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Base Erosion and Profit Shifting (BEPS): OECD/G20 Tax Proposals

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Summary

Taxes collected by countries around the world can be reduced through various avoidance mechanisms that shift corporate profits out of higher-tax-rate jurisdictions into lower-tax-rate jurisdictions and through other mechanisms that reduce taxes on interest, dividends, and royalties. The Organization for Economic Cooperation and Development (OECD) has been engaged in a project to reduce such base erosion and profit shifting (BEPS) in which firms use tax-avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low- or no-tax locations. In October 2015, the OECD published its final list of 15 BEPS action items. G20 Finance Ministers endorsed the OECD framework in February 2016.

A total of 139 countries and jurisdictions, including all OECD and G-20 countries have agreed to implement the four minimum BEPS standards:

1. Action 5, countering harmful tax practices (mostly aimed at patent boxes);
2. Action 6, preventing treaty abuse (largely about arranging payments to flow through countries with treaties that reduce withholding taxes on dividends and other passive payments);
3. Action 13, country-by-country (CbC) reporting; and
4. Action 14, increasing the effectiveness of dispute resolution.

These action items have led to limited changes to U.S. companies because of either a lack of relevance (no patent box regime exists in the United States) or existing practices, although CbC reporting requires additional information from U.S. multinationals.

Although implementation of some items can be done through regulation, others would require legislation or treaty amendments, which must be approved by the Senate. Other than the four agreed-upon standards, the remaining proposals are not specific recommendations because there was no agreement among the countries.

Action 1 contains an extensive discussion of the digital economy, but its proposals relate only to the value added tax (VAT), which the United States does not have. This action item proposed further development of proposals to address the digital economy, which resulted in two additional proposals with blueprints introduced in 2020. These proposals include a plan for allowing market companies a share in the residual profit of digital multinationals (Pillar 1) and a minimum tax on global income (Pillar 2). The United States and 133 countries, including the G20, have endorsed these proposals.

Actions 2-4 and 7-10 relate to profit shifting by multinational firms via a variety of mechanisms, including locating interest deductions in high-tax countries or through transfer prices of the sales of goods and services between related corporations. The United States has generally adopted few changes, although present practices in many aspects already embody the standards. One instance in which U.S. rules appear at variance with OECD suggestions are check-the-box rules, which create hybrid entities with, for example, interest deducted in one country but not taxed in another.

The OECD standards for transfer prices stress that the allocation of income should be based on an accurate delineation of the controlled transaction, which requires identification of factors in five categories: (1) the contractual terms of the transaction; (2) the functions performed by each of the parties to the transaction, taking into account assets used and risks assumed; (3) the characteristics of property transferred or services provided; (4) the economic circumstances of the parties and the market; and (5) the business strategies pursued by the parties. Cost-sharing arrangements commonly used in the United States, which allow foreign subsidiaries to provide financing for research in the United States in exchange for a share of profits, is also an area in

which U.S. practice appears inconsistent with BEPS proposals. The Government Accountability Office (GAO), in a study of the transfer-pricing issues, while indicating that a move from contract to content would reduce profit shifting, argued that risk could not be transferred between related firms in the same way as between unrelated firms.

The United States and other countries would benefit by gaining revenues from reductions in base erosion and profit shifting which, according to Action 11 on measuring and monitoring BEPS, costs between 4% and 10% of global corporate tax revenues. There have, however, been concerns that the United States risks losing some revenue and companies paying additional taxes if other countries inappropriately increase their taxation of U.S. firms, eventually generating foreign-tax credits that offset U.S. income tax. These effects might occur through changes in the definition of permanent establishment and through the inappropriate use of CbC data to move to an effective formula-based approach to taxation, which could produce double taxation. At the same time, a uniform set of standards and reporting requirements may be beneficial, as many countries were proceeding to enact unilateral changes and reporting requirements prior to the OECD project.

Firms expressed concerns regarding confidentiality and compliance costs of CbC reporting. The United States has opted for bilateral agreements to share CbC data in part to help ensure confidentiality.

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Introduction

Base erosion and profit shifting (BEPS) are "tax-avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations."[1] For example, countries worldwide can experience reduced tax collections through various mechanisms that firms use to shift corporate profits out of higher tax jurisdictions into lower tax jurisdictions and other mechanisms that reduce interest, dividend, and royalty taxes. The Organization for Economic Co-operation and Development (OECD) has been engaged in an ongoing project to reduce BEPS. In October 2015, the OECD published its final list of 15 BEPS action items to equip governments with measures to address tax avoidance (although some updated or additional material has been provided).[2] All 15 action items were adopted by consensus, including by the United States. These action items are not legally binding nor are they self-executing.

Some of these proposals can be (or have been) implemented in the United States and in other countries through administrative actions, and others would require legislative action. Some would require modifications of international tax treaties. U.S. multinational firms will be affected not only by actions taken by the United States but also by actions undertaken by other countries. G20 Finance Ministers adopted the OECD framework in February 2016.[3]

A total of 139 countries and jurisdictions, including all OECD and G-20 countries have agreed to implement the four minimum standards in the BEPS package:[4]

1. Action 5, countering harmful tax practices (mostly aimed at patent boxes);[5]
2. Action 6, preventing treaty abuse (largely about arranging payments to flow through countries with treaties that reduce withholding taxes on dividends and other passive payments);
3. Action 13, country-by-country (CbC) reporting; and
4. Action 14, increasing the effectiveness of dispute resolution.[6]

The OECD has issued a series of progress reports on the implementation of these standards.[7] In addition, the OECD/G20 final report called for further development of a consensus agreement on Action 1, The Digital Economy. This agreement—referred to as Pillar 1, which allocates some rights to taxing profits for certain digital activities to market countries, and Pillar 2, which

[1] See http://www.oecd.org/tax/beps/.

[2] The reports, along with summaries and other less technical materials, are on the Organization for Economic Cooperation and Development (OECD) website at http://www.oecd.org/tax/beps/beps-actions.htm.

[3] See OECD, *Inclusive Framework on BEPS, Progress Report July 2016-June 2017*, at http://www.oecd.org/tax/beps/inclusive-framework-on-BEPS-progress-report-july-2016-june-2017.pdf.

[4] For a list of countries, see https://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf.

[5] A patent box is an arrangement to provide a lower tax rate for earnings from innovations and patents; the term "box" refers to checking a box on the tax return.

[6] OECD members are listed at http://www.oecd.org/about/membersandpartners/. The 35 members include most countries in Europe, some countries in North America, and Australia, Japan, The Republic of Korea, New Zealand, Israel, Iceland, Chile, and Turkey. The G-20 include Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, The Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States, and the European Union.

[7] OECD, *OECD/G20 Inclusive Framework on BEPS Progress report July 2019 – July 2020*, at https://www.oecd.org/tax/beps/oecd-g20-inclusive-framework-on-beps-progress-report-july-2019-july-2020.pdf.

imposes a global minimum tax on intangible income—has been agreed to by 133 countries including the G20 countries, as of August 12, 2021.[8]

The BEPS project presents opportunities and concerns. One opportunity is that the United States could gain from more multinational cooperation to deal with profit shifting, which has been estimated to cause a loss in revenues of billions of dollars. The BEPS action items address the main methods of achieving profit shifting, including Action 4 (excessive interest deductions in high-tax countries) and Actions 8-10 (transfer pricing, that is, the price of purchasing and selling between related companies, in which pricing of intangibles is thought to be the major method used to accomplish profit shifting).

In contrast, the United States risks losing some revenue if other countries increase their taxation of U.S. firms, even if that income was previously in low-tax jurisdictions, because the United States imposes a minimum tax aimed at intangible income (global intangible low-taxed income) and provides a credit for 80% of foreign taxes paid (i.e., credits for foreign taxes paid offset U.S. tax on foreign source income). Concerns have been expressed, in congressional hearings and in articles, about claims to U.S. multinationals' income tax bases by other countries that may be viewed as inappropriate. The Senate Finance Committee requested that the Government Accountability Office (GAO) study BEPS actions; GAO's study focused on transfer pricing guidance and documentation, including CbC reporting. The concern is that CbC reporting, which will share data with other countries about the activities of large U.S. multinational firms, may be used inappropriately by countries to effectively implement a formula-based approach to taxation.[9] The United States has adopted CbC reporting for 2017 (a year behind most countries), even though all of its sharing agreements are bilateral, with a country-by-country agreement, whereas most countries signed a multilateral agreement.

Companies are also concerned about confidentiality, and there have been proposals by some nongovernmental organizations and the European Parliament to make CbC reports public. The OECD standard on CbC calls for the information to be kept confidential and to be shared through bilateral or multilateral agreements that protect the confidentiality. The United States will share these data only through confidential bilateral agreements.

In addition, some are concerned about the permanent establishment (which generally determines whether a country has any right to tax any profits under an income tax) issues in Action Item 7 and the use of an expanded permanent establishment treatment to allow foreign taxation of U.S. firms' income that is not appropriately allocated to the foreign sources.

Some concerns about capturing revenues by other countries have been heightened by the European Union's (EU's) State Aid actions against several U.S. multinational corporations (among them Apple in Ireland) calling for back tax payments and by the United Kingdom's (UK's) and Australia's enactment of diverted profits taxes (sometimes referred to as the "Google tax"), which addresses profits of firms without permanent establishments, as well as the

[8] For a member list, see https://www.oecd.org/tax/beps/oecd-g20-inclusive-framework-members-joining-statement-on-two-pillar-solution-to-address-tax-challenges-arising-from-digitalisation-july-2021.pdfhttps://www.oecd.org/tax/beps/oecd-g20-inclusive-framework-members-joining-statement-on-two-pillar-solution-to-address-tax-challenges-arising-from-digitalisation-july-2021.pdf.

