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16 October 2013

Centre for Tax Policy and Administration
Organisation for Economic Co-Operation
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Paris, France

Via Letter

RE: Additional Comments of Tax Executives Institute on the OECD's Action Plan on Base Erosion and Profit Shifting

To Whom It May Concern:

On 12 February 2013, the OECD published a document entitled *Addressing Base Erosion and Profit Shifting* (hereinafter the BEPS Report or the Report). As promised in the Report, the OECD published an *Action Plan on Base Erosion and Profit Shifting* (the Action Plan or the Plan) on 19 July 2013. The Plan sets forth 15 actions the OECD will undertake to address a series of issues that contribute to the perception that individual countries' tax bases are being eroded or profits shifted improperly. On 16 September 2013, Tax Executives Institute (TEI or the Institute) submitted written comments on the overall goals and approach of the Action Plan. On 1 October 2013, the OECD held a meeting with the Business and Industry Advisory Committee (BIAC) to solicit business feedback on the Action Plan. Representatives of TEI attended the meeting. On behalf of TEI, I am pleased to submit the following additional comments, which primarily address the Plan's individual actions.

TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organisation has 55 chapters in Europe, North America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our nearly 7,000 members represent over 3,000 of the largest companies in Europe, the United States, Canada, and Asia.

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Overall Comments on the BEPS Action Plan

TEI appreciates the OECD's efforts to ensure that the international tax system keeps up with the ever changing business environment. The BEPS project is the OECD's latest effort to address global tax issues faced by both tax authorities and multi-national enterprises (MNEs). From a business standpoint, the ideal result of the project would be a clear, predictable, and principled set of rules that taxpayers can easily apply and tax authorities can easily administer. In this regard, it is crucial that the OECD Member States and other nations participating in the BEPS project reach consensus on changes to the current international tax system.

If consensus is not achieved, the base erosion and profit shifting issues that gave rise to the BEPS project will persist, or even be exacerbated. Indeed, it is especially worrisome that countries have already begun the process of "cherry picking" certain aspects of the Action Plan for unilateral implementation, rather than waiting for the OECD's recommendations and other output. At the same time, states continue to promote their "competitive" tax regimes in an effort to attract additional business and investment from MNEs. These contradictory actions do not bode well for reaching consensus.

As the OECD produces the detailed output under the Action Plan's steps, it should keep in mind that MNE operations are complex, diverse, and generally reflect the sophistication of the worldwide economy. Companies must continuously adapt to changing economic and regulatory conditions of that economy, which still has many barriers. This trend will only continue in the future. Unfortunately, the inherent complexity of the economy, and therefore MNE operations, makes it difficult for taxing authorities to understand how a particular business decision fits within an MNE's worldwide business model. Tax authorities do not deal with complex business issues on a day-to-day basis and are therefore at a natural disadvantage when assessing the underlying reasons for a business decision. For this reason, tax authorities may often assume that the decision was motivated solely or primarily by tax planning. However, business decisions are essentially driven by economic and strategic considerations. Tax considerations are secondary.

Of course, once a business decision is made, an MNE will consider the tax consequences and attempt to minimise them. Minimisation may include the use of favorable tax rules and regimes specifically devised by countries, including OECD Member States, to attract business investment. In many cases, these rules and regimes are a primary driver behind the relatively low effective corporate income tax rates reported by MNEs. And yet, these low effective tax rates have led to much of the political pressure behind the BEPS project. Regrettably, the Report and Action Plan far too often give the impression that the sole purpose or overriding reason for MNE activity is tax planning, especially in the case of transactions between related enterprises. Hence, there are multiple references in the Plan to "recharacterising" taxpayer

contractual arrangements and "special measures" to address the purported failures of the arm's length principle.

