and local desires for tax incentives to encourage foreign investment.[118] In theory, the patent box regime,[119] in which countries adopt a lower tax rate on income from intellectual property, encourages research and development activities in the country offering the incentive. But studies have shown that this is rarely the case. European Commission researchers have demonstrated a tenuous connection between tax benefits conferred through a patent box and an increase in R&D activities that a patent box is supposedly designed to produce.[120] They conclude that "the tax advantage of patent boxes tends to deter local innovative activities, given the lack of incentives for companies to develop local research."[121] After surveying different countries' IP boxes, economists at the Centre for European Economic Research concluded that they are generally poorly designed to encourage investments in R&D.[122]

Yet despite rigorous economic data that is suggests skepticism about the efficacy of the patent box, countries continue to adopt such regimes. Patent boxes have been around since the early 2000s – France's incentives date to 2001 and Hungary's to 2003. But the frequency of adoption has increased in recent years. Since 2003, at least ten other countries have adopted them, including Belgium, Cyprus, the Netherlands, Luxembourg, and the United Kingdom.[123] In

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[115] IMF Incentives Paper at 6.
[116] IMF Incentives Paper at 28.
[117] IMF Incentives Paper at 28; *see also* UNCTAD paper.
[118] *See* Mindy Herzfeld, *The Politics of the U.S. Patent Box* 79 Tax Notes Int'l 905 (Sept. 14, 2015);
[119] The patent box is also frequently referred to as a "knowledge box" or an "IP box."
[120] European Commission, "Patent Boxes Design, Patents Location and Local R&D," June 2015, available athttp://goo.gl/ikHIXt.)
[121] *Id*.
[122] Lisa Evers, Helen Miller, and Christoph Spengel, *Intellectual Property Box Regimes: Effective Tax Rates and Tax Policy Considerations*, 22:3 INT'L TAX PUBL. FIN. 502 (2015), available at http://goo.gl/I2AIsP.) In a series of articles published in Tax Notes, economist Martin Sullivan has also laid out a case against the patent box, arguing that encouraging innovation through a patent box produces worse results with more complexity than providing tax benefits to encourage inputs, such as increased spending on R&D. See, e.g., Martin Sullivan, *A History Lesson for a Future Patent Box*, 148 TAX NOTES 1036 (Sept. 7, 2015); Martin Sullivan, *Do Patent Boxes Move More Than Patents?* 148 TAX NOTES 243 (Jul. 20, 2015); Martin Sullivan, *Can a Patent Box Promote Advanced Manufacturing?* 147 TAX NOTES 1347 (Jun. 22, 2015).
[123] See Evers, Miller and Spengel, *Intellectual Property Box Regimes, id*.; Jt. Comm. On Tax'n, *Present Law and Background Related to Proposals to Reform the Taxation of Income of Multinational Enterprises* JCX-90-14 (Jul. 21, 2014); Domenico Borzumato and Annalisa Vergati, *Italy's Finance Bill – Tax as a Tool for Growth*, WTD (Nov. 24, 2014); J.P. Finet, IP Box, Country-by-Country Reporting Featured in Irish Budget, 2015 WTD 198-3 (Oct. 14, 2015); American Action Forum, *Patent Boxes, Technological Innovation and Implications for Corporate Tax Reform* (Aug. 24, 2015), available at: http://americanactionforum.org/research/patent-boxes-technological-innovation-and-

conjunction with new guidelines offered as part of the BEPS project for patent boxes, even more countries have jumped on this bandwagon, including Ireland, Italy and Switzerland. In 2015, Congressmen Charles Boustany of Louisiana and Richard Neal of Massachusetts introduced a patent box proposal in the U.S. Congress (the Innovation Promotion Act of 2015).[124] And the idea remains popular in the U.S., although it has been overshadowed in recent tax reform debates.[125]

Throughout the course of the BEPS project, the OECD repeatedly emphasized that the project was not about harmonizing rates but instead about eliminating gaps that facilitate abusive planning. In response to the BEPS recommendations, countries that previously relied on such gaps to encourage foreign investment announced plans to lower their overall rates. These include the United Kingdom, which introduced a plan to lower its corporate income tax rate from the already low 20 percent to 17 percent.[126] In November, 2016, Hungarian Prime Minister Viktor Orbán committed to reducing Hungary's corporate income tax rate to 9 percent.[127]

The international competition for investment through tax incentives is often portrayed as a harmful race to the bottom. But it can alternatively be characterized as an important exercise of political autonomy and sovereignty. Some academics warned early in the BEPS project that if it the OECD was successful, "domestic policy decisions constrained by competition among jurisdictions to attract capital will be transformed into international decisions dominated by a cartel of wealthy nations."[128] Evidence of such cartel-like behavior is demonstrated through the results of BEPS action 5. [129] Ostensibly an attempt to cut down on harmful tax practices, the dominant role played by countries such as Germany and the UK in setting parameters for the patent box regime meant that the final rules worked to the benefit of their countries' unique qualities and to the detriment of others.

In its efforts to persuade countries to commit to foregoing offering special tax incentives, the BEPS project ran head on into local political considerations and provided the most benefit to those countries that had the loudest voice at the negotiating table.