[9] Government Accountability Office (GAO), *International Taxation: Information on the Potential Impact on IRS and U.S. Multinationals of Revised International Guidance on Transfer Pricing*, GAO-17-103, January 2017, p. 20, at http://www.gao.gov/assets/690/682330.pdf.

allocation of profits for firms with permanent establishments.[10] The General Court of the European Union has overturned the state aid cases against some firms, including Apple and Amazon.[11] If Pillar 1 were adopted, countries would agree to eliminate diverted profits taxes as well as taxes on digital firms not based on profits while waiting to settle the digital tax issue.

There are also reasons to expect that Pillar 1 under Action 1 (The Digital Economy) may cause lost revenue to the United States because of the strong U.S. presence in the multinational digital economy.

At the same time, a uniform set of standards and reporting requirements may be beneficial to U.S. multinationals, as many countries might otherwise have enacted unilateral changes in rules and reporting standards. In particular, the uniform CbC reporting may be beneficial in that it forestalled unilateral enactment of reporting requirements that vary from country to country and that may have been more burdensome to firms than the uniform reporting rules.

Although the United States has adopted the four minimum standards, other countries are in the process of adopting additional standards in various action items. The OECD's recent progress report highlighted increased transparency in rules, reduced opportunities for treaty abuse, curtailment of harmful tax practices via patent boxes, eliminating high returns to "cash boxes" addressed in the transfer pricing action item, and CbC reporting.[12] The most recent progress report noted the elimination of most harmful tax regimes, the implementation of country-by-country reporting by three-fourths of the jurisdictions and all of the G20, success in ratification of the multilateral agreement on tax treaties, and increased peer review of mutual agreement procedures affecting dispute resolution and an increase in closed cases.[13]

Europe has a general constraint in which EU rules prohibit laws that discriminate against cross-border restrictions on trade. Such a restriction is what BEPS measures are sometimes targeting, as in the Controlled Foreign Corporation, or CFC, rules (Action 3), which are designed to prevent artificial shifting of income into low-tax foreign subsidiaries, and limitations of benefits (LOB) in the multilateral instrument (Action 15).

Many of the action items may not be relevant to certain countries that already have achieved the standards (such as CFC rules or limits on interest deductions); also, many actions require legislative changes that may be difficult or time consuming. For the United States, the initial proposed actions in Action 1 (the digital economy) or most provisions under Action 5 (harmful tax practices) would not be relevant because they apply to value added taxes (or VATs) or special

[10] See CRS Insight IN10561, *EU State Aid and Apple's Taxes*, by Jane G. Gravelle, for a brief discussion of the Apple case. For an explanation of the diverted profits tax, see Ernst and Young, *Diverted Profits Tax: Details Released*, 2015, at http://www.ey.com/Publication/vwLUAssets/EY-Finance-Bill-2015-Diverted-profits-tax-Details-released/$FILE/EY-Finance-Bill-2015-Diverted-profits-tax.pdf.

[11] See Ruth Mason, State Aid After Amazon, *Tax Notes International*, May 31, 2021, pp. 1171-1178.

[12] The OECD has reviewed the progress on BEPS as of the end of June 2017. See *Inclusive Framework on BES, Progress Report July 2016-June 2017*, at http://www.oecd.org/tax/beps/inclusive-framework-on-BEPS-progress-report-july-2016-june-2017.pdf. Ernst and Young also have reviews of progress. Based on those reviews, some countries have taken steps with every action, even outside the four minimum commitments. Numerous countries, including the European Union (EU), which represents many countries, have adopted or proposed measures relating to hybrid mismatches (Action Item 2). The EU has taken steps on every action item except Action 1, which essentially relates to the value added tax (VAT). These reviews can be found at http://www.ey.com/Publication/vwLUAssets/EY-the-latest-on-beps-2016-mid-year-review/$FILE/EY-the-latest-on-beps-2016-mid-year-review.pdf and http://www.ey.com/Publication/vwLUAssets/EY-US-the-latest-on-beps-2016-in-review/$FILE/EY-US-the-latest-on-beps-2016-in-review.pdf.

[13] OECD, *OECD/G20 Inclusive Framework on BEPS Progress report July 2019 – July 2020*, at https://www.oecd.org/tax/beps/oecd-g20-inclusive-framework-on-beps-progress-report-july-2019-july-2020.pdf.

regimes (such as patent boxes) that do not exist in the United States.[14] (The subsequent proposals for Pillar 1 under Action 1 would be relevant, and under Pillar 2 whether the U.S. minimum tax, discussed below, should be more closely conformed to the multilateral minimum tax.)

Many of the other suggestions are already partly or fully captured in U.S. law and practice, even though in some cases U.S. practices are at odds with the BEPS outline. Notably, although the United States has strong CFC rules, some of its check-the-box and temporary look-through rules conflict with BEPS items. Its restrictions on interest deductions are weaker than those suggested by BEPS. An important approach used by multinational corporations, cost-sharing arrangements, also appears incompatible with the transfer pricing guidelines. These issues are discussed in further detail below.

In 2017, the United States enacted a major reform of international tax rules in P.L. 115-97, commonly known as the Tax Cuts and Jobs Act, which included a minimum tax on foreign source income.

This report first reviews the basics of U.S. international tax rules and how they changed in 2017. It then discusses the various action items organized into Action Item 1, which relates to the digital economy and proposes standards only with respect to VATS; Action Items 2-5, 7, and 8-10, items related primarily to profit shifting; Action Item 5, which relates to harmful tax practices; Action Item 6, regarding tax treaties; and Action Items 11-15, which are primarily administrative in nature.

Brief Overview of International Tax Rules

Territorial or Worldwide

Under a territorial or source-based tax, all income earned within a country is taxed only by that country regardless of the nationality of the firms. Alternatively, under a worldwide or residence-based system, a tax would be imposed on foreign source income and a credit allowed for foreign taxes paid. For purposes of the corporate profits tax, most countries have a territorial system (although most have some type of anti-abuse rules, as discussed below in reference to CFC rules).[15]

Both the prior and current U.S. tax system is a hybrid. It has some elements of a residence-based or worldwide tax, in which income of a country's firms is taxed regardless of its location, and some elements of a source-based or territorial tax. The provisions that introduce territorial features are deferral and cross-crediting.

Prior Law Deferral, CFC Rules, Check-the-Box, and the New GILTI Regime

Deferral allowed a firm to delay taxation of its earnings in foreign-incorporated subsidiaries until the income is paid as a dividend to the U.S. parent company. Some income, however, is taxed

[14] For a review of U.S. progress, see Deloitte, "BEPS Actions Implementation by Country: United States," March 2017, at https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-beps-actions-implementation-united-states.pdf.

[15] International tax rules are discussed in more detail in CRS Report RL34115, *Reform of U.S. International Taxation: Alternatives*, by Jane G. Gravelle, and CRS Report R42624, *Moving to a Territorial Income Tax: Options and Challenges*, by Jane G. Gravelle.

currently. Income that is not part of corporate profits, such as royalties and interest payments, and income earned by foreign branches of U.S. firms are taxed currently. In 2017, dividends of 10% owned foreign subsidiaries were exempted from tax and controlled foreign corporations instead became subject to a tax on global intangible low-taxed income (GILTI). GILTI income was taxed currently but was allowed a deduction for 10% of tangible assets, and an additional deduction of 50% of the remainder (37.5% after 2025). GILTI thus imposes a tax on the residual after deducting 10% of tangible assets of 10.5%, half the new U.S. rate of 21%. (The overall corporate tax rate was reduced from 35% to 21% in 2017.) This rate will rise to 13.125% after 2025.

In common with many other countries, the United States has anti-abuse rules to tax income that is easily shifted on a current basis and these rules were retained under the 2017 changes. Internationally, they are called CFC rules,[16] but in the United States, they are commonly referred to as Subpart F rules, after the section of the tax code containing the rules.[17] The rules apply to foreign firms in which U.S. shareholders own at least 50% of the voting power or value, for U.S. shareholders owning at least 10% of the voting interest. Many CFCs are wholly owned by a single U.S. parent.

Subpart F rules currently tax passive income (such as interest) received by a subsidiary, income of sales and services subsidiaries in foreign countries where the production and consumption of those goods and services take place in other countries, and income from insurance of risks outside the country (or within the country if receiving the same premiums). Income invested in U.S. property (including lending to the parent) is taxed currently (to prevent a way to repatriate without paying dividends). There are de minimis exclusions (for small amounts or shares or tax rates more than 90% of the U.S. rates) and full inclusion rules (when Subpart F income is more than 70% of total income).

Other countries have similar rule features that trigger current taxation, such as type of income and tax rate. EU member countries are constrained in applying CFC rules to other EU member states.[18]

Since the late 1990s, the scope of Subpart F has been reduced by the adoption of check-the-box rules. Check-the-box was a regulatory provision, but it has been codified and extended through the temporary look-through rules, set to expire after 2025. The provision allows a foreign subsidiary of a U.S. parent to elect to disregard its own (second tier) subsidiary, incorporated in a different country, as a separate entity. If the second tier subsidiary borrows from the first tier subsidiary, it can deduct the interest in the country of incorporation; normally, the payment of interest would be considered Subpart F income and taxed currently. Under check-the-box, the payment is not recognized because there is no separate entity. If the first tier subsidiary is in a no-tax jurisdiction, the interest will be deducted, but not taxed currently. This type of arrangement creates what is referred to as a hybrid entity, which is characterized differently in different jurisdictions.

[16] CFC in U.S. discussions stands for "controlled foreign corporation," but in Europe and the OECD in general, it stands for "controlled foreign company." Discussions also refer to "controlled foreign enterprises" (CFEs). The United States determines its deferral rule on the basis of foreign incorporation.

[17] For a summary of CFC rules in five major EU countries (Germany, UK, Italy, France, and Spain), see Ernst and Young, at http://www.m-i-tax.de/content/Wichtige_Links/Alumni_Netzwerk/documents/cfcrules_000.pdf. Currently, EU rules generally exempt other EU countries, following court decisions. For a list of selected countries with and without CFC rules and an indication of their strength, see Kevin Markle and Leslie Robinson, "Tax Haven Use Across International Tax Regimes," November 2012, at http://faculty.tuck.dartmouth.edu/images/uploads/faculty/leslie-robinson/marklerobinson.pdf.

