Is BEPS Good Policy?
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Tokyo, IFA, 18 February 2015

Topics

› Brief background to the Base Erosion and Profit Shifting (BEPS) project
› Action 11 on data (and policy)
  - Seems to be going nowhere
› The big policy picture: Can the corporate tax survive?
  - Questioning of arguments in the economic literature that it is doomed
› The smaller (but still significant) policy picture ... does not exist in BEPS
OECD/G20 BEPS Project
2012-2013

The Google etc publicity 2010-2012
- Commencement of work in OECD/G20 countries second half 2012

OECD Report February 2013
- Some discussion of policy of corporate income tax, largely of the negative
  modern public finance kind (see later)

Action Plan July 2013
- All action, little policy
- Organised around three policies/themes
  - Coherence of the corporate income tax (Actions 2-5)
  - Taxing income where value adding activities occur (Actions 6-10)
  - Transparency (Actions 11-14)
- With two cross-cutting issues
  - Digital economy (Action 1), multilateral treaty (Action 15)
### BEPS Action Plan: Bold = DD/Report 2014 out
Bold Italic = DD 2015 out, Plain = nothing out

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<th>Action</th>
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### BEPS Project mid 2014-2015

- Brisbane G20 meeting endorsed deliverables published and endorsed in September by Finance Ministers
  - Digital economy
  - Hybrids
  - Harmful tax practices
  - Treaty abuse
  - Transfer pricing intangibles and documentation
  - Multilateral treaty

- Virtually no discussion of policy except:
  "No or low taxation is not per se a cause of concern but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it" – BEPS Action Plan
Action 11

- Action 11 is only real effort to address policy (though it reads as if it is all about data)

"Develop recommendations regarding indicators of the scale and economic impact of BEPS and ensure that tools are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis. This will involve developing an economic analysis of the scale and impact of BEPS (including spillover effects across countries) and actions to address it. The work will also involve assessing a range of existing data sources, identifying new types of data that should be collected, and developing methodologies based on both aggregate (e.g. FDI and balance of payments data) and micro-level data (e.g. from financial statements and tax returns), taking into consideration the need to respect taxpayer confidentiality and the administrative costs for tax administrations and businesses."

- Request for input August 2014, comments published October 2014
- DD January 2015 now delayed to end March 2015: what is happening?

Can the corporate tax survive?

- Economic literature on mobile income
  - Views in OECD 2012 advice to Canada & Australia (e.g. increase GST, cut corporate tax rates) continues in 2014 Economic Surveys

- BEPS by contrast proposes to reinvigorate the international corporate income tax
  - The arguments are still to be made – an attempt follows

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Focus on corporate income alone

- In a variety of ways the economic models and theories focus on capital income and ignore labour income
  - Widely agreed that taxation of labour income is distortive
  - Untaxed choices: Household production and leisure
  - Optimal tax theory suggests that if distortion in one part of system, it is likely not the optimal policy to remove distortions in another part of the system
  - Work of Apps and Rees

Capital mobility

- Models often assume:
  - Perfect capital markets and mobility
  - Marginal investor non-resident tax exempt in home country
- Conclusion that source tax impossible
  - Investor will invest elsewhere and/or
  - Tax will be shifted to immobile factors
  - Policy recommendation is to reduce or do away with corporate income tax and taxation of income from capital generally
  - Taxes should be on immobile factors which are taken to be land, average employees, and consumption
- Capital market failures everywhere: global financial crisis or GFC
Segmentation of corporate returns

- Basic risk free rate of return can/should not be taxed
  - Unlimited borrowing/consumption tax style arguments
- Tax return to risk symmetrically > with no net revenue
  - Focus on tax system whereas optimal tax shows need to view tax and transfer systems as a whole; corporates receive large transfers
- Economic rents
  - Inmobile can be taxed, mobile cannot be taxed (capital mobility again)
  - Impossible to observe line between risk and rents
  - Corporate returns are mixture of both varying over time (digital economy)
  - Rents are capitalised in prices and significant transitional issues for rent taxes

Model of firm ignores real taxpayers and incidence

- Company (modelled as black box with attributes of welfare maximising individual
- Avoids questions of incidence of corporate tax
  - Is efficiency not affected by incidence
  - See above - incidence a consequence of shifting, not of efficiency
- Avoids issues of internal dynamics of firm
  - Rent-seeking executives
  - Moral hazard
  - Compare corporate literature
Modelling of investors in companies