C. Value Creation

implications-for-corporate#_ftn47. Other countries that have announced plans to introduce a patent box in light of BEPS include Singapore and Mauritius. *See* Amanda Athanasiou, Singapore's 2017 Budget Gives Nods to BEPS, Innovation, WTD (Feb. 22, 2017); Stephanie Soong Johnston, Mauritius Proposes Innovation Box, Moving in Line With Global Tax Norms, 2017 WTD 111-4 (Jun. 12, 2017).

[124] *See also* H.R. 2605 (introduced by Rep. Allyson Schwartz in the 113th Congress); *see generally* Jane G. Gravelle, *A Patent/Innovation Box as a Tax Incentive for Domestic Research and Development*, Cong. Rsch. Svc. 7-5700 (Jun. 13, 2016).

[125] *See* Stephen Cooper, *Innovation Box Proposal Still Evolving, Neal Says*, 2016 TNT 101-5 (May 25, 2016).

[126] *See* Stephanie Baker, *U.K. Cuts Corporation Tax Rate Again in a Boon to Britain Plc*, BLOOMBERG NEWS (Mar. 16, 2016) available at https://www.bloomberg.com/news/articles/2016-03-16/u-k-cuts-corporation-tax-rate-again-in-a-boon-to-britain-inc; HMRC Policy Paper, Corporation Tax to 17% in 2020 (Mar. 16, 2016), available at https://www.gov.uk/government/publications/corporation-tax-to-17-in-2020/corporation-tax-to-17-in-2020 ; Instit. For Fiscal Studies Briefing Note, *What's been happening to corporation tax?* (May 10, 2017) available at https://www.ifs.org.uk/publications/9207 .

[127] 2016 WTD 224-26 (Nov. 17, 2016).

[128] *Cartelizing Taxes; see also* Dagan, INTERNATIONAL TAX POLICY.

[129] *See* BEPS Action 5.

The BEPS project is based on the assumption that the right to tax corporate profits belongs to the jurisdiction where economic activities take place and the jurisdiction where value is created.[130] But the OECD, in articulating this standard, glossed over the fact that in setting such a goal it was super-imposing a brand new standard on the international tax system, which had never considered the allocation of profits based on value creation.[131]

First, it is questionable whether the jurisdiction where economic activities take place is always the same jurisdiction where the greatest value is created. If economic activities are correlated with the number of people employed (as many developing countries assert), and fairness mandates assessing corporate income tax in the location where there is the greatest number of employees, less developed countries where more people are employed in routine tasks might be allocated a greater share of corporate profits. If taxes should be allocated where value (intellectual property; knowledge) is created, one may reach different conclusions. For example, if the value of a company such as Apple is derived primarily from the activities of designers and engineers working in Cupertino, California, a greater portion of its income tax obligations might be due to the jurisdiction where the ideas originate. Such a system may encourage innovation, but it may not reach the result that many participants in the BEPS project intended. And the language used by the OECD in BEPS is sufficiently vague so as to allow all countries to read into it what they wish.

III Poor Outcomes

This section describes just a few of the poor outcomes that derived from the unresolved issues that lay at the heart of the BPES undertaking.

A. Minimum Standards and Lack Thereof

The BEPS action plan included fifteen action items, and the OECD published fifteen reports (albeit that some of the reports on transfer pricing were consolidated) on its October 2015 target date. But only four of these items achieved sufficient consensus to enable the OECD to label them "minimum standards," that all participants would commit to. The "minimum standards" label disguises the fact that for most of the remaining action items – nine of the fifteen – the participants failed to agree to a uniform approach.[132]

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[130] Michael Devereux and John Vella of Oxford have pointed out that that assumption, which drives the 15-item BEPS action plan, would impose a new economic substance requirement over the existing international tax system. Devereaux and Vella, *Are We Heading Towards a Corporate Tax System Fit for the 21st Century*? 35 FISCAL STUDIES 449 (2014).

[131] *See* David Stewart, *'Value Creation' Understanding Key to Transfer Pricing's Future*, 2015 TNT 142-4 (Jul. 24, 2015).

[132] The OECD has explained that in other areas, (such as recommendations on hybrid mismatch arrangements and best practices on interest deductibility), "countries and jurisdictions have agreed a general tax policy direction," and that "domestic rules are expected to converge through the implementation of the agreed common approaches." OECD Background Brief, *Inclusive Framework on BEPS*, (Jan. 2017) available at https://www.oecd.org/ctp/background-brief-inclusive-framework-for-beps-implementation.pdf; EY Tax Insights, *Deciphering BEPS: What do the Categories Mean?* (Apr. 26, 2016), available at http://taxinsights.ey.com/archive/archive-articles/deciphering-beps-what-do-the-categories-mean.aspx .