[18] See the Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue case, at the European Commission website, at http://ec.europa.eu/dgs/legal_service/arrets/04c196_en.pdf.

Foreign Tax Credit and Cross-Crediting

The U.S. tax system allows a credit against U.S. tax due on foreign source income for foreign income taxes. For GILTI only 80% of foreign taxes can be credited. This foreign tax credit is designed to prevent double taxation of income earned by foreign subsidiaries of U.S. corporations. Thus, firms are not levied a combined U.S. and foreign tax in excess of the greater of the foreign tax or U.S. tax due if the income were earned in the United States. If the foreign tax credit had no limit, a worldwide system with current taxation and a foreign tax credit would produce the same result, for firms, as a residence-based tax, because the tax effectively applying would be the tax of the country of residence. Firms in countries with a higher rate than the U.S. rate would get a refund for the excess tax, and firms in countries with a lower rate than the U.S. rate would pay the difference. However, to protect the nation's revenues from excessively high foreign taxes, the credit is limited to the U.S. tax due.

Cross-crediting occurs when credits for taxes paid to one country, that are in excess of the U.S. tax due on income from that country, can be used to offset U.S. tax due on income earned in a second country that imposes little or no tax. If the limit were applied on a country-by-country basis, a firm would pay the minimum of the U.S. tax or the foreign tax in each country.

Cross-crediting also allows income subject to a low tax to have its U.S. income tax offset by credits on highly taxed income. For this reason, foreign tax credit limits are applied to different categories of income, or baskets. The main baskets are passive and active baskets. Notably, however, royalties on active business operations are classified in the active basket, and because they are typically not taxed in the country of source, they can benefit from excess credits against U.S. tax from foreign taxes on active income. There are also restrictions on the use of excess credits generated from oil and gas extraction, which is often subject to relatively high foreign tax rates.

The combination of deferral, which allowed firms to choose the income to be subject to tax, and cross-crediting means that multinational firms on average had relatively little U.S. tax; the effective U.S. residual tax was estimated at 3.3%.[19]

Allocation of Income

The first right of taxation goes to the source country, regardless of whether the residence country has a territorial tax or a worldwide tax with a foreign tax credit.

To assess some of the actions considered in the allocation of income, whether suggested or rejected, it is important to consider the fundamental definition of a tax on profits (or income from capital). Income from capital is created by investment, which involves forgoing resources in the present to obtain income in the future. The return can simply be the cost of waiting or opportunity cost (because resources could earn interest elsewhere) in the form of a riskless return and a risk premium that compensates for uncertainty and variability of the future return. Presumably, then, the profit representing waiting should accrue to the owner of the asset or the entity that gave up resources to make investments, and the profit representing risk should be borne by the person subject to the risk. When firms, especially closely related firms, are located in different taxing

[19] See Melissa Costa and Jennifer Gravelle, "Taxing Multinational Corporations: Average Tax Rates," *Tax Law Review*, vol. 65, issue 3 (spring 2012), pp. 391-414. See also Melissa Costa and Jennifer Gravelle, "U.S. Multinationals Business Activity: Effective Tax Rates and Location Decisions," Proceedings of the National Tax Association 103rd Conference, 2010, at http://www.ntanet.org/images/stories/pdf/proceedings/10/13.pdf.

jurisdictions, the allocation of profits, whether returns to waiting or returns to risk, can become complicated.

Successful innovations can also result in excess returns (beyond the amounts necessary to attract capital), either because of patent protection or other features that incur a degree of monopoly power over some time period. Because the returns are the upside of risk bearing, they should accrue to the party bearing the risk.

Note that under an income tax, the returns should accrue based on the investment; the size of the market (i.e., the provision of customers) is not a source of value, although the prospective market size is a factor in a decision to undertake an investment. This view is embodied in the basic international rules.[20]

As discussed later in this report, risk bearing is an important issue in the BEPS standards as well as in the GAO review of the transfer pricing issues addressed by BEPS.

Nexus and Permanent Establishment

Nexus is the first step in the process of determining whether a country has the right to tax any of a firm's profits. A U.S. firm that exports abroad, without taking part in an activity within the country it is exporting to, is not subject to profits taxes by that country. To establish the right to tax, a firm has to have nexus, or connection, with the country, which requires a permanent establishment. A permanent establishment is generally viewed as having a physical presence, which means that some assets are in the country (and a profits tax is a tax on the return to assets). Obviously a firm that manufactures abroad or has retail stores abroad has a physical presence, but other circumstances with a minimal presence are less clear. If nexus is established, then the amount of income sourced in that country must be determined.

In the U.S. tax law, this establishment of a presence is termed *effectively connected income* and generally must require a physical presence or be derived from assets that are used in the United States. Tax treaties (discussed below under Action 6) also contain provisions on permanent establishment.

Because most income sourced abroad is not subject to U.S. tax on a current basis, U.S. firms can benefit by recognizing profit in low-tax-rate jurisdictions. The country to which corporate profits are sourced is a major concern of the BEPS projects. Evidence exists of significant profit shifting out of high-tax and into low-tax jurisdictions (as discussed in Action Item 11 below).

Profit Shifting: Leveraging and Transfer Pricing

Two major methods used to recognize more profit in low-tax jurisdictions than economic reality suggests are increased leveraging and use of transfer pricing, primarily of intangible assets such as drug formulas, technological advances, and trademarks.

To shift profits through leveraging, firms locate their debt in high-tax countries, including the United States. This technique involves both U.S. multinational firms locating their debt in the United States rather than abroad and foreign parents of U.S. subsidiaries locating debt in their U.S. subsidiaries. As noted above, the creation of a hybrid entity by check-the-box can also lead

[20] India and China have argued that the market should be considered a source of value in allocating profits. India has enacted an equalization tax based on sales of nonresident companies, but it is not called a corporate income tax. See Mindy Herzfield, "India and the United States—Half a World Apart on Tax," *Tax Notes International*, December 12, 2016, pp. 953-955.

to reducing profit taxable by the U.S. system, although it is not clear whether the United States or other high-tax countries lose revenue.

The U.S. tax code contains general provisions (called thin capitalization rules) to restrict large interest deductions, disallowing deductions that exceed 30% of earnings before interest, taxes, depreciation and amortization (EBITDA). After 2021, this income base will be narrowed to earnings before interest and taxes (EBIT). Recently, new regulations issued under Section 385 would require some debt between related entities to be reclassified as equity.[21]

The second method of profit shifting is through transfer pricing methods that determine the price associated with a transfer of goods and assets. The standard for transfer pricing is that goods and assets bought and sold between related firms should reflect arm's length pricing, that is, the price that would be paid by two unrelated firms. If a U.S. firm sells a good or asset to its foreign subsidiary for a price that is too low, profit in the United States is reduced and profit abroad is increased.

Most of the transfer pricing issues arise due to intangible assets that are often unique, so there is not a market to observe arm's length prices. A variety of different methods are used to determine transfer prices. When an intangible asset is transferred abroad (such as the right to sell a mobile phone or to sell advertising for a search engine), there is sometimes a buy-in payment by the foreign subsidiary, followed by cost-sharing payments. The subsidiary pays for a share of the research costs in the United States in return for a share of the rights (to future technological advances).

Tax Treaties

The United States and other countries have tax treaties designed to avoid double taxation. An important area of coverage in treaties is the agreements regarding withholding taxes, but treaties cover other issues as well, such as the recognition of a permanent establishment or other grounds to impose source-based taxes, such as corporate profits taxes. For U.S. firms' subsidiaries incorporated abroad, the treaties of those countries of incorporation and other countries are also relevant.

Withholding Taxes on Dividends, Interest, and Royalties, and Treaty Shopping and Abuse

The United States and other countries may impose withholding taxes on dividends, interest, royalties, and capital gains payments.[22] In the case of the United States, a 30% withholding tax is applied to dividends and royalties. Interest is subject to a withholding tax, but interest paid by banks and insurance companies is exempt. Capital gains are generally exempt with some exceptions, notably from the sale of real estate.

Member states of the European Union cannot impose withholding taxes on each other.

The United States has a number of treaties with other countries that reduce tax rates, in some cases to zero on royalties, and in the case of U.S. subsidiaries of foreign parents to 5% for major trading partners. A network of such treaties exists around the world.

[21] TD 9790, "Treatment of Certain Interests in Corporations as Stock or Indebtedness," *Federal Register*, vol. 81, no. 204, October 21, 2016, pp. 72858-72984 at https://www.gpo.gov/fdsys/pkg/FR-2016-10-21/pdf/2016-25105.pdf.

[22] For a summary of U.S. withholding taxes, see PwC, "United States: Corporate-Withholding Taxes," at http://taxsummaries.pwc.com/ID/United-States-Corporate-Withholding-taxes.

One issue addressed by the OECD BEPS action items is treaty shopping, in which recipients without treaty benefits funnel payments through countries with generous withholding tax treatment to avoid withholding taxes. Treatment of withholding taxes also plays a role in some of the tax planning arrangements to shift profits to low-tax jurisdictions. For example, some tax planning arrangements in Europe funnel profits (via royalties) through the Netherlands to eliminate withholding taxes on royalties.

The United States has a limitation on benefits (LOB) article in its tax treaties that requires a foreign person to certify to the payer that it qualifies for benefits of reduced withholding rates in treaties. Other countries may have general anti-treaty shopping provisions in domestic law, in tax treaties, or in both.

Other Issues

Tax treaties also address other issues such as defining residency and defining the circumstances under which profits of U.S. firms will be taxed abroad (and vice versa). Business profits are taxed in the state of residence unless business is carried on in the foreign country through a permanent establishment (i.e., the mere fact of selling to customers who are located in a foreign country is not adequate to establish a basis for profits taxation in that country). If a permanent establishment exists, the business must file a local income tax return and report the profit or loss allocable to the permanent establishment for local tax.

