SUMMARY

The OECD has published an Action Plan on Base Erosion and Profit Shifting. It has been welcomed by the G20.

The Action Plan sets out a series of workstreams to be followed over the next 2½ years. The OECD will propose changes to domestic laws and international treaties:

- to help governments understand the issues;
- to close unintended loopholes allowing multinationals to shift profits; and
- to prevent governments from providing incentives for profit shifting.

Most of the problems addressed in the Action Plan are not new, and it envisages largely incremental changes to the current model of international taxation. In many cases the OECD may look to examples of existing domestic measures or treaty provisions for solutions. The OECD’s current approach suggests at least that these solutions should be practical.

There are likely to be difficulties in reaching consensus or in implementing any consensus reached: for example, the European Union’s treaties may limit what its members can sign up to and jurisdictions (such as the UK) which have sought to entice corporate taxpayers by making their tax regimes more “user-friendly” may well baulk at some of the changes proposed. Some states, however, are likely to take aggressive unilateral action (with strong public support) to deal with the problems as they see them. Lack of consensus and unilateralism carry with them the risk of double taxation, which can only hinder growth at a time of overall economic weakness.

Giving effect to any proposals will take time as treaties will need to be signed or amended, and domestic laws changed. In order to avoid the need for lengthy bilateral negotiations, the OECD has suggested
using a multilateral treaty to implement changes on which there is broad consensus. If that level of agreement can be reached on a number of BEPS remedies, a multilateral instrument may well set a new tax standard among OECD and G20 countries. Even if this shortcut succeeds, however, taxpayers will have some scope to react and restructure.

In spite of the potential disagreements, the current political support for the BEPS project in general is significant and unprecedented. As a result, we can expect to see the BEPS workstreams lead to substantial changes over the next several years; and domestic policy-making is likely to reflect the new climate before that.

BACKGROUND

In the course of 2012, the Organisation for Economic Co-operation and Development began to bring together existing workstreams on aggressive tax planning by multinational enterprises under the heading “base erosion and profit shifting”. The initiative was welcomed and supported by the G20.

Members of the G8, G20 and OECD

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* Member states of the European Union
* The European Union is a non-voting participant in the OECD

1 Now commonly referred to as “BEPS”. “Profit shifting” involves the allocation of revenue streams or other assets to affiliates in lower-tax jurisdictions. “Base erosion” is the reduction of the tax base in higher tax jurisdictions, whether by profit shifting or other means, such as taking tax deductions for payments to foreign affiliates.
The G20 has a wider spread of members than the OECD geographically and in terms of economic development, and has led the multilateral policy-making response to the financial crisis. But the OECD has long been at the forefront of work on international tax cooperation, and has the infrastructure for it that the G20 (and even the UN) does not. As a result, the G20 has largely subcontracted tax policy to the OECD.

The OECD released a report on Addressing Base Erosion and Profit Shifting in February 2013. The report set out:

- what techniques multinationals may employ to erode the tax base;
- why this is now more relevant (globalisation, the move in trade from goods to services and the increasing importance of intellectual property); and
- how the OECD proposed to work on addressing it, starting with an action plan.

In May all the OECD members and all the G20 members except China, India and Saudi Arabia signed up to a declaration welcoming the report and calling for the OECD to produce and implement its action plan quickly, while including “all relevant countries” in discussions.

Support for the BEPS initiative also formed a key plank of the G8 communiqué from the Lough Erne summit in June.²

On 19 July the OECD published an Action Plan on Base Erosion and Profit Shifting.³

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**THE ACTION PLAN**

**What is the Action Plan?**

“Action Plan” is perhaps a misnomer: it does not change the law, announce any changes in the law, or propose any changes in the law. Instead it sets out a series of workstreams to develop proposals for changes to the law or, in some cases, to decide whether there is a problem at all. The OECD expects to:

- adopt changes to its own instruments and guidance;
  - the Model Tax Convention and Commentary and
  - the Transfer Pricing Guidelines; and
- recommend changes to countries’ domestic law.