The four minimum standards include a treaty anti-abuse rule; transfer pricing documentation in the form of country-by-country reporting; rules against harmful tax practices including standards for preferential regimes (patent boxes) and a requirement for automatic exchange of tax rulings; and minimum standards for improving dispute resolution. Even within these minimum standards, there is a lot of room for different approaches to implementation; for example, not all countries could agree on a single treaty anti-abuse rule. (Specifically, the U.S. refused to commit to a principal purpose test, the anti-abuse rule of choice for most other countries). The U.S. continues to adhere to the approach it has been utilizing in its treaties for the last several decades, the limitation on benefits test – a highly technical test that requires rigorous analysis of ownership facts for tested taxpayers. The principal purpose test, in contrast, provides tax administrators significant flexibility for determining when a taxpayer's behavior violates the "purpose of the treaty." The challenges inherent in a vague standard – one for which there is limited international guidance and less local country law -- are exacerbated because the commentary provided in the BEPS final reports has not been incorporated into the multilateral instrument. This instrument, which is designed to allow countries to incorporate BEPS changes into existing treaties with a single document (rather than having to go through renegotiation of multiple treaties), is not being incorporated into existing treaties, but as OECD officials have described, hovers on top of them.[133]

In the case of some of the other minimum standards, countries are disputing their implementation, despite having committed to them. France, for example, has a patent box that is clearly in violation of the new standards agreed to in action five. Nevertheless, France is refusing to change the terms of its patent box, arguing it should qualify under the new standards because its preferential rate for intellectual property income is higher than other countries' normal statutory rates.[134]

The requirement for transfer pricing documentation, including country-by-country reporting, is one of the most identifiable successes of the BPES project. Many countries have eagerly adopted the reporting rules,[135] while taxpayers are scrutinizing structures to be able to tell the right story on a reporting form. In some cases, they are modifying structures in order to be able to tell a more compelling story. If the goal was to modify taxpayer behavior, the country-by-country reporting requirement may be accomplishing that goal.

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[133] See OECD EXPLANATORY STATEMENT TO THE MULTILATERAL CONVENTION TO IMPLEMENT TAX TREATY RELATED MEASURES TO PREVENT BASE EROSION AND PROFIT SHIFTING, available at https://www.oecd.org/tax/treaties/explanatory-statement-multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf. For an outline of a number of the concerns with the approach to revising bilateral tax treaties being adopted by the multilateral instrument, see comments to the discussion draft on the multilateral instrument submitted by the International Tax Group, available at http://www.oecd.org/ctp/treaties/public-comments-received-discussion-draft-Development-of-MLI-to-Implement-Tax-Treaty-related-BEPS-Measures.pdf.
[134] *See* Ryan Finley, *Germany Passes Anti-Patent-Box Law as Neighbors Keep Pre-BEPS Regimes*, 2017 WTD 16-2 (Jan. 26, 2017).
[135] *See* KPMG, BEPS Action 13-Latest Country Implementation (updated weekly) available at https://home.kpmg.com/xx/en/home/insights/2016/04/beps-country-by-country-implementation.html.

For the remaining substantive action items, meanwhile, the reports produced not minimum standards, but either recommendations or descriptions of best practices. The flaws with the revisions to the transfer pricing guidelines undertaken as part of the BEPS project are described below, and the irony of failure to agree on rules for the digital economy are discussed in the next section. For the remaining action items, the paper fixes dressed up as recommendations and surveys of practice did nothing to address the structural tensions in the international tax system that gave rise to the BEPS project to begin with. To the contrary: the failure to adequately patch the cracks has allowed deeper fissures to develop.[136]

B. U.S. Non-Participation

The U.S. is often assigned a large share of the responsibility for multinationals' tax planning activities that eventually prompted the OECD to undertake the BEPS project. A confluence of characteristics of the U.S. tax system are blamed, including a singularly high U.S. corporate tax rate; its worldwide system of taxation, which operates to discourage repatriation of overseas profits and creates incentives to reduce foreign taxes on those earnings; accounting rules that generally permit the deferral of the accounting charge for U.S. tax on those earnings; and lax CFC rules that facilitate cross-border planning and foreign base erosion. One significant impetus for the BEPS project was to force the U.S. to modify these incentives and thereby prompt a change U.S. companies' behavior. But those efforts seem to have failed, largely due to growing recognition in the U.S. that the BEPS project was adverse to its interests.

For example, poor enforcement of U.S. CFC rules is partly due to a set of rules that allows U.S. taxpayers to disregard the separate tax treatment of many foreign entities. Known as the "check-the-box" rules (because taxpayers can elect treatment as a corporation or disregarded entity by checking the box on a U.S. tax form), these rules are often blamed for inappropriately perpetuating the use of foreign base-eroding techniques by U.S. multinationals.[137] But the political reality is that the check-the-box rules permit the U.S. Congress to subsidize U.S. multinationals without the political cost of having to lower the corporate tax rate. U.S. legislators have a vested interest in preserving a system that allows for foreign base eroding by U.S. multinationals, which in turn allows them to keep their foreign tax rates low, to the ultimate benefit of the U.S. Treasury.