Action 1: The Digital Economy

Action 1 focuses on the general issue of the effects of the digital economy. It discusses the broad set of consequences of a digital economy that may exacerbate base erosion and profit shifting issues or even render existing rules obsolete. The discussion deals with three types of taxes: (1) corporate profits taxes; (2) withholding taxes on income such as dividends, interest, and royalties (in this case, royalties); and (3) the value added tax (VAT). Standards, however, are provided only with respect to the VAT.

The digital economy is an economy based on digital technologies. It refers to numerous online activities, such as advertising, broadcasting and media, production monitoring, retailing, and tracking, as well as financial services, remote education and health care diagnosis and records, software, and cloud computing. Digital activity also involves gathering customer data and converting it into revenue (such as through sales of advertising) and user-generated content.

These activities are characterized by mobility, reliance on intangible assets, network effects that may lead to oligopoly or monopoly, and in some cases low barriers to entry that lead to volatility. The OECD analysis also raises questions of whether income from certain activities, such as cloud computing, should be considered profit or royalties.

The digital economy issues are particularly important to U.S. multinationals because U.S. firms are the major firms in this industry.

With many aspects of the digital economy rendering the physical presence rules for nexus irrelevant, this discussion focuses on new approaches for establishing nexus as well as tightening (but not abandoning) physical presence (addressed in the permanent establishment standards under Action Item 7).

The OECD considered, but abandoned, using economic presence rather than physical presence as the standard nexus test. Economic presence might be measured by sales, having a local domain name or website, having a local payment option, the volume of data collected, contract

conclusion with customers, and monthly active users. Action Item 1 also considered allocating income through fractional apportionment, and a modified deemed profit ratio on presumed expenses. In addition, the action item discussed a withholding tax on digital transaction payments and an equalization levy (an excise tax, for example, on gross sales). None of these approaches were provided as a standard, although countries are free to adopt such an approach if needed to address BEPS issues.

It can be argued that these particular standards are inconsistent with the concept of where profit accrues, meaning that the profit from remote sales or digital sales should accrue to the source of the investment and ownership of the asset, and not be based on the location of customers (just as exports of goods into a foreign market would not trigger profits tax). A physical presence in a country would require some amount of capital assets (such as a building or equipment), but a digital presence would not. The adoption of economic rather than physical presence as a basis for nexus could have consequences for U.S. firms in that other countries might increase taxes imposed, which might ultimately be credited by the United States.

Standards were not provided specific to the digital economy with respect to profits taxes and passive income from capital. Related standards were subsumed in other actions, such as the definition of permanent establishment (Action 7), in which proposals were made to limit exceptions, and CFC rules (Action 3), in which proposals were made to ensure current taxation of income in the digital economy to the ultimate parent company, as well as other action items.

Action 1 did discuss options to ensure that the digital enterprises that provide business-to-customer direct sales be subject to the VAT by requiring compliance by the nonresident remote sellers. This issue is not directly relevant to the United States, although U.S. firms could be affected by other countries' VAT regimes.

Further Developments: Pillars 1 and 2

Action 1 included a plan to develop further actions relating to the digital economy. These plans, with blueprints provided in 2020, are in two parts: Pillar 1, providing market countries a share of residual profits of digital firms, and Pillar 2, providing for a global minimum tax.[23]

Pillar 1

Pillar 1 would allocate some rights to market countries to tax profits of digitalized firms (and these countries would eliminate their digital services taxes).[24] The Pillar 1 blueprint would allow market countries a share of 20% of the residual profits (defined as profits after a 10% margin for marketing and distribution services) of large multinational companies. The proposal would allocate the residual share based on revenues (such as sales of advertising) and the location of the user or viewer for an array of digital services and split the residual share 50:50 between the location of the purchaser and seller for online markets. The OECD/G20 blueprint provides a positive list of the businesses covered: "sale or other alienation of user data; online search engines; social media platforms; online intermediation platforms; digital content services; online

[23] For a recent OECD document outlining some additional details, see https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf.

[24] OECD, *OECD/G20 Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint, 2020*, https://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-one-blueprint-beba0634-en.htm.

gaming; standardized online teaching services; and cloud computing services" and online market places.

In 2020, then-Secretary of Treasury Steve Mnuchin signaled the U.S. position that negotiations over Pillar 1 were at an impasse.[25] On June 5, 2021, finance ministers of the G7 countries, including the United States, agreed to allow market countries a share of 20% of the residual profits (defined as profits after a 10% margin for marketing and distribution services) of large multinational companies.[26] The proposal would allocate the residual share based on revenues (such as sales of advertising) and the location of the user or viewer for an array of digital services and split 50:50 between purchaser and seller for online markets.

The tax would cover multinational enterprises with global turnover above 20 billion euros and profits as a percentage of revenue above 10% with the turnover standard reduced to 10 billion euros in the future.

Countries that have enacted digital service taxes or diverted profits taxes would eliminate those taxes with implementation of Pillar 1.

Pillar 2

Pillar 2 would impose a global minimum income tax to address base erosion, or GLoBE.[27] It includes an income inclusion rule (IIR) to raise the effective tax rate on a country-by-country basis to 15% on profits in excess of a fixed return for substantive activities (including tangible assets and payroll). This rule is termed a top-up tax. The income base is financial profits. These taxes would be imposed on the parent company. In cases where the IIR does not apply, there is a subsidiary rule to tax payments to low-tax countries (the undertaxed payment rule, or UTPR) at the same rate. The tax would be imposed on companies with 750 million euros in revenue, although countries could elect to tax smaller firms. Many details would need to be worked out.

The proposal would be coordinated with the existing minimum tax in the United States (the GILTI), which might continue to serve as the U.S. compliance with the global minimum tax. GILTI is similar in some ways to the minimum tax that would be imposed by GLoBE under the IIR. It imposes a tax at a lower rate (currently half the U.S. rate, or 10.5 %) to income in excess of a deemed return of 10% of tangible assets. The rate is scheduled to rise to 13.125% after 2025. In addition to the lower rate, three other features of GILTI differ from the IIR. First, although the fixed return for substantive assets in GLoBE has not been specified, it applies to a broader range of spending that includes payroll as well as tangible assets. Second, GILTI achieves the "top-up" tax by imposing the full tax and then allowing credits against the GILTI tax for 80% of foreign taxes paid, up to the amount of U.S. tax due. This limit is imposed on a global basis so that unused credits in high-tax countries can offset U.S. tax due in low-tax countries; the IIR would apply on a country-by-country basis. Finally, the IIR would allow carryforwards of losses and excess taxes, which is not allowed under GILTI.

[25] See https://assets.kpmg/content/dam/kpmg/us/pdf/2020/06/tnf-mnuchin-oecd-jun19-2020.PDF.

[26] U.S. Department of Treasury, "G7 Finance Ministers and Central Bank Governors Communiqué," press release, June 5, 2021, at https://home.treasury.gov/news/press-releases/jy0215.

[27] OECD, *OECD/G20 Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint, 2020*, at https://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-two-blueprint-abb4c3d1-en.htm.

Action Items Relating to Profit Shifting by Multinational Corporations

The following actions relate primarily to reducing profit shifting by multinationals.

Action 2: Neutralizing the Effects of Hybrid Mismatch Arrangements

Hybrid mismatch arrangements involve the use of hybrid entities or hybrid instruments to provide multiple deductions for a single expense, deductions in one country without taxation in another, and multiple foreign tax credits for a single amount of foreign tax paid. Hybrid entities generally involve cases in which the entity is not seen as a separate entity from one country's perspective but is from another country's perspective. Hybrid instruments are financial arrangements that are treated as debt in one jurisdiction and equity in another.

The most common example of a hybrid entity from the United States' perspective is in check-the-box, in which an entity can be disregarded for purposes of Subpart F rules. For example, a subsidiary of a U.S. parent in the Cayman Islands has in turn a German subsidiary that borrows and deducts interest in Germany. If the German subsidiary were a separate entity for U.S. tax purposes, Subpart F rules would treat the interest income paid by the German subsidiary to the Cayman Islands subsidiary as currently taxable. Because check-the-box allows the German subsidiary to be disregarded for U.S. tax purposes, the interest income is not seen as an item of income and is not taxed. (Note that this hybrid mismatch is created by the check-the-box rule, and there is a suggestion to disallow this check-the-box treatment for purposes of measuring Subpart F income in Action Item 3.)

An example of a hybrid instrument might be an instrument considered debt, with interest deductible, in the United States but as equity in a foreign country, which does not tax foreign source income and therefore does not tax dividends.

The action item addresses three types of situations: (1) the payment is deductible in one country and not included in the other (D/NI); (2) the payment gives rise to double deductions (DD)—for example, both parent and subsidiary take the deduction and it exceeds the dual inclusion, or the firm is a dual resident of two countries; and (3) an indirect D/NI arrangement.

The action item suggests the treatment of D/NI as the denial of a deduction by the payer, and if that does not occur, the inclusion of income by the payee as a defensive move. For a double deduction, the remedy would deny the parent deduction (and if not, the payer deduction) or deny the resident deduction.

This action contains a number of additional detailed proposals for domestic law changes (such as denying dividend exemptions when payments are deductible, preventing duplicate credits, altering CFC rules to include hybrid entity incomes, and encouraging information reporting). It also contains changes to ensure hybrid instruments and entities are not used to obtain treaty benefits inappropriately.

The United States already has rules that cover certain standards associated with deductible hybrid payments and dual residents, as well as tax treaty provisions that cover the treaty recommendations. Otherwise, no legislative proposals are active.[28]

Action 3: CFC Rules

Many of the standards in Action 3 are for countries that do not have CFC rules to establish them (most countries, especially developed countries, do), but also to strengthen them. Most of these standards are not particularly relevant to the United States, which already has a fairly strong set of CFC rules.