**When Will We See Changes?**

Even once the OECD has amended the Model, Commentary and Guidelines, and made its recommendations on changes to domestic law, nothing will happen without action at national level.

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³ Available from the OECD’s BEPS web page: [www.oecd.org/tax/beps.htm](http://www.oecd.org/tax/beps.htm).
Any changes the OECD recommends to preferential tax regimes will be controversial. Adopting such a regime in order to attract foreign investment is a political decision, repealing one all the more so: no country competing for investors wants a reputation for instability. Recommendations for strengthening anti-avoidance legislation may be more technical and less controversial, but still take legislative time to implement. In any case, such changes may still provoke controversy because they will only add to the formidable range of anti-base erosion rules already in place in most developed tax jurisdictions.

Changes to the Model Convention will only have effect when countries

- sign new treaties based on the Model,
- amend existing treaties to reflect the changes or
- possibly, sign up to a multilateral convention to make the changes (an avenue the OECD will explore under the Action Plan)

– and they then ratify those changes in domestic law. Different countries take different positions on what weight should be placed on changes to the Commentary after a treaty based on the Model Convention has been signed: should the treaty be interpreted in the light of the old version of the Commentary or the new? They may also take different positions on whether updates to the Transfer Pricing Guidelines apply automatically: the UK transfer pricing rules, for example, cross-reference to the Guidelines as at 22 July 2010 and then provide a mechanism for importing later changes to them.

The Action Plan sets out a series of phased deadlines for its 15 proposed actions. In the Annexes to the Plan, these are described as September 2014, September 2015 and December 2015; the body of the Plan talks instead of actions to be completed within 12 to 18 months, within two years and in more than two years, which implies that the timings may slip.

This is an aggressive timetable when compared against past efforts to achieve international consensus, and it will be some time before any of the proposals bear fruit.

What Does the OECD Propose?

As noted above, the OECD acknowledges that some issues are not yet fully understood. The Action Plan therefore includes several preliminary workstreams:

- establishing methodologies to collect and analyse data on BEPS and the actions to address it;
- suggesting rules to require taxpayers to disclose aggressive structures and mechanisms for tax authorities to share that information;
- identifying the difficulties that the digital economy poses for the application of existing international tax rules.

At the more concrete level, the Action Plan focuses largely on the same technical areas as the report preceding it:
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- hybrid instruments and entities\(^4\);
- controlled foreign company rules;
- deductions for interest and other financial payments;
- abuse of treaties in general and of permanent establishment rules in particular; and
- transfer pricing.

The table in the Appendix summarises the 15 proposed actions, as numbered in the Action Plan.

The February report, however, discussed the balance between source and residence taxation as needing review – and not just in the context of services provided electronically. For now the OECD has moved this to the “too difficult” pile: the Action Plan is “not directly aimed at changing the existing international standards” on allocation to source or residence states.

The OECD does not try to throw all the blame for base erosion onto business. One of the workstreams is on countering preferential tax regimes: initially those offered by OECD members, and then those of non-members. There are also some conciliatory noises for business:

- transfer pricing documentation requirements should be less burdensome and more targeted;
- dispute resolution mechanisms under treaties should be made more effective (in particular, by extending access to mutual agreement and arbitration procedures).

Both these proposals go against the political current – governments are looking to obtain ever greater real-time disclosure from corporate taxpayers and are under pressure to squeeze ever more revenue from the corporate tax base – so they may not get far: actions will speak louder than words. For similar reasons, questions of allocation to source or residence states may well resurface within the BEPS project as well as outside it.

REACTION AND FOLLOW-UP

The G20 finance ministers welcomed the Action Plan in the communiqué from their meeting on 20 July.\(^5\) As well as “fully endorsing” the Plan, the ministers called on member countries “to examine how our own domestic laws contribute to BEPS”.