The strong interest that congressional lawmakers, at the insistence of their corporate constituents, have in maintaining the check-the-box rules has been made abundantly clear to multiple administrations. When the Clinton administration tried to shut down these rules administratively in 1998, it received harsh rebuke from Congress and withdrew the proposal. And when President Obama attempted to introduce plans to overturn the rules in the 2009 budget, the proposal was also quickly killed.[138] U.S. legislators have every reason to continue supporting

[136] See David Ernick, *Can the OECD Remain an International Tax Standard-Setting Organization*? 45 T.Mgt.Int'l J. 745 (Dec. 9, 2016).
[137] *See* Kleinbard, *Stateless Income* at 721 (citing Lawrence Lokken, *Whatever Happened to Subpart F U.S. CFC Legislation After the Check-the-Box Regulations*, 7 FLA. TAX REV. 185 (2005)); Stephanie Soong Johnston, *Politics Shouldn't Steer BEPS Implementation Policy, Stack Says*, 81 TAX NOTES INT'L 929 (Mar. 14, 2016).
[138] Reuters, *How Treasury's tax loophole mistake saves companies billions each year*, (May 30, 2013), available at http://www.reuters.com/article/us-usa-tax-checkthebox-insight-idUSBRE94T17K20130531.

the check-the-box system, rather than coordinating with other countries on rules that would penalize hybrid entities, because the system benefits U.S. multinational enterprises and ultimately the U.S. Treasury (by virtue of the fact that the U.S. provides a dollar for dollar offset against U.S. taxes for foreign taxes paid in the form of the foreign tax credit).

The same political dynamics at play in U.S. debates over reform of the check-the-box rules were evident in the U.S. approach to BEPS. Although the U.S. Treasury was originally an eager participant in the project, it soon came to see the goals of the BEPS project as contrary to U.S. economic interests and the fiscal health of U.S. companies.[139] The evolving U.S. perspective was evident in a speech given by Robert Stack, senior international tax official of the Treasury Department during the time period in which BEPS went from an idea to fruition. In his remarks, Stack noted that "many countries viewed BEPS as a way to increase their own tax bases, potentially at the expense of the U.S. tax base."[140] The view that the project impinged on U.S. sovereignty and ran counter to U.S. economic interests was even more strongly expressed in Congress.[141] At the same time, a series of administrations and Congress have been hampered by a failure to develop a coherent set of international tax policy goals.[142]

Congressional views were based on the strong negative reactions of the business community to the BEPS project as well as ideological opposition to the OECD rulemaking power generally. Conservative media outlets strongly criticized the U.S. commitment to the BEPS project, highlighting the risks of the information exchange required by the transfer pricing documentation requirements (CbC reporting), arguing that:

> *The OECD is demanding a complete rewrite of American tax policy without the authorization of Congress. This constitutional end run is being worked out with officials from Obama's Treasury Department, who are quietly negotiating and making informal agreements for the*

[139] The U.S. Treasury initially was a strong supporter of the BEPS project, the broad principles of which were generally consistent with rhetoric President Obama used in the 2012 election campaign, when he repeatedly insisted on the need to ensure corporations pay their fair share of taxes. *See* Mindy Herzfeld, *The U.S. Treasury and the BEPS Mess*, 78 TAX NOTES INT'L (Jun. 22, 2015).

[140] Quoted in Alexander Lewis, *U.S. Using BEPS Project to Safeguard Tax Base, Stack Says*, 2016 TNT 94-7 (May 16, 2016).

[141] *See Hatch Statement at Finance Hearing on OECD BEPS Reports* (Dec. 1, 2015), available at https://www.finance.senate.gov/chairmans-news/hatch-statement-at-finance-hearing-on-oecd-beps-reports; Letter to Treasury Secretary Lew from Senator Orrin Hatch and Representative Paul Ryan (Aug. 27, 2015), available at https://waysandmeans.house.gov/wp-content/uploads/2015/08/Letter-to-Secretary-Lew-on-BEPS.pdf (stating that "the benefits to the U.S. government, businesses and workers from providing sensitive information in the CbC reports . . . is unclear, at best"); Letter to Treasury Secretary Lew from Orrin Hatch and Paul Ryan expressing concerns about "several other proposals of the BEPS project, including, among others, [and] modifying the permanent establishment (PE) rules, using subjective general anti-abuse rules (GAAR) in tax treaties." (Jun. 9, 2015), available at https://www.finance.senate.gov/imo/media/doc/Hatch,%20Ryan%20Call%20on%20Treasury%20to%20Engage%20Congress%20on%20OECD%20International%20Tax%20Project.pdf.

[142] The most recent, compelling, evidence of such failure was the lack of congressional and administration support Republican congressional leadership were able to achieve for their proposal for a border adjustment tax. *See*

> *United States that Obama will then recognize as "executive actions," with the full force of law.*[143]

Such criticism benefited from a receptive ear among congressional Republicans in particular and played out in strong congressional opposition to the Treasury's agreement to the OECD standard on country-by-country reporting.[144] It was not difficult for conservative activists and U.S. business representatives to make the case that OECD proposals to require more information reporting from U.S. companies were not in the best interests of American taxpayers. Many members of Congress are not eager to support new rules that could result in U.S. companies being subject to greater foreign taxes, while limiting the United States' ability to tax their profits.[145] Ultimately, though, congressional opposition to country-by-country reporting requirements was muted due to business support for U.S. involvement in the information exchange process.

In general, the BEPS project proved a useful target for Congress to voice its disapproval of Treasury's commitments to international organizations to adopt specific international tax rules, in conflict with the congressional tax-writing prerogative.[146] According to Senator Hatch, Chairman of the Senate Finance Committee, Treasury's failure to involve Congress in the negotiation of international tax rules ran counter to constitutional principles.