One suggestion, however, is not to allow check-the-box treatment with respect to Subpart F income. Another is to consider including certain types of additional income, such as intellectual property (IP) income; digital activities income; and finance, banking, and insurance incomes. The action also discusses the possibility of a substance analysis, which would determine if there is little enough economic activity (through employees, business premises, or other measures) that all of the income of the CFC should be taxed. In addition, the action item discusses two possible features that are not in current U.S. CFC rules. One is to subject returns to IP in excess of a normal return to CFC rules. Another is to tax income at some minimum or partial rate.

Some approaches similar to these proposals have been advanced in the past. For example, proposals have been made to tax excess income from intangibles based on a cost mark-up as Subpart F income or to impose a minimum tax on intangible income earned in low-tax jurisdictions.[29] The U.S. GILTI regime, enacted in 2017, is a minimum tax aimed at low-taxed intangible income.

The current tax regime in the United States already incorporates many of these standards,[30] although, as noted earlier, no changes have been proposed to eliminate check-the-box and the look-through rule.

The United States had been discussing the possibility of moving to a territorial tax at that time. The director of the OECD's Center for Tax Policy and Administration, Pascal Saint-Amans, indicated that "from a European perspective, it is hard to understand how you would move to a territorial tax without repealing check-the-box."[31] The regime adopted in 2017 is a territorial tax system along with a minimum tax aimed at low taxed intangible income (GILTI).

Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

One of the key methods used to shift profits into low- or no-tax jurisdictions is leveraging—that is, borrowing and deducting interest. Some countries, including the United States, have thin

[28] Deloitte, "BEPS Actions Implementation by Country: United States," March 2017, at https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-beps-actions-implementation-united-states.pdf.

[29] The former was proposed by the Obama Administration in budget proposals prior to the proposal to end deferral and impose a minimum tax. The latter was included in the then-Chairman of the Ways and Means Committee Dave Camp's Tax Reform Act of 2014, the latter part of his proposal to move to a territorial tax. Earlier Obama Administration budget proposals also proposed to tax certain income associated with digital goods and to limit deductions associated with digital goods.

[30] Deloitte, "BEPS Actions Implementation by Country: United States," March 2017, at https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-beps-actions-implementation-united-states.pdf.

[31] Ryan Finley, "OECD Members Want U.S. Tax Reform to Repeal Check-the-Box, Saint Amans Says," *Worldwide Tax Daily*, June 6, 2017.

capitalization rules that limit interest deductions, and, as noted in the discussion of U.S. tax law, provisions that treat foreign subsidiary loans as repatriations subject to tax.

The discussion considers three types of leveraging: (1) third-party debt in high-tax countries, (2) intragroup loans to generate deductions in excess of expense, and (3) third-party or intragroup to fund tax-exempt operations.

It also notes a variety of rules that have been adopted to address leveraging:

- arm's length tests, which compare interest rates with those between unrelated parties;
- a withholding tax on interest payments;
- disallowing a percentage of interest expense as a share of income;
- limiting interest deductions to the worldwide income share; and
- targeted anti-avoidance aimed at special transactions needing a consistent approach.

Challenges with some of these rules are the complications (with respect to arm's length) and withholding that may be either inadequate or too high and cannot be imposed on payments between EU member states.

The proposal combines several effects of the rules: a fixed limit on interest that cannot exceed a percentage (between 10% and 30%) of pretax earnings (before interest and depreciation), supplemented by a worldwide group ratio rule, which allows interest to exceed the fixed limit up to the average of the worldwide interest share. These rules might be accompanied with de minimis rules for entities with a low level of interest. It also suggests an exclusion for loans used to fund public-benefit policies, which are frequently highly leveraged. The proposal noted that these general rules might not apply to the banking and insurance sectors.

An updated 2016 report provided additional technical details and concluded that the common approach was not appropriate for banking and insurance, suggesting that each country independently identify risks and take actions.[32]

The general BEPS-proposed rules limiting leveraging are stricter than the current U.S. rules in some respects, and changes to meet this recommendation would require legislation. The restriction on interest (no more than 30% of earnings) was adopted in 2017. A worldwide allocation rule was considered but not included in the final legislation. The Administration and several congressional proposals would apply a worldwide allocation rule.[33]

The Section 385 debt-equity regulations would also restrict interest deductions by related businesses by characterizing certain debt as equity.

Action 7: The Artificial Avoidance of Permanent Establishment Status

The first step in allocating income to a particular source jurisdiction for the purpose of profits taxes is establishing nexus, which requires a permanent establishment. Traditionally, a permanent establishment has been considered to be a physical presence. Tax authorities in many countries

[32] Updated 2016 report on Action Item 4 is also posted at http://www.oecd.org/tax/beps/beps-actions.htm.

[33] See CRS In Focus IF11809, *Trends and Proposals for Corporate Tax Revenue*, by Donald J. Marples and Jane G. Gravelle.

and cases have not been able in court to impose a tax on profits of a non-resident business from sales to local customers because of the lack of a permanent establishment.

This action item addresses several issues in avoiding permanent establishment.

A clause in the OECD Model Tax Convention, Article 5(5), provides there is no permanent establishment if contracts are not concluded in the state where sales take place, and Article 5(6) provides there is no permanent establishment where the person who habitually exercises the authority to conclude contracts is an independent agent.

This measure would modify Articles 5(5) and 5(6) to include as a basis of permanent establishment circumstances where the agent habitually concludes contracts or plays the leading role or when the independent agent acts almost exclusively for the principal where it is closely related (based on all the relevant facts and circumstances).

One method of avoiding the permanent establishment status is through the use of a commissionaire arrangement, which is an arrangement in certain civil law countries (such as France and Germany). In a commissionaire arrangement, a firm (the agent) would sell products in its own name but on behalf of a foreign enterprise (the principal) that owns the products. Legal title passes directly from the principal to the customer. Customers, however, have only a contract with the commissionaire and can only sue the commissionaire; the commissionaire has a contract with the principal. The agent can substitute for a distributor and avoid creating a permanent establishment in the country where the sales are made. The firm owning the products does not have permanent establishment and thus does not pay tax on profits where the sales are made. The commissionaire pays taxes only on a commission that is set by contract usually based on a cost-plus formula or a percentage of sales value. This treatment can reduce the amount of a group's profit that is taxed in the country where products are sold, which could be larger if the sales were made by a subsidiary established in the country of sales.

A second way to avoid permanent establishment status is due to a list of exceptions to business operations that were considered to be preparatory or auxiliary. A concern is that these activities, in the digital age, may now be considered core (as discussed in Action 1). (An example might be a warehouse for storing and delivering goods that the enterprise sells online.) Another concern is fragmentation, in which firms divide operations into several smaller ones to make the argument that the activities of each are preparatory or auxiliary. The action item would add language to define what is preparatory or auxiliary in light of the core activities or the firm and to consider the whole of activities.

This action item also addresses other strategies, such as those that split up contracts into shorter periods of less than a year with different companies so that they do not meet the standards for permanent establishment. It notes that the principal purposes test, or PPT (discussed below in Action 6), would address splitting up of contracts as well. The action item mentioned, but did not address, the use of a network of agents to sell insurance.

These changes only become effective between countries when they have been incorporated in their bilateral or multilateral tax treaties. The OECD subsequently released a discussion draft on the attribution of profits to permanent establishments, even though this issue is addressed in Actions 8-10 on transfer pricing. These changes in determining permanent establishment have been included as options in the multilateral instrument discussed in Action 15. Note also that Actions 8-10 also limit intragroup interest paid to companies without sufficient substance to a risk free rate.

Why permanent establishment revisions should be an important part of BEPS is a concern, because a significant amount of profit shifting would be unlikely. These limited business

involvements would seem to imply modest, if any, profit reallocations. U.S. firms are concerned that permanent establishment status may open the door to inappropriate assignment of profits to what are, essentially, countries that are the target of exports (concerns that may have increased given some actions in the EU state aid cases, with Apple and other firms, and the enactment of diverted profits taxes and equalization taxes that impose taxes on firms without permanent establishments).

A more benign reason that other countries might be interested in addressing the permanent establishment status is because it is necessary for local tax authorities to investigate and possibly prevail in the courts on matters of the allocation of profits.

A number of countries agreed to the permanent establishment rules.[34] The United States has not yet taken any actions relating to this action item.[35]

Actions 8-10: Aligning Transfer Pricing Outcomes with Value Creation

When related companies buy or sell commodities, services, or assets internally, a transfer price must be charged to allocate profits. The core of transfer pricing rules is the arm's length principle, that is, that goods and assets must be exchanged with the same prices that would be charged between unrelated firms.

Ideally, the method of setting prices would be to rely on a comparable uncontrolled price (CUP). In many instances, there are no comparables, and a variety of other methods are used, including resale costs, cost-plus methods, and net profit indicators, such as profit margins. Intangibles, such as technology, know how, and brand value, are often unique and particularly hard to value.

The basic thrust of these action items is to move from the current emphasis on contractual arrangements to actual economic issues of functions performed, assets used, and risk undertaken. This objective is reflected in the title of this set of action items: pricing should reflect value creation.[36]

In aligning transfer pricing outcomes with value creation, the BEPS plan focused on three key areas. To this end, the guidance under this set of action items provides that the allocation of income should be based on an accurate delineation of the controlled transaction, which requires identification of factors in five categories: (1) the contractual terms of the transaction; (2) the functions performed by each of the parties to the transaction, taking into account assets used and risks assumed; (3) the characteristics of property transferred or services provided; (4) the economic circumstances of the parties and the market; and (5) the business strategies pursued by the parties.

[34] Alexander Lewis, "40 Countries Adopt New Permanent Establishment Provisions of MLI," *Worldwide Tax Daily*, June 7, 2017.

[35] Deloitte reports that the Treasury appears somewhat favorably disposed to some standards, but is waiting for the report on the attribution of profits. It also notes that signed tax treaties in the Senate have seen no action since 2011, leading to uncertainty about changes. See "BEPS Actions Implementation by Country: United States," March 2017, at https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-beps-actions-implementation-united-states.pdf.