Missing from the BEPS Report and Action Plan is consideration of the administrative environment in which MNEs operate, as well as their system of internal controls. Many MNEs are under continuous audit by multiple tax jurisdictions. The auditors in these jurisdictions have a natural incentive to be aggressive because of the perceptions that MNEs have deep pockets, are non-compliant, are willing to settle in the face of large assessments and accompanying penalties, and want to avoid the uncertainty of litigation. From a broader regulatory point of view, MNEs have strong internal controls to ensure compliance with legal obligations, both tax and non-tax. In the presence of these inherent checks on the tax planning of MNEs, many MNEs nevertheless manage to achieve a relatively low effective tax rate. Instead of taking this environment as evidence that MNEs have lawfully reduced their tax burden, the Report and Plan give the strong impression that MNEs are non-compliant. The BEPS Report and Action Plan therefore begin with the wrong frame and generally adopt an anti-abuse posture rather than a more considered and objective analysis. In our view, adopting the latter approach is more likely to result in principled changes to the international tax system that would accomplish the BEPS project's goals without creating significantly increased uncertainty for business.

Also missing from the BEPS report is the concept of administrative cooperation between tax jurisdictions outside of a mutual agreement procedure (MAP). A bilateral or multilateral advance pricing agreement program, if adequately funded and staffed, provides an efficient and transparent mechanism to avoid disputes in the transfer pricing area. Similarly, joint audits between two or more jurisdictions could also potentially be used to resolve disputes without the need to resort to the MAP process or changing the basic rules of the international tax system. The Action Plan is silent on these two approaches.

TEI urges the OECD to consider the use of optional safe harbours wherever possible while drafting the Action Plan's output. Safe harbours have the potential to dramatically reduce the compliance burden imposed on taxpayers, as well as to simplify tax administration, especially in the transfer pricing area. Further, safe harbours can prevent bilateral and multilateral controversy and relieve pressure on the MAP process. These benefits will only arise, however, if the safe harbours are consistent across multiple jurisdictions. If a safe harbour for a particular transaction is different for each bilateral agreement, then its utility is greatly reduced as the rules multiply across jurisdictions. We recommend that any safe harbours be optional at the election of the taxpayer.

Given the complex issues the Action Plan intends to address, we are concerned by the "one size fits all" implication of many of the outcomes of the current OECD work and the BEPS project. From the perspective of medium-sized and smaller international groups with cross-

border transactions, the BEPS initiatives will result in higher compliance obligations without any added value for tax authorities. This will especially be the case in emerging markets. This would increase entry barriers and tax considerations would become more important to the underlying business decision making process. This may cause businesses to forego otherwise profitable investments because of the tax burden or the inability to forecast the tax consequences with certainty. *De minimis* rules or the implementation of safe harbours could ameliorate these problems and avoid needless controversy. It would also be good tax administration.

Finally, in its effort to combat the perceived problem of base erosion and profit shifting, TEI urges the OECD not to lose sight of the problem of double taxation. The OECD's goal is to promote economic growth and the global economy and not to create new barriers to entry. Any unrelieved double taxation that results from the BEPS project will run counter to that goal. Uncontrollable tax risks can lead to systemic risks for MNEs (large or small), which can lead to severe financial consequences. We therefore recommend that the OECD incorporate the point of addressing double taxation as an overall goal of the Action Plan and in the relevant action steps.

Comments on Individual Actions Items

The remainder of this letter provides comments on individual action items in the OECD's Action Plan. We begin with Actions 14 and 15, which the Institute supports, and then move on to the remainder of the Plan's actions.

Action 14: Make dispute resolution mechanisms more effective
Action 15: Develop a multilateral instrument

TEI supports each of these actions. As the Action Plan acknowledges, if fundamental changes are made to the rules governing the international tax system, then the MAP process will become more important than ever in settling treaty-related disputes. During the past five years, our members have experienced a significant increase in tax controversy without any corresponding increase in the capacity (or willingness) of tax authorities to effectively eliminate double taxation. The bilateral dispute resolution mechanisms are currently too cumbersome, expensive, and time consuming, with cases taking years to complete. In many cases, the MAP process is not legally or practically available at all. Indeed, generally only large MNEs have the capacity to engage in the MAP process.

An improved MAP process would be welcomed by taxpayers, even in the absence of any changes to the international tax system that result from the BEPS project. Further, we encourage the OECD to develop a dispute resolution mechanism that can be used when no MAP process is available due to the absence of a treaty. One such option is binding arbitration,

utilising independent arbitrators that have the necessary international tax and transfer pricing expertise.