In the end, the U.S. agreed to adopt rules that constituted part of the "minimum standard" only in those areas where it already had rules in place, such as a treaty anti-abuse rule (in the U.S. case, the limitation on benefits provision); saw benefits for itself or its taxpayers (such as with respect to improved mutual agreement procedures); or where the rule did not directly impact U.S. tax laws (such as the action 5 rules regarding harmful tax regimes). With respect to some action items, such as action 7 concerning the PE standard, the U.S. has been noncommittal. For other action items, such as the action 3 report on best practices for CFC rules, the U.S. has taken the position that it satisfies best practices. The most significant exception to the U.S. generally being able to prevent consensus on standards that it opposed from being adopted was the transfer pricing documentation requirements of action 13.

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[143] Neil McCabe, *Will This Global Bureaucracy Get U.S. Tax Data?* WorldNetDaily (May 8, 2015) at http://mobile.wnd.com/2015/05/will-this-global-bureaucracy-get-u-s-tax-data/ . Writing on the website Human Events, Brian McNicoll similarly denounced what he called the "massive and unprecedented gathering of information on U.S. corporations by the IRS" for the purpose of enabling "foreign governments to rummage around in the books of American corporations to determine the 'fair share' they should pay in this new global tax scheme." Brian McNicoll, *Obama Advocates European Ideas on Taxes*, (May 18, 2015) http://humanevents.com/2015/05/08/obama-advocates-european-ideas-on-taxes/).

[144] See Letter dated June 9, 2015, available at http://waysandmeans.house.gov/wp-content/uploads/2015/08/Hatch-Ryan-Call-on-Treasury-to-Engage-Congress-on-OECD-International-Tax-Project.pdf Such critiques of international rulemaking bodies are not unique to the OECD and the BEPS project. *See Republicans Attack New Global Insurance Rules*, FT (Apr. 28, 2015).

[145] *See* Mindy Herzfeld, *Making Bets on CbC Reporting*, 78 TAX NOTES INT'L 595 (May 18, 2015).

[146] In the first congressional hearing on BEPS, Hatch issued a statement noting that he had "urged the Obama Administration to both acknowledge the limits of their authority under the law and to cooperate with Congress on any and all efforts to implement the recommendations." He further stated that "[w]hile the U.S. was a party to the BEPS negotiations, Congress had neither a seat at the negotiating table nor a meaningful opportunity to weigh in with the administration on the substance of the proposals." Hatch Statement on OECD BEPS Reports (Dec. 1, 2015).

Not only has the U.S. not – and seems unlikely in the future to – make any additional changes to its tax rules and agreements specifically to accommodate BEPS consensus agreements, the BEPS project and initiatives like it may have been counterproductive in terms of getting the U.S. to change its rules. The U.S. is now in the midst of a project of substantially revising the U.S. corporate tax rules in a way that could negatively impact many other countries. Instead of being upset about U.S. tax rules that facilitated multinationals' profit shifting, other countries may soon have much greater concerns if the U.S. adopts a more aggressively competitive tax system, with a potential unilateral rewrite of international tax rules that could tilt the benefits of the international tax system more heavily in favor of the U.S. fisc.

C. Digital Economy

Crafting new rules to address perceived failures of the existing laws to accommodate changes to business practices resulting from the digital economy was a significant impetus for the BEPS project. But that part of the project simply failed to progress in a significant fashion. France and the U.S. were co-heads of action item 1, which addressed the digital economy, and from the beginning, the U.S. was skeptical of the initiative.[147] In the end, the U.S. staunchly refused to agree to rules that it viewed as adverse to U.S. technology companies.[148]

But undertaking a big project with fanfare and then failing to agree on a way forward isn't a favorable outcome for anyone. The most likely result is that countries will simply act on their own, with each adopting a different path. India provides one example of what might be expected going forward in this regard. Instead of waiting for the next version of a report on the digital economy – due out in 2018 – India has proceeded to adopt one of the approaches to tackling the digital economy concerns that was not recommended by the final action 1 report. Effective in June 2016, India enacted an equalization levy, a tax described but not recommended in the report.[149] The new six percent withholding tax is required to be withheld from amounts paid to non-residents who do not have a permanent establishment (PE) in India, for specified services. Indian residents conducting business or non-residents with a PE in India must withhold the equalization levy. The specified services include online advertisement, any provision for digital advertising space, or any other facility or service for the purpose of online advertisement.

D. <u>Vague Rules</u>

For many of the BEPS action items, the final reports, agreed to by consensus, disguised substantive disagreements between the parties. Such disagreements were manifested in vague language intended to minimize opposition. Two examples of such vague outcomes are the revised transfer pricing guidelines and the new permanent establishment standard.

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[147] *See* Margaret Burow, Kristin Parillo, and David Stewart, *Stack Provides Insights on BEPS Reports, Outlines Next Steps*, 144 TAX NOTES 1497 (Sept. 29, 2014). Robert Stack, deputy assistant secretary (international) has noted that "the U.S. contingent had deep concerns at the beginning of the project over some countries' efforts to develop special rules for the digital economy." Kristen Parillo, *Robert Stack -- BEPS and the United States,* 76 TAX NOTES INT'L 1055 (Dec. 22, 2014).

[148] . *See* Ryan Finley, *Stack Reflects on Turbulent Days at Treasury, Future of the OECD*, 85 TAX NOTES INT'L 1045 (Mar. 20, 2017).