[36] The proposals in these action items have been incorporated into the revised OECD transfer pricing guidelines, issued June 10, 2017. See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2017*, at http://www.oecd.org/tax/transfer-pricing/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-20769717.htm.

1. Action 8 considers transfer pricing of intangibles.
2. Action 9 considers the contractual allocation of risks, including funding by a capital-rich funding member of the multinational group whose returns do not correspond with activities.
3. Action 10 considers a variety of issues, including transactions that are not commercially rational for the individual enterprises, the diversion of profits from the economically important activities, and payments (such as management fees and head office expenses) that erode the tax base.

The action items introduce two important clarifications. The first is that the undertaking of risk is associated with a higher expected return and cannot be allocated by contract to a party that does not exercise control or have the financial capacity to assume the risk. The second is that legal ownership alone does not necessarily generate a right to the return from exploiting an intangible. This latter concern specifically mentions cost-contribution arrangements, which are referred to as cost-sharing arrangements in the United States.

In addition, the items note that a capital-rich member that provides funding but does not control the risks will be entitled to no more than a riskless return or less (e.g., if the transaction is not rational). The OECD documents sometimes call these cash boxes, which are also limited by other BEPS action items.[37] The CbC reporting in Action 13 (discussed below) provides information that assists in the risk assessment and other transfer pricing issues.

These action items stress that outcomes based on contracts do not necessarily reflect reality. Risks must be associated with actual decisionmaking, capital provided without functions should have no more than a risk-free return, and commercially irrational transactions can be disregarded. To undertake risk, the entity must have both control and the financial capacity to bear risk; otherwise, it should receive only a risk-free return.

The following sections provide further guidance on various items, not necessarily in numerical order, partly because of some of the specific actions (e.g., some actions in Action 8 are discussed in the context of the general guidance in Action 9).

Guidance for Applying the Arm's Length Principle (Action 9)

Various factors that might be considered in determining arm's length pricing are contractual terms, functions (including assets used and risks assumed), characteristics of property transferred or services provided, economic circumstances of the parties and the market, and business strategies pursued. The fundamental theme of this section is that conduct is more important than the contract.

In addition, terms of arrangements may change over time, and care should be exercised when changes are triggered by knowing the risk outcomes (risk assumption is not relevant when risk outcomes are known).

The treatment of risk, including actual control and financial capacity, is a concern. Risk management is not the same as assuming a risk, and true control is the actual making of a decision. According to the proposal, risk assumption should be ex ante. Other issues that would affect transfer pricing include whether the geographic market is homogeneous or diverse, whether the firm is attempting to penetrate a new market by underpricing, location effects (e.g.,

[37] The discussion of cash boxes also refers to other action items that will restrict their return, including the interest deductibility in Action 4, withholding taxes in Action 5 (discussed below), and CFC rules in Action 3.

restrictions on foreign firms), and group synergies. Persistent losses in one firm when the group as a whole is profitable should raise questions, although there are some legitimate reasons for shorter-term losses.

Commodity Transactions and the Transactional Split Profit Method (Action 10)

Countries face several problems and policy challenges regarding commodity transactions. In some cases CUP can be used, although pricing dates in contracts should not be used, but rather estimates of shipping dates.

The transactional profit split method may be appropriate when other methods do not work (e.g., in the case of global trading of financial instruments or of unique intangibles). Some of the inputs into this approach include invested capital costs, functional contributions, and the weighting of factors. In some cases, inexact comparables may be better, but the transactional split profit may be better for highly integrated operations (e.g., global trading of financial instruments). Whether the profit split can be used to support results under a TNMM (transactional net margin method) and other methods is under discussion. The profit split method is being considered further.[38]

Transfers of Intangibles (Action 8)

This section focuses on defining intangibles, ensuring the appropriate profit allocation, and developing rules for hard-to-value intangibles. Many of the issues are related to the risk issues discussed in Action 9, with only a risk-free return allowed if there is no function performed or control of risk.

Under circumstances where there are information asymmetries between the firm and tax authorities, tax authorities can consider ex-post outcomes as evidence of ex ante pricing arrangements for hard-to-value intangibles. This position is similar to the U.S. "commensurate with income" standard.[39]

Legal ownership does not determine returns; returns should be aligned with value creation (development, maintenance, enhancement, protection, and exploitation of intangibles). The assumption of risk requires exercising control and having the capacity to bear risk. If the entity provides financing without functions, it should receive only a risk-adjusted return, and if it provides only financing with no control over financial risks, it should have a risk-free return.

The discussion defines intangibles to include patents; know-how and trade secrets, such as trademarks, trade names, and brands; rights under contracts and government licenses (but not company registration); licenses and similar limited rights in intangibles; and good-will and going concern value. Group synergies are not intangibles but should be addressed as comparability factors; market-specific characteristics are also not intangibles.

Transfer pricing should assure group members are compensated for functions, assets, and risks assumed, with risk requiring control and capacity to bear; generally these are determined on an ex ante basis. The discussion continues the emphasis on actual functions, assets, and risks regardless of conflicting contractual provisions.

[38] The OECD released a discussion draft on the transactional split profit method in July, 2016. Revised Guidance on Profit Splits, at https://www.oecd.org/tax/transfer-pricing/BEPS-discussion-draft-on-the-revised-guidance-on-profit-splits.pdf.

[39] Section 482, Internal Revenue Code.

Various methods can be used in transfer pricing, excluding rules of thumb that apportion income between licensor and licensee and discouraging methods based on cost. Other approaches discussed are CUP, transactional cost methods, and discounted cash flow. The discussion notes that risk also depends on payment form: payments contingent on sales or profits are more risky than a fixed amount.

For hard-to-value intangibles, tax authorities should be able to consider ex-post outcomes, and use their consistency with ex ante outcomes to monitor transfer pricing.

Management Fees and Head Office Expense (Action 10)

This section of the discussion looks at low value-adding intra-group services, suggesting that CUP or cost-based approaches might be used.

Cost-Contribution Arrangements (Action 8)

This section discusses profit attribution based on cost-contribution arrangements (CCAs), the type of cost-sharing arrangement used by U.S. multinationals (in which foreign subsidiaries finance part of research and development [R&D] in return for the right to sales in a geographic area or a share of profits). These arrangements are contractual ones that allow business enterprises to share in the contributions and risks of developing, producing, or obtaining intangibles, tangible assets, or services. This particular part of the action item is provided to ensure that the same rules applying to contractual arrangements in general are also applied to cost contribution arrangements, whether in allocating risks, valuing and pricing intangibles, or corresponding to economic reality.

These contractual allocations are not generally compatible with the Action 8 guidelines if the subsidiary does not exercise control over the risks it assumes or does not have the capacity to bear the risk. Contributions should not be measured at cost, but rather value.

For CCAs for developing assets, the entity must exercise control over risk, including the opportunity to take on, lay off, or decline a risk-bearing operation, make decisions about how to respond to risks, and exercise control.

For service CCAs, allocation could be based on some formulas, for example, shares of income, costs saved, sales, profits, and units employed, as well as the value of contributions consisting of performance of services.

This issue is an important one from a U.S. standpoint because of the common use of cost-sharing arrangements in developing intangibles and sharing the benefits of the research, often on the basis of geographic rights to product sales. In cases in which the firm has developed excess returns (due, for example, to market power or brand name), it would be unlikely to share those high returns with an unrelated firm in exchange for financing a proportionate share of research.

Further Risk Allocation Issues

The GAO report on transfer pricing, while agreeing that profit shifting would be lessened when actual conduct rather than contractual agreements determine profit allocation, expressed some fundamental reservations about applying the arm's length principle because it does not account for the ways in which entities bear risk. Its argument is that a parent cannot transfer risk to its subsidiary "because any costs incurred by the subsidiary will be reflected in a change in the market value of the parent corporations. In general, related corporations do not have the same

ability to transfer risk as unrelated corporations."[40] Subsequently, the report notes with respect to arm's length pricing (ALP) with risk that "…the application of the ALP is problematic in this situation because risk cannot be allocated between parties by the very fact that they are related."[41]

A similar view was taken by Ed Kleinbard, law professor at the University of Southern California, when commenting on a court case relating to Medtronic and its Puerto Rican subsidiary.[42] The Internal Revenue Service (IRS) viewed the manufacture of medical devices in Puerto Rico as routine manufacturing (with a cost plus markup), but the Tax Court found additional income could be attributed to the subsidiary because it faced significant quality control challenges for instruments implanted in the body.[43] Kleinbard's point was that if these instruments suddenly began exploding in the body, it would be the reputation and value of the parent Medtronic company that would bear the costs. IRS has appealed that decision.[44]

These observations relate to a fundamental conceptual issue—separate-entity taxation within a controlled group of companies—and take a view outside the framework of Actions 8-10 guidance. Actions 8-10 within the framework of separate-entity taxation minimizes BEPS risk related to contractual allocations of risk between associated enterprises.

U.S. Actions

The United States has not taken any actions regarding these standards. Although indications have been made by Treasury authorities that current U.S. practices are consistent with the new OECD guidelines,[45] current cost-sharing arrangements may appear not to be. In fact, the notion of an independent voice in making decisions about risk or controlling the operation by a subsidiary seems inconsistent with the common management of a firm and its subsidiary, especially where separate management is largely a paper operation.[46] Thus, even if there were a true separation of control of risk, the reality, as suggested by GAO and by Kleinbard's comment, is that risk cannot be allocated away from the parent.

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[40] GAO, *International Taxation: Information on the Potential Impact on IRS and U.S. Multinationals of Revised International Guidance on Transfer Pricing*, GAO-17-103, January 2017, p. 9, at http://www.gao.gov/assets/690/682330.pdf.

[41] Ibid., p. 11.

[42] Remarks by Ed Kleinbard during a panel discussion on Taxing International Property (International), at the National Tax Association Annual Meeting in Baltimore, November 10, 2016.