The OECD should encourage countries to permit increased taxpayer participation in the MAP process. Indeed, the OECD Manual on Effective Mutual Agreement Procedures (MEMAP) includes the possibility of a joint presentation by the taxpayer to the competent authorities. This should be a routine part of the MAP process, but is rarely applied in practice. MAP processes are often delayed by the need for further fact finding, which can be avoided through taxpayer participation. A second way the OECD can encourage taxpayer involvement is to invite taxpayers to be on hand ("waiting in the hallway") when the two competent authorities meet to discuss the taxpayer's case. When the inevitable factual questions arise, the taxpayer can join the meeting to provide the answers, after which the competent authorities can resume their meeting. Taxpayers could also provide additional facts between competent authority meetings. Under this approach, the MAP process would remain a privileged procedure between the two competent authorities, but would not be delayed by the need for the taxpayer to answer additional questions or provide further factual details. All sides would benefit from the more efficient and less time consuming MAP process.

Other items that would enhance the utility of the MAP process for taxpayers include making it available for eliminating double taxation with respect to permanent establishment (PE) issues, eliminating penalties from transfer pricing cases brought to the MAP level, and the use of mediation and arbitrators to facilitate or settle disputes.[1]

With respect to Action 15, the development of a truly multilateral and useful instrument to uniformly implement the Action Plan's recommendations across jurisdictions would allay many of the concerns expressed in this letter. Inconsistent rules across jurisdictions are a primary cause of double taxation and double non-taxation. Sufficiently clear and uniformly implemented rules would reduce much of the controversy between taxpayers and tax authorities. Of course, even clear rules are subject to interpretation. Thus, we recommend that any multilateral instrument, as well as an improved MAP process, provide the opportunity for taxpayers to use mandatory binding arbitration if an agreement cannot be reached within a designated time period. We suggest a maximum period of 12 months including appeals (if any). This would spur tax authorities (and taxpayers) to move cases to completion to avoid arbitration. Mandatory binding arbitration, however, should only be used in cases where (i) the

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[1] *See, e.g.*, Section 3.5.2. of the OECD's MEMAP (""A mediator's role may offer an opportunity for the competent authorities to view a specific case, or the MAP process itself, from a much different perspective. This perspective, perhaps acquired through the mediator's restatement of the positions or of the critical issues, may illuminate elements of a case or of the MAP process that are not perceptible when viewed from the standpoint of an administration defending an adjustment or one that is being asked to provide relief. In this regard, mediation may assist in resolving some of the more systemic issues of a MAP relationship.").

taxpayer consents to the process if the taxpayer is bound by the arbitrator's decision along with the Competent Authorities, or (ii) the taxpayer can appeal the arbitrator's decision through the usual domestic legal process if the taxpayer has no choice in the decision to move to arbitration.

Actions 14 and 15 have the potential to produce the most helpful results for business out of the BEPS project. Unfortunately, they are both the last two actions listed in the Plan and also have the latest deadlines (September and December of 2015). TEI urges the OECD to give these actions top priority and devote the necessary OECD and delegate resources to drive them to completion. The Institute stands by to assist the OECD in this effort.

Action 1: Address the tax challenges of the digital economy

This action addresses the "main difficulties that the digital economy poses for the application of existing international tax rules . . . ."[2] The OECD expects to issue a report identifying the issues raised by the digital economy and possible actions to address them by September 2014. Because of the breadth of this action, the Action Plan states that a "dedicated task force on the digital economy will be established."[3]

This action will address wide ranging issues, including nexus, the source and characterisation of income, and VAT/GST collection. We urge the OECD task force to consult extensively with industry representatives while preparing its report for this action. This will be especially important for developing the underlying facts regarding how digital businesses operate. The Institute stands by to assist in this effort.