[149] See Indian Finance Act, 2016, Chapter (VIII).

1. Transfer Pricing Guidelines – Deliberate Incoherence?

Intended to satisfy all participants, the final BEPS reports were so watered down as to be meaningless, and so vague that they could be interpreted by every country's tax administrators as they wished. Such vagueness is particularly evident, and particularly acute, in the new transfer pricing guidelines (actions 8-10).[150] Those guidelines purport to apply the arm's length standard, which requires pricing of transactions among members of multinational groups to be set in accordance with the behavior of parties acting at arm's length. But rigorous application of that standard has resulted in companies being able to shift profits to lower taxed jurisdictions. As a consequence, in the course of the BEPS project, countries demanded revision to the arm's length standard. Unable to draft such revisions while remaining within the constraints of the economic theory on which the guidelines rested, yet not willing to abandon the standard (nothing better having been presented), the OECD was forced to produce anti-abuse or substance-over-form rules that continued to profess adherence to the arm's length standard.[151] The resulting rules leave themselves open to multiple interpretation by both taxpayers and administrators, opening the door to even more aggressive planning and numerous cross-border disputes, as well as an abandonment of the rule of law by tax administrators.[152] They could also prompt companies to move jobs and business operations out of high-tax jurisdictions and into low-taxed ones, not the result desired by those countries pressing for changes.

The rules' incoherence was demonstrated on numerous occasions in which current or former OECD and government officials tried to explain them at various tax conferences. Such officials often made two contrary claims regarding the changes made to the transfer pricing guidelines through the BEPS project. One was that the changes did not represent substantive modifications to the guidelines but merely introduced new rigor into their application. At the same time, they argued that the rules represented a significant change because they provided for profit sharing between and among capital investors and those who controlled risk. The latter explanation is hard to reconcile with the arm's-length principle.[153] OECD officials have referred to the lack of integrity for economic analysis purposes as deliberate, calling it a "pragmatic fudge."[154]

Many of the revisions to the OECD transfer pricing guidelines address taxpayers' contractual allocation of risks and the allocation of profits to risks.[155] Taxpayers' ability to shift profits between jurisdictions rankled many countries, and changes to the guidelines were intended

[150] *See* BEPS Transfer Pricing Report.
[151] *See* Ryan Finley, *Forget 'DEMPE' Label, McDonald Says*, 2017 WTD 59-4 (Mar. 29, 2017).
[152] *See* Philip Morrison, *BEPS 2015 Final Report Regarding Transfer Pricing of Intangibles*, 45 TMIJ 224 (April 8, 2016); David Ernick, *New OECD Rules Seek Broad Expansion of Tax Authority Power to Disregard Transactions*, 45 Tax Mgt. Int'l J. 90 (Feb. 12, 2016).
[153] *See* Ryan Finley, *BEPS Report on Transfer Pricing 'Could Have Been Worse,' Hickman Says*, 151 TAX NOTES 1440 (Jun. 13, 2016).
[154] *See* Mindy Herzfeld, *Will the OECD's 'Pragmatic Fudge' Save Transfer Pricing?* 83 TAX NOTES INT'L 360 (Aug. 1, 2016).
[155] *See* Wolfgang Schoen, *International Taxation of Risk*, WP of the Max Planck Instit. for Tax Law & Publ. Fin. No. 2014-03 (Feb. 28, 2014). Available at https://ssrn.com/abstract=2402612.

to address situations in which allocation of profits to risks did not correspond with activities of the entity being allocated the risk. To tackle tax planning involving allocation of risks to low-tax jurisdictions, sometimes without any significant change in business operations, the guidelines put new emphasis on control over risk. They says that risks contractually assumed by a party that cannot exercise meaningful control over them will not be entitled to the higher return normally associated with risk.[156]

Under the arm's-length standard, an entity's functions, assets, and risks have generally formed the basis for the analysis of how much profit it should be allocated. The revised guidelines altered that calculus by placing increased emphasis on risk. They introduce a complex six-step process for analyzing risk. But even disregarding the complexities, the new standards are problematic. There are significant discrepancies between the methodology required for analyzing the appropriate return to risk, and the economic principles incorporated into the arm's-length standard.[157] Because assigning the residual return to the controller of risk rather than the investor is inconsistent with economic principles which generally assign residual returns to capital, the only way to really make sense of the new guidance is to view it is an anti-abuse rule. But the lack of coherent economic theory in the new guidelines leaves a void for taxpayers and their advisors, who need to apply these rules to real fact situations in order to prepare tax returns in different jurisdictions.

It's not just practitioners that face a problem interpreting the new rule. The revised guidelines seem unlikely to provide the results that their advocates hoped for. Policy officials generally pointed to two types of egregious structures in justifying the need for changes to the transfer pricing guidelines: the cash box and supply chain restructuring.[158] The cash box, most closely associated with U.S. pharmaceutical and technology groups, relies on the U.S. transfer pricing regulations to justify an arrangement in which a U.S. company funds development of intellectual property through a subsidiary resident in a low-tax jurisdiction, such as Bermuda. Cost sharing arrangements can permit a large share of the profits from the developed intangible to be allocated to the funding entity. If undertaken properly, the group's Bermuda affiliate earns significant returns from royalties paid by affiliates worldwide for the right to use the intangible in production or in distributing the product. The cash builds up in Bermuda because of the disincentives to repatriate it to the U.S.