[43] T.C. Memo. 2016-112, United States Tax Court, Medtronic Inc. and Consolidated subsidiaries, Petitioner v. Commissioner of Internal Revenue, Respondent, Docket No. 6944-11, filed June 9, 2016, at https://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=10819.

[44] Deloitte, "IRS Files Notice of Appeal in Medtronic Case," May 2, 2017, at https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-global-transfer-pricing-alert-17-015-2-may-2017.pdf.

[45] According to Deloitte, the Department of the Treasury has indicated that current transfer pricing rules are consistent with BEPS standards and harmonizing will not require substantial changes. Deloitte, "BEPS Actions Implementation by Country: United States," March 2017, https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-beps-actions-implementation-united-states.pdf. The current U.S. cost-sharing arrangements might be seen as substantial differences from the OECD transfer pricing action item, and there is no indication these will be changed.

[46] For example, when the Irish law permitted management of Irish Holding Companies to take place in other jurisdictions that would create the tax home, such as Bermuda or the Cayman Islands, or in the United States itself, it is difficult to see that relationship as a separation of management objectives.

Discussion Drafts Under Actions 8-10

The OECD circulated, for comment, discussion drafts on two issues. The first is the attribution of profits to permanent establishments created in Action 7. These profits, after deducting the arm's length payment to the agent, may be zero or in some circumstances may be positive. The second discussion draft is on a particular method of transfer pricing not fully addressed in the October 15 report, the transaction profit splits method. This method may be appropriate for transactions between highly integrated businesses. The draft indicates that the split is of actual profits but should be based on information known or reasonably seen. It requires a high level of integration of activities, offers flexibility, and is less likely to have extreme and improbable results. It is difficult to apply, and the lack of comparables is insufficient reason to use that method because an inexact comparables method may be better.

The GAO study raises the same questions about the transaction profit splits method as they did about risk allocation in general, namely the profit split method when based on contributions can permit profit shifting.[47] The GAO study acknowledged however that the OECD's July 2016 discussion draft addressed the possibility of using an inappropriate criterion for the relevant contributions of the parties.

Action 5: Harmful Tax Practices

This action item is not particularly relevant to U.S. rules, as it primarily addresses preferential regimes, largely focused on patent boxes, or special regimes that provide for lower tax rates for income from certain types of innovations or intellectual property (IP). The United States does not have a patent or innovation box, although proposals have been made for adopting one; a proposal by Representatives Boustany and Neal would appear to be consistent with OECD requirements in most respects.[48] A number of other countries do have preferential regimes, although they vary substantially.[49] Although this provision would not affect U.S. rules (at least not currently), it could have economic effects that might be of concern. Notably, while it would reduce the likelihood of artificial profit shifting due to preferential regimes, it might increase the attractiveness of locating research abroad rather than in the United States.

This action item is also concerned with transparency in certain tax rules, which would affect the United States, largely because the item covers advance pricing arrangements (APAs) that agree in advance to transfer prices.

The OECD has had a long history of examining harmful tax practices, and this action item continues that examination and makes recommendations.

Identifying Preferential Regimes

This recommendation focuses on the substantial activity requirement for a preferential regime and on the use of risk allocation for artificial profit shifting.

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[47] GAO, *International Taxation: Information on the Potential Impact on IRS and U.S. Multinationals of Revised International Guidance on Transfer Pricing*, GAO-17-103, January 2017, pp. 37-40, http://www.gao.gov/assets/690/682330.pdf.

[48] CRS Report R44522, *A Patent/Innovation Box as a Tax Incentive for Domestic Research and Development*, by Jane G. Gravelle, discusses proposals for a U.S. patent/innovation box and the effects on research.

[49] See CRS Report R44829, *Patent Boxes: A Primer*, by Gary Guenther, for a discussion of the features of different patent boxes.

Prior OECD work on identifying a harmful preferential regime considered four fundamental factors: (1) no- or low-tax rates on geographically mobile income as a threshold criterion, (2) ring fencing (allowing benefits for foreign and not domestic firms), (3) lack of transparency (details not apparent or inadequate regulation or disclosure), and (4) no effective exchange of information. They also identified eight other factors to consider: artificial base, no transfer pricing principles, a foreign source income exception, a negotiable rate or base, secrecy, a wide network of tax treaties, promotion as tax minimization device, and encouragement of arrangements that are tax driven with no substantial activities. A no- or low-tax rate must apply to characterize a regime as potentially harmful.

To determine if a potentially harmful regime is actually harmful, several factors are considered: shifting activity rather than generating new activity, activities commensurate with income or investment, and whether the preferential regime is the primary motivation for location. A harmful regime can be abolished or changed, and if not, other countries can take defensive measures.

The action item elevates the no-substantial-activities test to a primary factor.

IP Regimes

The item has a specific focus on IP regimes (often referred to as parent boxes). It requires that R&D expenses occur in the country, rejecting the alternatives of value creation and a transfer pricing approach based on functions and risk. The proportion of expenditures on research as a share of total expenditures determines the share of income that is eligible for the preferential rate. The approach allows outsourcing (perhaps limited) to unrelated firms but not to related ones.

The action item covers patents and functionally equivalent treatments (i.e., broadly defined patents, copyrighted software, and certain certified items [for smaller firms]). Coverage of acquired patents would be limited. Firms must track income and expenses by product; current patent boxes could be grandfathered, with no new participants.

The action item subsequently examines existing IP regimes and finds them generally inconsistent with the proposed actions. It subsequently discusses tax incentives for disadvantaged areas and generally found them not to be an issue.

Non-IP Regimes

The action item also considers briefly aspects to establish substantial activities or core income-generating items in the case of other types of preferential regimes: headquarters, distribution and service centers, financing or leasing, fund management, banking and insurance, shipping, and holding companies. Holding companies are a special case, and their potential for profit shifting may be addressed with other work on information exchange, treaty abuse, hybrid mismatches, and ring fencing.

The subsequent examination of non-IP regimes finds most to not constitute harmful tax practices.

Transparency in Rulings

The action item requires transparency and information exchange for certain types of rulings related to preferential regimes, advance pricing agreements, downward adjustments in profit, permanent establishment, conduits, and any other ruling that would give rise to BEPS issues.

U.S. Actions

The only U.S. action planned is to exchange information about unilateral advance pricing agreements (i.e., agreements between the taxpayer and the IRS on transfer prices). This information would include the taxpayer's name, the transaction, and the countries involved, but not the actual rulings. Other countries could request the rulings under the regular exchange of information process, subject to treaty requirements.[50]

Action 6: Treaty Abuse

The treaty shopping item has three major elements:

1. an inclusion of a statement in tax treaties that the parties intend to avoid creating an opportunity for no or reduced taxation through tax evasion, including treaty shopping;
2. a limitation on benefits (LOB), such as that in U.S. treaties, aimed at treaty shopping; and
3. a more general anti-abuse rule based on a principal purpose test (PPT) of transactions.

If one of the principal purposes is to obtain treaty benefits, these benefits would be denied unless in accordance with the purpose of the treaty.

The action item proposes flexibility and allows implementation through a combined LOB and PPT rule, a PPT rule alone, or an LOB rule with a mechanism to deal with any remaining conduit financing arrangements not already dealt with in the treaty. The LOB rules have specific criteria and are more certain, whereas the PPT rule is a more flexible rule that deals with a broader range of abuses but with less certainty. The statement of intent to avoid opportunities through tax evasion is a minimum provision.

The need for flexibility reflects the presence of restrictions within the EU on withholding taxes on member states, the existence of domestic law anti-abuse rules in some states, or a general economic substance rule.

The United States does not plan to include PPT and already has LOB rules.

Actions 11-15: Tax Administration and Information

This section addresses the remaining five provisions (11-15): monitoring BEPS, mandatory disclosure, country-by-country (CbC) reporting, dispute resolution, and a multilateral instrument to incorporate BEPS into bilateral tax treaties.

Measuring and Monitoring BEPS (Action 11)

Action 11 provides a review of indicators, evidence, and data needs to monitor BEPS. It notes that revenue losses due to BEPS are estimated at between 4% and 10% of global corporate income tax revenues ($100 billion to $240 billion annually) at 2014 levels.

[50] See Stephanie Soong Johnston, "U.S to Exchange Only Unilateral APAs Under BEPS Action 5," *Tax Notes*, December 19, 2016, pp. 1432-1433.

It summarizes BEPS indicators, including (1) profit rates of affiliates in low-tax countries are higher than the multinational firms' worldwide profit; (2) effective tax rates of large multinationals are lower (by 4 to 8.5 percentage points) than those of similar domestic firms; (3) foreign direct investment is increasingly concentrated in countries with high ratios of investment to gross domestic product (GDP); (4) the separation of taxable profits from the location of value-creating activities is especially clear with intangibles and has grown (e.g., royalties compared with R&D spending are six times higher in low-tax countries than on average and have increased three-fold between 2009 and 2012); and (5) debt is more concentrated among affiliates in high-tax countries (e.g., ratios are three times higher than worldwide firm ratios).

The action item also notes that measuring the magnitude of BEPS is constrained by existing data limitations. It provides suggestions to improve the analysis of existing data and uses new data provided under Actions 5, 13, and 12. It proposes that the OECD work with governments to report and analyze more corporate statistics and notes that CbC data analysis has the potential to improve BEPS economic analysis.

Action 11 goes on to describe existing data sources, including private and government entities (i.e., both public and private tax return data). It has an extensive review of empirical studies, including the effect of tax rates on profit shifting. It notes that there is a difference between the effect of unilateral policy changes and internationally coordinated ones.

Action 11 discusses the need for additional analysis on the pervasiveness of BEPS (whether profit shifting is due to a small group of firms or most firms); differences in profitability of multinational and domestic firms that make comparisons difficult; factors contributing to group and affiliate profitability; other tax factors in location decisions; effects of uncertainty, reputation and compliance costs, and disclosures; the mobility of capital and labor; and governments' strategic behavior. Two appendices discuss evidence of tax planning (e.g., profit rates and patent locations) and provide a toolkit for estimating BEPS effects.

