BEPS and the Principles of International Taxation

International Tax Tax voice

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Philip Baker notes the impact of the BEPS Project: whilst it did not set out fundamentally to amend or rethink the basic principles and those principles remain largely intact, there are significant modifications

The international tax agenda has been dominated for the last three years by BEPS – base erosion and profit shifting. This focuses on the corporate income taxation of large, multinational corporations, many of which are alleged to have taken part in base eroding and profit shifting activities. These activities have arisen following business restructuring by many of these multinationals in the 1990s and 2000s.

The issue of base erosion and profit shifting first came on to the international agenda in 2012, though there had been growing disquiet with the low amounts of corporate income tax paid by some multinationals in a number of countries, highlighted by parliamentary enquiries such as those carried out by the UK's Public Accounts Committee. The issue was picked up by journalist and by civil society groups. In 2012 the topic appeared on the agenda of the G20 group of most industrialised countries, though it appears that it was the OECD that put the item on the agenda and then encouraged the G20 to refer the topic back to the OECD for a solution.

In early 2013, the OECD published a short report on “Addressing Base Erosion and Profit Shifting”, and followed this in the middle of 2013 with an Action Plan identifying 15 different action points.

The intensive work carried out by the OECD Countries together with some of the G20 Countries led to a series of interim reports in September 2014 and the final BEPS Reports in October 2015. After endorsement of those conclusions, the project has moved into an implementation phase. This has a number of aspects. First, it involves the adoption of domestic legislation in countries that have accepted the BEPS conclusions: this involves, for example, legislation to limit the deductibility of interest in computing corporate profits. Secondly, it involves some implementation at a multilateral level, such as the amendments to the OECD’s Transfer Pricing Guidelines to give effect to the BEPS conclusions. Thirdly, current work is taking place during 2016 to draft a Multi-Lateral Instrument which is intended to implement the BEPS conclusions on the amendment of tax treaties by a streamlined process of amending a large number of bilateral tax treaties.

The BEPS Project itself did not set out fundamentally to amend or rethink the basic principles of international taxation. Those principles remain largely intact, though with significant modifications as a result of the BEPS conclusions. Thus, for example, the basis of allocation of tax jurisdiction between countries of residence and countries of source by bilateral tax treaties is not affected. Small changes at the margins, such as the changes to the definition of permanent establishment to combat commissionaire arrangements, or to amend the exclusion for preparatory and auxiliary activities, may reallocate tax jurisdiction to a limited extent. However, the basic concept of a permanent establishment, for example, remains the same. Similarly, the arm’s length principle remains the basis for the allocation of profits between associated enterprises, though there are changes to the Guidelines to take into account, for example, of group synergies.

Perhaps one of the most significant changes adopted through the BEPS process is the recognition of a minimum standard to counter tax treaty abuse. That will be implemented by including via the MLI specific provisions on treaty abuse, such as a Principle Purpose Test to deny the benefit of tax treaties where the principal purpose was the avoidance of tax. However, even here there is no fundamental change to the role, nature and structure of tax treaties.

Many people see the BEPS Project as essentially applying a bandage, or a series of bandages, to a wounded but still functioning international tax system. But the real question is whether more fundamental surgery will be required in the coming years. Some of the work begun in the BEPS Project, on the digital economy for example, suggest that we may just be at the start of a process involving a more radical rethink of the principles of international taxation. If we are at the start of that process, it will be years before any radical conclusions are agreed.

One of the changes brought in by BEPS, and likely to trigger pressure for more fundamental change, is the introduction of Country by Country Reporting of various tax and financial information by large multinationals. Once this information becomes public (and it is likely to become public quite soon) it may highlight the significant mismatch between the place where multinationals carry on their business and the place where they report profits for tax purposes. Some elements of that misallocation have been tackled through the BEPS conclusions, but it may become apparent that the Project has not addressed some of the fundamental causes for the misallocation. Civil society groups are unlikely to give up their calls for more fundamental reform and a new chapter may be opened.

It would be interesting to speculate what some of these new principles of international taxation in a post-BEPS period of reform might be. Acknowledging that corporate residence is a largely meaningless concept, we may see a heavy swing towards source-based taxation. The arm’s length principle may not be formally abandoned, but transfer pricing may come to look more and more like formulary apportionment, possibly through some form of profit split approach. If low tax jurisdictions cannot be required, because of sovereignty issues, to impose a higher level of taxation, then at least their “jurisdiction” to tax might be ignored by other countries: thus, for example, in a formulary apportionment/profit split world, no apportionment would be made or profits allocated to a low tax jurisdiction.

Though the world changes very fast these days, it may be years before any of these approaches are adopted. In the meantime, we have our established principles of international taxation, neatly dressed in a new bandage supplied by the BEPS Project.