TEI supports treating the digital and traditional economies equally. While the digital economy presents difficult and complex issues, we do not see the need to create special legal rules or exceptions that only apply to digital goods, services, and transactions. The Action Plan notes that the digital economy presents an "ever-changing business landscape" and that the "understanding of the generation of value in this sector" may be lacking. Due to this changing landscape, any special rules or exceptions that the OECD develops will inevitably be outdated by the time they are finalised. Further, definitions of digital goods, services, and transactions would need to be developed, which would only increase complexity.

Instead, what is needed is an in depth understanding by tax authorities of how digital businesses operate, which the Action Plan acknowledges. Such an understanding would enable tax authorities to implement a sensible and principled application of the current international tax rules to the digital economy, which, in turn, would obviate the need to develop a special tax regime for digital goods and services. Separate rules for the two economies would only lead to

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[2] Action Plan, page 14.

[3] *Id*.

more controversy. For example, taxpayers and tax administrations would have an incentive to shoehorn a business into the set of rules that produces the most favorable result in their view.

Moreover, in practice, there are very few purely digital businesses. Most digital businesses have some physical infrastructure or activities, and most traditional "bricks and mortar" businesses have some digital elements. Many businesses, of course, combine digital and traditional elements. If there were a special tax regime for digital businesses it would be necessary to separate the individual elements of a single business for application of the rules. Such an artificial separation would be difficult, contentious, and add to the compliance burden.

We note that a number of proposals under consideration in OECD Member States include a new kind of "digital" PE, usually arising based on where customers are using digital products or services. As a threshold matter, accessing customers in a jurisdiction, absent more, does not give rise to a PE. Indeed, the PE concept was created in the first place to facilitate cross-border trade and investment by allocating taxing jurisdiction to the residence country in circumstances where a business's physical presence in the source country was minimal. It is therefore unclear why there should be a different PE concept for digital businesses.

Should jurisdictions embrace the concept of a digital PE, it would raise a number of profound difficulties. It is not always possible to determine a customer's location (*e.g.*, where the customer accesses a digital service remotely via a virtual private network (VPN)). In addition, it is difficult to determine how revenue should be allocated. Is it on the basis of contractual payment, usage, value or some other allocation measure? It is not at all clear how value could be assessed or even how usage would be estimated. Would the latter be by reference to the quantity of data, the amount of user interaction or the minimum level of availability? Cost allocations raise similar questions.

Even if these issues can be overcome, there will be tension between the country of the digital PE and the country where the significant people functions are performed, as each will attempt to tax the same profit. It is critical for states to agree that profits subject to tax in the jurisdiction of the digital PE should be relieved from tax in the jurisdiction of the significant people functions. In this regard, clear and precise multilateral rules would be essential.

These issues can only be fully investigated and resolved by reference to the specific business models of the full range of businesses active in the digital economy. TEI therefore welcomes the proposal by the OECD to consult with digital businesses so that their business models can be properly understood.

Action 2: Neutralise the effects of hybrid mismatch arrangements

This action envisions developing model treaty provisions and recommendations regarding the design of domestic legislation to neutralise the effect of hybrid instruments and

entities, such as double non-taxation, double deductions, long-term deferral, *etc*. The work is to be coordinated with other actions, including the work on interest expense deduction limitations,[4] the work on controlled foreign company (CFC) rules, and the work on treaty shopping.

The Action Plan states that in hybrid arrangements "the laws of each country involved have been followed . . . ."[5] TEI appreciates this acknowledgement. Hybrid mismatches are an inevitable, structural feature of the international tax system where "each country has the right to design its tax system in the way it considers most appropriate."[6] MNEs are required to comply with each country's tax laws, which in many cases mandate hybrid treatment even in the absence of tax planning. In this regard, the scope of this action should be strictly limited to the use of hybrid entities or arrangements that are inappropriate or abusive, based on objective criteria and bright-line tests. This would permit MNEs to use hybrid entities or arrangements in other cases.

TEI supports the OECD's efforts to combat double non-taxation. Nevertheless, this action is one-sided since it only targets double non-taxation and similar issues. TEI submits that this action should also work to end double taxation that arises because of the existence of hybrid instruments and entities. The need is particularly acute because taxpayers will not have access to an efficient and effective MAP process in many cases.