Supply chain restructuring can be useful even to companies without the potential for high-growth intellectual property. Under a principal company structure, the group's supply chain is realigned so that key decision-making is centralized and top personnel in manufacturing, logistics, or sales are located in a low-tax jurisdiction. Operations in high-tax jurisdictions are then restructured to become low-risk manufacturers or distributors, earning lower profits. Revenue administrators feel that taxpayers are abusing the system when they see the same number of personnel and the same types of activities going on pre- and post-restructuring, but a reduced tax base.

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[156] See BEPS Transfer Pricing Report ¶ D.1.2.1.
[157] *See* Jens Wittendorff, *At Arm's Length: BEPS Actions 8-10: Birth of a New Arm's-Length Principle*, 81 TAX NOTES INT'L 331 (Jan. 25, 2016).
[158] *See* David Stewart, *OECD to Address Cash Boxes Without Special Guidance*, 148 Tax Notes 172 (Jul. 13, 2015.

But the new focus on control of risk may not change the profit allocations in a way beneficial to those countries that thought they would benefit. Instead, allocating a greater return to risk might dictate that the U.S. is entitled to an even larger share of multinationals' profits than under current rules. For many high-tech companies, management decisions -- that is, the control of risk -- take place in this country. Reallocating profits to the U.S. is probably not the result many other countries had in mind. And unless the U.S. enacts a minimum tax or changes its controlled foreign corporation rules to assert tax jurisdiction over those profits, the profits will remain trapped, potentially subject to very low rates of tax. For supply chain restructurings, the rules also could have results opposite of what some countries intended. An increased focus on control of risk means that companies might move 10 people to the principal company rather than three, leading to a migration of even more high-value functions from high- to low-tax jurisdictions. The OECD's new rules may therefore be paving the way to even greater transfers of assets to tax havens, or, alternatively, encourage countries to enact new, preferential regimes to attract a minimum amount of substance.[159] Tax administrators writing anti-abuse rules don't always have the foresight to see the potential negative impact of law changes.[160]

2. The Permanent Establishment Standard

Revisions to the permanent establishment standard – an area of the law that has been in place for decades – were also a significant focus of the BEPS work. The BEPS project was supposed to address specific perceived abuses in the PE standard. The action plan listed a number of these abuses, including what it described as artificial avoidance of PE status through *commissionnaire* arrangements and similar strategies; fragmentation of a cohesive operating business into several small operations in order to argue that each part is merely engaged in preparatory or auxiliary activities (such activities are subject to an exception from the general standard); and the practice of splitting-up contracts between closely related enterprises.[161] Business fought back against the broadening of the PE standards, arguing that changes to the standard could negatively impact cross-border commerce. For example, the Business and Investment Advisory Committee to the OECD (BIAC) said that despite OECD assertions that the standard wasn't changing dramatically, "[b]road PE rules, combined with a lack of clear guidance on profit attribution, may encourage some countries to assert that the international standards have been fundamentally changed."[162] According to BIAC, this concern was "greatly increased because the proposals include a number of new and (to date) undefined terms and appear to substantially lower the existing threshold (compared to the current OECD model)." Other business group, along with the U.S. Treasury, tried to make the case that new

[159] *See* EY Global Tax Alert, *Israel Proposes New Innovation Box Regime to Attract IP Investment* (Jul. 19, 2016), available at http://www.ey.com/gl/en/services/tax/international-tax/alert--israel-proposes-new-innovation-box-regime-to-attract-ip-investment.
[160] The consequences of enactment in the U.S. of anti-inversion rules -- under which inversions have transitioned from paper transactions to substantive outbound mergers – is illustrative of the sometimes perverse incentives created by antiabuse rules. *See* Mindy Herzfeld, *Have Treasury's Anti-Inversion Rules Backfired*? 149 TAX NOTES 1214 (Dec. 7, 2015)
[161] *See* BEPS Action 7 Report.
[162] BIAC Letter to the OECD on revised Action 7 discussion draft (Jun. 12, 2015), available at http://biac.org/wp-content/uploads/2015/01/Final-BIAC-Comments-Action-71.pdf.

rules for determining when a PE existed were irrelevant or meaningless without additional work on how to attribute profits to newly formed PEs. But even though the OECD was unable to reach consensus on attribution of profits as part of finalizing its BEPS work, it went ahead with recommended changes to the PE standard.[163]

Even before the BEPS changes, determination of PE status was already one of the most subjective and fact-driven areas of international tax law. For businesses investing in new location or trying to increase sales in new jurisdiction, the precise parameters of permanent establishment guidelines is generally an afterthought. For new businesses expanding abroad at a rapid pace, they often discover – too late, with numerous adverse consequences -- that a permanent establishment, along with all the compliance obligations that entails, was created through the actions of an individual employee or agent whose activities were little known to central management. Fact driven analysis means that assessment of a PE is an easy way for local revenue agents to assess additional taxes on multinationals doing business in their jurisdictions. Quantification of PE risk was already challenging for financial statement and valuation purposes. New broadened standards that lack agreed upon definitions and interpretation will exacerbate this situation.