- Investors cannot achieve better than general market or risk-free rate of return
  - Efficient market theory for public markets in securities
- Hence tax on flat rate of imputed return or something similar
  - What happens to the rents?
  - Do shareholders matter or not?
  - Hard to connect with other theories/models

The smaller (but still significant) policy picture

- Digital economy and tax claims of country of the customer
  - Postponed to after BEPS by Digital Economy Report
- Coherence of corporate income tax
  - Assumption that corporate income should be taxed somewhere (and not end up in havens where no activity occurs)
  - But where: Source (Actions 2, 4, 5) v Residence (Action 3)
- What is the purpose of the PE threshold and does the current threshold fit the policy in the modern world?
- What is the policy of the arm’s length principle given the theory of the firm?
  - See also above regarding taxing the unobservable, risk and rents
- No attempt to articulate the policy and seek to implement it (taking into account path dependence, tax sovereignty, political dynamics)
Some thoughts on Action Item 2 - Hybrids

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18 February, 2015

The underlying problem

- Disagreements can be everywhere
- With us, tax idiosyncrasy is the norm (Australian exceptionalism)
- The 7 Examples reflect disagreements about
  - debt v. equity
  - hybrid financial instruments
  - imported hybrids
  - Transactions – sale v. secured borrowing
  - hybrid transfers
  - existence / number of entities
    - receipts by owner from ‘hybrid payer’
    - receipts by ‘reverse hybrid’
    - payment by ‘hybrid payer’
    - ‘dual consolidated’ entities
Hybrid financial instrument

Secondary rule
Include in income

State R
Recipient Co

Payment

State P
Payer Co

Primary rule
Deny deduction

State R
- considers amount received to be a dividend
- exempts dividends received from foreign subsidiaries

State P
- considers amount paid to be interest
- gives a deduction to payer

‘Imported mismatch’

State R
Recipient Co

Payment

State P
Intermediary Co

State B
Borrower Co

Only rule
Deny deduction

State R
- considers amount received to be a dividend
- exempts dividends received from foreign subsidiaries

State P
- includes interest received in income
- considers amount paid to be interest
- gives a deduction to Intermediary

State B
- gives a deduction to Borrower for Interest
Payment to reverse hybrid

Parent Co

State P
- respects Hybrid as entity
- [has no CFC rules?]

State H
- disregards Hybrid
- treats Parent as proper taxpayer

Foreign hybrid

State B
- gives a deduction to Borrower for Interest
- [imposes IWT?]

Borrower Co

State P
- disregards Hybrid
- sees borrowing by Parent Co
- allows Parent interest deduction
- [imposes IWT?]

Primary rule
Deny deduction

Parent Co

State P

Secondary rule
Deny deduction

Foreign hybrid

State H
- treats Hybrid as entity
- respecting borrowing
- allows interest deduction to H
- allows loss to offset income of Group Co

Interest payment

Bank

Group Co

Payment made by hybrid entity (to third party)
Payment made by dual resident entity (to third party)

- State P
  - allows interest deduction to P-
  - Sub A group
  - [imposes IWT?]

- State S
  - allows interest deduction to Sub A-Sub B group

Only rule
Each state deny deduction

- Both State P and State S allow consolidation of resident companies only
- Sub A is incorporated in State P; managed in State S

A small target

- Hybrid outcome
  * affecting instrument that is debt / equity / derivative
- Between related or controlled entities; part of a structured arrangement
  * presumably a marker for avoidance
- involving physical payments
  * between the parties to the arrangement?
- but not timing
- which generates an overall (not individual) revenue loss
  * compared to ...?
- resulting a D / NI outcome or a DD outcome
  * but not NI / NI
  * nor FTC / FTC
Comments

- The remedy is deliberately
  - domestic
    - improve domestic law
    - an anti-hybrid rule that gets turned on
    - and adjusts to get turned off
  - unharmonised
  - agnostic
- So the BEPS policy gets shifted closer to, ‘all income must be taxed somewhere’
  - and either country is sufficient
- Becoming dependent upon actions of other countries

Treating companies as real and final
- Solving every problem by denying deductions
  - what about CFCs / IWT / entity recognition rules
- What happened to withholding taxes
- Consistent with the BEPS paradigm
  - or rules that will be BEPS engines?