On 30 July the OECD itself published two documents on transfer pricing issues:

- a Revised Discussion Draft on Transfer Pricing Aspects of Intangibles; and
- a White Paper on Transfer Pricing Documentation.

\(^4\) Instruments treated as debt in one jurisdiction and equity in another, or entities treated as a company in one jurisdiction and disregarded or otherwise treated as tax-transparent in another.

\(^5\) Available at [en.g20russia.ru/load/781659263](http://en.g20russia.ru/load/781659263).
Both documents acknowledge the Action Plan. The White Paper on Documentation covers the ground envisaged by Action 13 of the Plan and makes initial suggestions for discussion. The Revised Discussion Draft on Intangibles does not fit as neatly into the Action Plan framework: it raises some issues to be dealt with under the Action Plan as well as others that fall outside it. Both are open for consultation until 1 October this year.\(^6\)

**IMPLICATIONS**

The issues raised in the OECD’s report in February and addressed in its Action Plan are generally not new. Perhaps the only exception is the focus on the digital economy – where there is not yet consensus on what problems there are.

The Action Plan shows little appetite for radical solutions, such as:

- changing treaties to allocate profits to source rather than residence jurisdictions;
- moving generally from the arm’s-length transfer pricing standard for branches and affiliates towards formulary apportionment (although the Plan suggests that – unspecified – exceptions from the arm’s-length standard may be appropriate in some areas, especially that of intangibles); or
- introducing treaty mechanisms which impose tax, rather than give relief.

For many of the issues there is already a menu of solutions which the Action Plan provides impetus to develop further. For example:

- **Requiring taxpayers to disclose their aggressive tax planning arrangements** – the US has been doing this for over ten years; the UK copied the US in 2004, has tightened its rules several times since and is actively considering further extending these rules. The French tax administration has tried several times to propose the same requirement in France, with no success so far. The UK’s rules require real-time disclosure of a wide range of tax-motivated transactions.

- **Getting tax administrations to share information on international tax schemes** – Australia, Canada, the United Kingdom and the United States set up the Joint International Tax Shelter Information Centre (JITSIC) in 2004 to identify and curb abusive tax transactions; Japan, Korea and China have since joined as full members and France and Germany as observer members. Tax treaties and (in the EU) Directives provide in any case a comprehensive framework for exchanging information on taxpayers, often on a spontaneous or automatic basis. In a related development, intergovernmental agreements (also known as IGAs) for implementing the US foreign account tax compliance (commonly known as FATCA) rules will add to the financial data exchanged under the treaty network when they become effective over the next few years.

- **Denying tax benefits arising from hybrid instruments or entities** – the UK introduced “anti-arbitrage” rules in 2005 (in fact, as a result of its participation in JITSIC): the basic concept is that, where a taxpayer deploys a hybrid instrument or entity to obtain a double deduction or a deduction with no corresponding inclusion, the UK deduction is denied;

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ordinarily the rules require that a “main purpose” of the arrangements is avoiding UK tax, not non-UK tax.

- **Limiting base erosion through interest deductions** – governments have been alive to this for a long time: in the UK alone interest may be restricted by the “anti-arbitrage” rules, the “unallowable purposes” rule (which are likely to be expanded by 2015), the “worldwide debt cap” or thin capitalisation rules (now part of the transfer pricing code) as well as older rules treating certain interest payments as akin to dividends. Many countries impose caps of various sorts (like the US “earnings stripping” rules and the disallowance of 15% or 25% of interest expense in France) on the proportion of profits that can be offset by interest deductions.

- **Preventing treaty abuse** – the US includes limitation of benefits clauses in its treaties as a matter of course, as well as rules dealing with transparent entities and triangular situations involving permanent establishments in third countries. Modern UK treaties routinely deny treaty protection from UK tax where a “main purpose” of arrangements is securing treaty relief from UK tax. The UK Government has also legislated retrospectively to prevent UK residents using treaties to achieve double non-taxation in some circumstances and may well use its new general anti-avoidance rule to tackle some treaty abuse.