It is critical that an MNE know the correct treatment of hybrid entities and instruments in advance. A multilateral instrument would be the most effective approach to resolving the hybrid issue because of the multitude of different mismatches between jurisdictions. Model language for use in bilateral tax treaties would also be useful, especially if jurisdictions could incorporate the language into existing treaties without a full renegotiation. We recommend that any model language include a mandatory binding arbitration clause to facilitate closure for both taxpayers and tax authorities on hybrid issues.[7]

Treaty changes may not address the hybrid issues that arise because of fundamental differences in the design of international tax rules (*e.g.*, the differences between a worldwide system with a foreign tax credit and an exemption system). In such cases, domestic legislation

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[4] To the extent part of the BEPS project is to ensure that "tax is paid somewhere," coordination with the work on limiting interest deductions is essential to prevent double taxation. For example, if a thin capitalisation rule denies an interest deduction in one jurisdiction and yet that interest is fully includible in another jurisdiction, a relief mechanism would need to be developed to prevent the resulting double taxation.

[5] Action plan, page 15.

[6] *Id*.

[7] As noted above, mandatory binding arbitration should only be used if the taxpayer consents to the procedure, or where the taxpayer retains its right to appeal the arbitrator's decision.

is the only way to implement the changes necessary to address hybridity. This will be difficult because it may require wholesale amendments to a country's system of international taxation. We therefore urge the OECD to closely coordinate its recommendations for changes to the model treaty with those for domestic legislation so the combination of the two does not exacerbate the issues that can only be addressed domestically.

Any action taken should also address timing differences. Certain jurisdictions allow deductions only for expenses paid within a certain period of time after year-end, while the payee is taxable upon receipt. This timing problem could be addressed by granting relief at the earlier of the two events (deductibility or taxation) if the taxpayer can establish, within a certain timeframe or on audit, that the event has occurred. The OECD should provide similar relief in cases where actual cross-border payments are restricted by local currency control laws.

Action 3: Strengthen CFC rules

This action will "[d]evelop recommendations regarding the design of controlled foreign company rules."[8] As the Action Plan notes, the OECD has not undertaken significant work in the CFC area. One reason for this may be that the design of effective CFC rules differs depending on the system of international taxation employed by the taxing jurisdiction. CFC rules in a worldwide system operate differently than those in an exemption system. Further, some CFC rules operate by income stream and some CFC rules operate on an entity-by-entity basis. Thus, implementing strong CFC rules may require wholesale changes to domestic law and would only be useful if there is a strong consensus among OECD Member States and others participating in the BEPS project. Indeed, Action 3 is a prime example of an issue where the OECD's good intentions may exacerbate a perceived problem if international consensus is not reached.

We recommend that any model CFC rules proposed by the OECD be as clear as possible and updated as necessary to account for changes in the global economy (*e.g.*, many of the U.S. CFC rules date back to the 1960s). In this regard, we recommend that the OECD establish clear exemptions for non-controversial activities that cannot be, or are not easily, conducted off-shore. The OECD should also make use of safe harbours as much as possible to decrease the compliance and administrative burdens on taxpayers and tax authorities.

Action 4: Limit base erosion via interest deductions and other financial payments

This action focuses on limiting base erosion accomplished via excessive interest payments, or other financial payments that are economically equivalent to interest, to related or unrelated parties. The OECD expects to issue recommendations regarding the design of domestic rules and changes to the OECD Transfer Pricing Guidelines (Guidelines).

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[8] Action Plan, page 16.

Currently, many countries have implemented limits on interest and other deductible payments in bilateral tax treaties through limitation on benefits (LOB) provisions. In particular, an LOB provision that denies an otherwise qualified resident the benefits of a treaty if they reach a certain threshold of deductible payments (including interest) to persons that are ineligible for the treaty would accomplish much of this action's goal. Treaty LOB provisions, especially those in U.S. treaties, are generally objective, easily understood and applied by taxpayers, and administrable by tax authorities. In our view, the use of clear and objective LOB treaty provisions is one of the most useful ways countries can combat base erosion of operating income via interest and other deductible payments.