The final BEPS reports significantly scaled back the proposed changes to the PE standards, and business celebrated those victories.[164] But it's not clear who has the last word here. For one, much of the authority that business needs to rely on for the tightened standards (relative to the proposals) is contained in the commentary to the action 7 report. But the commentary has not been incorporated as official commentary to the multilateral instrument, potentially meaning that the commentary is not authoritative in interpreting the new treaty language. In addition, the reluctance of many countries to adopt the language finally agreed on in BEPS is fully evident at the United Nations, whose new model treaty and commentary goes back to and in some cases expands on the proposed BEPS language.[165] Tighter treaty language and helpful commentary may not unify the interpretation of new permanent establishment standards if the backstory is that countries agreed to language in the BEPS project with no intention of conforming audit practices to the agreed-upon language. All of this seems likely to play out in audit in the years ahead.

In addition to ambiguities created by the agreed upon treaty language, there is another movement for broadened PE standards occurring in parallel. Some countries – which either thought the agreed upon language was insufficiently broad, or thought it would take too long to reach agreement, have proceeded unilaterally, adopting new laws to broaden the traditional PE definition even further. The U.K. government in 2015 enacted the diverted profits tax (DPT), which radically redefines the concept of a PE in situations where a foreign company has allegedly artificially avoided having a PE in the UK; or when a U.K. company, or a foreign company with a

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[163] The U.S. has said it would not commit to the revised PE standards without the final guidance on the attribution of profits. *See* Ryan Finley, *U.S. Taking Cautious Approach to Adoption of New PE Standard*, 2016 TNT 89-19 (May 9, 2016).
[164] *See* Richard Collier, *More Guidance Needed on PE Threshold Issues*, 80 Tax Notes Int'l 249 (OCT. 19, 2015).
[165] [NOTE: due out in October]

U.K. PE, creates a tax advantage by using entities or transactions that lack economic substance.[166] Australia has subsequently introduced its own version of the diverted profits tax in two separate provisions. And New Zealand has followed suit with its own proposal.[167]

In other words, the revised permanent establishment rules have done little to achieve a new universal standard of PE. The U.S. – the world's largest economy – has refused to agree to the new standard. For other countries that have stated their willingness to revise their treaties to include the new standard, the ambiguous nature of the BEPS commentary means that there will be a multitude of interpretive questions. Ambivalence over the new standard can be seen in the limited adoption in the multilateral instrument signed by many countries in 2017.[168] For many other countries, agreement to the language appears to be but lip service, with an intention to adopt even broader standards – either in treaties or on audit – in the works. And those taking the most radical step have essentially made a decision to deviate from agreed upon language in situations they view as abusive.

IV Conclusion

Without a reexamination of underlying principles to formulate goals for an international tax system that take into account both global inequalities and the benefits countries obtain from tax competition, it will be difficult for any coordination effort to make substantive progress that could achieve widespread acceptance in fixing the system.[169] The BEPS project – which ostensibly was not about fixing the system, but only about addressing certain perceived abuses – generated unsatisfactory outcomes because different countries had varying objectives. While some (such as the U.S.) resisted most changes, others viewed the project as a means of addressing the system's larger perceived inequities. The project's outcomes – which failed to address these larger concerns – produced vague rules that further weakened the system due to the depth of the lack of underlying consensus. Unilateral action that places even greater pressure on the system was a result.

While the international tax system is broken, there is no ready mechanism to fix it, because the ability of a small group of like-minded countries to coordinate global rules does not exist today as it did in the early twentieth century. Attempts at coordination led by developed countries – of which BEPS represents the most obvious example – are doomed to be unsuccessful because they lack full participation from non-OECD global economic players, are based on incoherent principles, and fail to take account of strong nationalist interests. The BEPS project was inherently problematic precisely because it masked deep underlying differences between

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[166] See Part 3 UK Finance Act 2015 (Mar. 3, 2015), available at http://www.legislation.gov.uk/ukpga/2015/11/part/3/enacted; Explanatory Notes to UK Finance Act 2015, §§ 78 et seq. available at http://www.legislation.gov.uk/ukpga/2015/11/notes/division/1/78; H.M. Rev. & Customs Consultation Draft on Diverted Profits Tax (Dec. 10, 2104), available at https://www.gov.uk/government/publications/finance-bill-2015-diverted-profits-tax.

[167] Shinasa Wasimi, Jai Nario, and Kathryn Bertram, *Diverted Profits Tax: U.K., Australian, and New Zealand Approaches*, 87 Tax Notes Int'l 349 (Jul. 24, 2017).

[168] Mindy Herzfeld, *The Multilateral Instrument and Permanent Establishments*, 86 Tax Notes Int'l 1029 (JUN. 19, 2017).

[169] *See* Weisbach, Neutralities at 3, citing Graetz (2000) (arguing that the best way to make international tax policy is to first develop the social goal and then to determine the best set of trade-offs for achieving it given the tools and information available). *See also* Cui, *Minimalism* at 18.

countries in the interest of claiming success on achieving consensus. In attempting to rewrite international tax rules, doing a little can be worse than doing nothing, if the result is vague rules that mask fundamental disagreements and weaken the rule of law. Moving forward on a coordinated basis will require a reexamination of fundamental principle and broad agreement on such principles.