- **Amending transfer pricing rules to make it harder to transfer profit streams with intangibles** – it is already very doubtful whether a tax authority will accept as arm’s-length an intra-group sale of non-routine intangibles for a fixed sum, rather than on some form of profit-splitting or contingent payment basis. The US in particular asserts a strong focus on whether the price paid to the transferor is commensurate with the transferee’s income attributable to the intangible.

- **Countering harmful tax practices** – the OECD began work on reviewing member country regimes in 1998 but lost momentum before the financial crisis; the EU developed its own non-binding code of conduct for business taxation in 1997 and also invokes its state aid rules against preferential regimes. This has not, however, prevented the creation by some member states of preferential regimes for taxing intangibles (like the UK’s “patent box”), subject to conditions designed to limit abuse. Also, to date at least, the EU institutions have not regarded low corporate income tax rates (such as the 12.5% rate in Ireland) in themselves as “harmful” practices.

- **Using a multilateral instrument to implement an international consensus more quickly** – if implemented, this proposal may actually be the most fundamental change resulting from the BEPS initiative. If consensus is reached on workstreams involving treaty changes, countries would ordinarily need to agree separately with each treaty partner to make those changes. The OECD wants to promote the idea that the lengthy bilateral process is no longer adapted to the ever-changing international tax environment. The obvious precedent for a multilateral instrument is the Joint Council of Europe/OECD Convention on Mutual Administrative Assistance in Tax Matters: since this was opened up in 2011 to countries outside the two sponsoring organisations, more than 50 countries have signed up or said they will do so. A multilateral convention on BEPS issues would have two main effects. First, adopting it (or amending it in future) could be much quicker than revising all bilateral tax treaties. Second, such an instrument would set an international standard for addressing BEPS issues: most countries might find it very difficult to refuse to sign up to it. OECD officials may have in mind the success of multinational standards such as IFRS for accounting or Basel II/III for bank regulations.

It will not be possible, however, simply to agree on best practice and roll it out in all participating jurisdictions. For one thing, countries may disagree about what is best practice. As already mentioned, some EU member states have adopted patent box regimes, reducing the tax payable for profits coming within the box. France and the UK both have such regimes, as do Ireland, Luxembourg and the
Netherlands. Germany, on the other hand, does not; and on 9 July this year Wolfgang Schäuble, the German finance minister, called on the EU to ban them. The question is simple: what is fair tax competition between jurisdictions? But no answer will please everyone.

For another, there may be obstacles to implementing some types of rule. Most obviously, EU member states are restricted by the EU treaties, particularly in applying over-broad anti-avoidance rules targeted against companies from other member states. (As shown in the diagram on page 2 above, EU member states account for almost half of the combined membership of the G20 and OECD.) The European Commission has already laid down a marker on this.

Moreover, given the amount of time it will take for the OECD’s workstreams to produce proposals, countries may look to take unilateral action. Hopefully, such action would be limited to those that anticipate any changes – if not by introducing new measures to implement them, at least by avoiding any new measures which might contradict them. But countries might not be able to resist the temptation to introduce unilateral measures which clash with each other and give rise to double taxation. This would hinder growth at a time of overall economic weakness. Whether the OECD can keep participating countries in check remains to be seen.

The BEPS project is a new combination of mostly well-worn ideas. What is new and significant is the political momentum behind them. The key point for business, though, must be that the OECD is currently guiding the work. The OECD’s technical expertise and willingness to listen to business at least raise the hope that it can channel this new political momentum to produce a practical set of measures which will be applied consistently.

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<td>15 – Develop a multilateral instrument</td>
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<td>11 – Establish methodologies to collect and analyse data on BEPS and the actions to address it</td>
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<td>Revise existing criteria</td>
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<td><strong>Develop a multilateral instrument</strong></td>
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