If the same treaty included a thin capitalisation test, then it seems the goals of this action would be met between the countries party to the treaty. In this regard, the expected output for this action – changes to domestic law and the Guidelines – seems misaligned with its objective. The OECD should shift its approach to focus on LOB and thin-cap treaty provisions. Addressing the problem identified in this action through treaties has the added benefit of more immediately addressing double taxation issues.

With respect to basic principles, the OECD should confirm that the principle set forth under paragraph 1.3 of the Guidelines is fully applicable to financing transactions. Under the separate entity concept, compensation for a loan or other financial transaction should be based solely on the subsidiary's risk profile and economic situation. The credit rating, financial capabilities, or contingent credit support of the parent company or the MNE group as a whole should not be taken into account.

Action 5: Counter harmful tax practices more effectively, taking into account transparency and substance

The OECD envisions that this action will revamp its previous work on harmful tax practices. It will focus on improving transparency, providing compulsory spontaneous information exchanges on preferential regimes, and requiring "substantial activity" for any preferential regime.[9]

The primary obstacle facing this action is defining what constitutes a "harmful tax practice." This requires addressing who is harmed, because what is harmful to one jurisdiction may be helpful to another. Thus, a clear and consistently applied definition of "harmful" is crucial to the success of this action and to the ability of taxpayers to manage their tax affairs.

The OECD should also explain why it considers a certain practice to be harmful and provide a set of underlying principles that can be used to assess whether tax practices are harmful. Taxpayers would therefore have an indication of what other tax practices the OECD

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[9] *Id*. at 18.

may decide are harmful in the future. In this regard, the OECD could draw on its prior work in this area, with appropriate updates to reflect recent developments and the goals of the BEPS project.

More broadly, this action runs counter to the stated policies and goals of a number of the countries participating in the BEPS project. States often list developing a "competitive" tax system as a goal in their annual budget documents. Even the most advanced economies provide special rates for certain types of income (*e.g.*, intellectual property (IP) "boxes" for royalties) or credits for certain types of activities (*e.g.*, research and development). The OECD should clarify whether it considers these types of practices "harmful." To the extent a practice or regime is not considered harmful by the OECD, TEI submits that taxpayers purposely utilising the practice or regime should not have that arrangement negated or altered by another jurisdiction. Equally, it should not be negated or altered by another of the BEPS action steps. To the extent the OECD recommends eliminating or altering certain preferential tax regimes or harmful tax practices, appropriate phase-outs or grandfathering provisions should be included to minimise the adverse effect on MNEs and other businesses who relied on those regimes and practices.

Action 6: Prevent treaty abuse

Under this action, the OECD will develop model treaty provisions and recommendations regarding the design of domestic laws to prevent a grant of treaty benefits in inappropriate circumstances. The OECD will also identify tax policy considerations that countries should bear in mind when assessing whether to enter into a treaty and clarify that treaties are not intended to be used to achieve double non-taxation.

TEI agrees that cases of abuse should be addressed by tax authorities. Unfortunately, not all jurisdictions seem to agree on what constitutes "abuse." In TEI's view, cases of abuse should only include arrangements that lack a legitimate business purpose and whose sole reason is tax savings (*e.g.*, pure conduit arrangements used to access treaties).

Further, only objective LOB provisions should be used to combat abuse rather than a general anti-abuse or economic substance rule. General anti-abuse and economic substance rules are too complex to introduce into a treaty and would permit tax authorities to deny treaty benefits for unprincipled reasons. In addition, many countries have their own economic substance jurisprudence that can be used to address abusive cases. Introducing a similar, but not identical, rule in a treaty would be unhelpful and only increase complexity and uncertainty.

Action 7: Prevent the artificial avoidance of PE status

This action aims to develop changes to the definition of a PE to address inappropriate use of commissionaire arrangements and the specific activity exemptions in the OECD model

treaty. Profit attribution issues will also be addressed. As a threshold matter, TEI recommends that the OECD coordinate work on this action with the work on Action 1 addressing the digital economy.