Action 11 encourages publication of new corporate tax statistics on a consistent basis across countries and also suggests that governments improve public reporting of business tax revenue statistics, especially for multinational firms.

Although the focus of Action 11 is worldwide, U.S. multinational firms are likely responsible for a significant share of the profit shifting from the United States to low-tax countries. Estimates suggest that, for 2012, revenue losses amounted to 5%-19% of U.S. corporate profits taxes, or $20 billion to $76 billion.[51] Another indicator of profit shifting out of the United States is the share of taxable income as a ratio of GDP, made possible by tax data on the distribution of profits of foreign affiliates by country that is available in the United States, but not in general in other countries. While profits of U.S.-controlled foreign corporations as a share of GDP in the remaining six of the G-7 countries was 0.6% in 2004, rising to 0.7% in 2010, large tax havens showed much higher ratios and, in some cases pronounced growth (e.g., the share in Ireland rose from 7.6% to 41.9%). Small tax havens also showed high-growth rates (e.g., the share rose from 546.7% to 2,065.6% in the Cayman Islands).[52]

[51] See Jane G. Gravelle, "Policy Options to Address Profit Shifting: Carrots or Sticks?" *Tax Notes*, July 4, 2016, pp. 121-134.

[52] See CRS Report R40623, *Tax Havens: International Tax Avoidance and Evasion*, by Jane G. Gravelle. This measure was also used in a chapter in the *Economic Report of the President*, February 2015, available at https://www.gpo.gov/fdsys/pkg/ERP-2015/content-detail.html. For further discussion of profit shifting, see CRS Report R42927, *An Analysis of Where American Companies Report Profits: Indications of Profit Shifting*, by Mark P. Keightley; and CRS Report R44013, *Corporate Tax Base Erosion and Profit Shifting (BEPS): An Examination of the Data*, by Mark P. Keightley and Jeffrey M. Stupak.

Mandatory Disclosure Rules (Action 12)

The action item proposes mandatory disclosure rules for aggressive or abusive transactions and structures. The idea behind this proposal is to provide tax authorities with early information and to act as a deterrent. Disclosure would also place pressure on tax avoidance markets, and there would be a more limited opportunity to intervene.

Current mandatory disclosure regimes are of two basic types. A transaction-based approach is used in the United States, which identifies schemes and then requires disclosure from taxpayers who benefit and persons (such as promoters) who provide assistance. This approach requires reporting from both taxpayers and promoters. A promoter-based approach is used in the United Kingdom and Ireland and places the primary disclosure obligation on the promoter. The transaction-based approach tends to rely on specific hallmarks, whereas the promoter-based approach covers generic ones, for example, in which tax benefits are one of the main benefits. In various cases (e.g., when the promoter is offshore and there are practical difficulties in compliance), the disclosure obligation must fall on the taxpayer.

A country may introduce a dual reporting requirement or one that falls primarily on the promoter, but the recommendation for offshore promoters, and for no promoter or cases where the promoter asserts legal privilege, is that the obligation should fall on the taxpayer. The action also discusses defining the scope of a disclosure regime: single step or multistep. A single-step regime would broadly cover tax benefits even if the tax benefit is not identified as avoidance or the main benefit. This approach may generate a large number of disclosures. A multistep regime would define a threshold condition (such as cases in which the tax benefit is the main benefit), although this approach might not work well for international transactions. A dollar de minimis is also an option.

In addition, the action discusses generic hallmarks, such as confidentiality, containing a premium fee or contingent fee, contractual protection (e.g., insurance against failure), and a standardized-tax product, and specific hallmarks, such as the generation of losses, common to a number of countries. The United States also includes listed transactions (used before), transactions of interest (with potential), and generating book-tax differences. Other countries have hallmarks such as leasing transactions, schemes to convert salary into nontaxed compensation, schemes involving entities in low-tax jurisdictions, schemes with hybrid instruments, converting income into capital or gifts, differences used in the United States. The action suggests a mix of generic and specific hallmarks. The action recommends disclosure at the date of availability in which the promoter discloses and at implementation when the taxpayer discloses. It also discusses penalties and some other procedural matters.

This action item also has a number of recommendations for international tax schemes, including removal of the threshold condition, hallmarks that focus on BEPS risks, a broad definition, and to make inquiries as to whether the arrangement will be covered by disclosure requirements. It encourages information exchange and, in particular, recommends using the Joint International Tax Shelter Information and Collaboration (JITSIC) network.

Existing U.S. law has disclosure provisions, and there is no indication of any action in this area.

Transfer Pricing Documentations and Country-by-Country Reporting (Action 13)

This action item provides for a standardized approach to providing information to document multinationals' activities. The first is the provision of a master file that contains information on

operations and transfer prices and is available to all tax administrations. The second is detailed transfer pricing information in a local file for each country that identifies related-party transactions and transfer pricing analyses. The third is a CbC report that will provide, for each jurisdiction, information on revenue, profit, taxes paid, employees, capital, retained earnings, and tangible assets. It also requires information on the business activities of each entity in the jurisdiction.

The first two reports will be provided directly to local tax administrations, and the CbC report will be filed in the parent's jurisdictions and shared through automatic exchange of information. The reports apply to firms with revenue of 750 million euros or more. Reporting will begin in 2018 for the 2016 tax year.

The action item provides recommendations for the design including penalties, focuses on international tax schemes, and proposes information sharing.

The Treasury has implemented CbC reporting but is not requiring the master or local file to be submitted. The GAO study indicated that Treasury officials believed they already have enough information to enforce transfer pricing.[53] Although many countries have signed multilateral agreements,[54] the United States is implementing bilateral agreements in 2017. The United States has opted for bilateral treaties because of concerns about confidentiality and inappropriate use. As of June 12, 2017, bilateral agreements have been signed with Iceland, New Zealand, Norway, and the Netherlands, with more in the pipeline. The GAO study reported stakeholder (representing companies) concerns about several issues. One was that the information in the reports could be misused and lead, effectively, to formulary apportionment, where profits are based on the share of business factors. Such a move could lead to double taxation and audit disputes. GAO also discussed administrative costs for the IRS, indicating they would be similar to other regulatory changes of this nature, and compliance costs for firms. The OECD had indicated the CbC reporting could reduce compliance costs by standardizing reporting, but stakeholders believed compliance costs would be increased both because of requirements to collect new information and increased audits and disputes. They indicated that most costs for U.S. multinationals would be the CbC reporting rather than the reports filed with local authorities.

Making Dispute Resolutions More Effective (Action 14)

The action item seeks to improve the effectiveness of the mutual agreement procedure (MAP) to provide for more certainty and limit double taxation. It has a minimum standard that includes three elements for countries:

- ensure treaty obligations for MAP are implemented and cases resolved in a timely manner,
- ensure that administrative processes promote the prevention and timely resolution, and

[53] GAO, *International Taxation: Information on the Potential Impact on IRS and U.S. Multinationals of Revised International Guidance on Transfer Pricing*, GAO-17-103, January 2017, at http://www.gao.gov/assets/690/682330.pdf.

[54] Ernst and Young report 50 countries had signed a multilateral agreement by the end of 2016. See http://www.ey.com/Publication/vwLUAssets/EY-US-the-latest-on-beps-2016-in-review/$FILE/EY-US-the-latest-on-beps-2016-in-review.pdf. By May 8, 57 countries had signed the multilateral agreements. See Ryan Finley, "U.S. Making Progress on CbC Reporting Agreement Negotiations," *Tax Notes International*, May 8, 2017, p. 493. The OECD reports 58 countries as of June 22, 2017. See https://www.oecd.org/tax/beps/CbC-MCAA-Signatories.pdf.

- ensure access to the procedure.

Peer reviews are being conducted on each country's practices. Some countries committed to binding arbitration.

Action 14 is consistent with the United States' position, and U.S. tax treaties call for mandatory binding arbitration, although treaties with Japan, Spain, and Switzerland that would require binding arbitration have been delayed in the Senate for unrelated reasons with no definite prospects for approval.[55]

Some of the developing countries have been reluctant to adopt binding arbitration as a part of dispute resolution because of fears of giving up sovereignty over tax matters.[56]

One commentator has suggested that the minimum standards in Action 14 are not meaningful because nearly all treaties already have MAP rules.[57]

Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (Action 15)

The multilateral instrument (MLI) was a document designed to modify bilateral tax treaties to quickly implement the BEPS measure. This agreement has been signed by almost 70 countries,[58] although the United States has not, and has not indicated any intention to sign.[59] To accommodate differences across countries as to what elements of the BEPS standards are to be adopted, the MLI was made very flexible, and some see that flexibility weakening its value.[60]

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[55] Deloitte, "BEPS Actions Implementation by Country: United States," March 2017, at https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-beps-actions-implementation-united-states.pdf.

[56] See Alexander Lewis, referring to Jeffrey Owens, Past Director of the OECD's Center for Tax Policy and Administration, in "India Cites Sovereignty Concerns on Binding Arbitration," *Tax Notes International*, December 12, 2016, pp. 970-971.

[57] Stephanie Soong Johnston, describing comments on Michael Land of the Vienna University of Economics and Business. See "Taxpayer Rights Conference: EU Dispute Resolution Directive a Welcome Development, Panelists Say," *Tax Notes International*, March 20, 2017, pp. 1064-1065.

[58] J. P. Finet and Stephanie Soong Johnston, "Nearly 70 Jurisdictions Sign OECD's Multilateral Instrument," *Tax Notes International*, June 12, 2017, pp. 933-935.

[59] Deloitte, "BEPS Actions Implementation by Country: United States," March 2017, at https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-beps-actions-implementation-united-states.pdf.

[60] Institute for Austrian and International Tax Law, "The Multilateral Instrument: Legal Concerns and the Way Forward," *Tax Notes International*, May 29, 2017, pp. 805-811.

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