In general, we are surprised that this action is included in the Plan because PE issues rarely give rise to double non-taxation. It is also unclear why the OECD is singling out commissionaire arrangements for special scrutiny. It is far more likely that PE issues lead to double taxation because of PE assertions by taxing authorities that cannot be resolved by the current MAP process.

The OECD has updated its official commentary to the definition of a PE in its model treaty on several occasions. Regrettably, the PE definition is less clear today than before. The length of the commentary, along with the multiple revisions, have also allowed jurisdictions to take different and opposing views on whether particular activities create a PE, even though the treaty language is the same in nearly all cases. Moreover, the OECD has essentially used the commentary to work changes to the treaty language without updating the treaty itself. In particular, the commentary now appears to permit the concept of a services PE even though the model treaty definition does not.

MNEs have the right to determine their business models, which are dictated by regulatory and economic conditions. Commissionaires and similar distribution arrangements are part of these business models. If the formal contractual arrangement is superseded or contradicted by the MNE's actual operations, then a PE could be properly asserted. However, TEI believes that a proper application of the transfer pricing rules that reflects the actual risk profile and functions of these distribution arrangements should mitigate or eliminate the controversy surrounding this issue. Certain jurisdictions assert that a PE exists in these circumstances because they do not want to engage in a transfer pricing analysis or discussion with the taxpayer. Unfortunately, in those cases the tax authority has an incentive to make an unprincipled PE assertion without regard to double taxation because no international relief or adjustment is available.

The OECD should provide a clear and unambiguous definition that specifically spells out what constitutes a PE. MNEs wish to know the activities in which they can engage without creating a PE, as well as the activities that will rise to the level of a PE. It is our view that tax authorities have sufficient tools to combat "artificial" PE structures without a need for significant modifications to the treaty language. Finally, if the OECD decides to give tax authorities the ability to ignore or recharacterise a taxpayer's structure, we urge the OECD to limit such authority to clear cases of abuse where (i) insufficient functions exist at the level of the principal company; (ii) the operational business reality is not aligned with the underlying contractual framework; (iii) the compensation of the least sophisticated entity does not respect the arm's length principle; and (iv) there is a material tax rate differential.

Actions 8, 9, 10: Assure that transfer pricing outcomes are in line with value creation

Several of the individual actions in the Plan undermine the arm's length principle. Actions 8, 9, and 10 in particular all reference unspecified "special measures" that the OECD believes may be needed to address perceived deficiencies in the arm's length standard. TEI strongly supports the arm's length standard as the only approach to pricing related party transactions that is both principled and economically sound. We urge the OECD to stand by the arm's length principle and not to adopt positions that undermine the principle.

Action 8: Intangibles

Action 8 is closely related to the OECD's recently published Revised Discussion Draft on Transfer Pricing Aspects of Intangibles (Intangibles Draft). TEI submitted extensive comments regarding the Intangibles Draft to the OECD on 1 October 2013.[10] We highlight below some of the comments in that letter along with a few additional concerns with respect to this action.

This action aims to "[d]evelop rules to prevent BEPS by moving intangibles among group members." This statement reflects a misunderstanding of how MNEs operate. With the exception of some business restructurings, there is generally no need for an MNE to transfer or move intangibles among its group members. Instead, in the vast majority of cases the MNE's intellectual property policy, its internal contractual framework, and its overall business model effectively organises the MNE's intangibles without the need to move them among affiliates.

It appears from the Intangibles Draft that the OECD believes that intangibles are deemed to be "located" where the development functions are performed, or perhaps where the functions that control and protect them are located. Thus, to the extent that an MNE has located the legal and beneficial ownership of the intangible elsewhere (*e.g.*, where the funding for the development of the intangible originated), it has therefore been "moved" from its proper place in the OECD's view. This new approach by the OECD creates unnecessary confusion and disregards the legal and beneficial ownership of the intangible that flows from the taxpayer's contractual arrangements, which should be the starting point when applying the arm's length principle.

Each MNE has the freedom to organise its enterprise as it wishes. In many cases, MNEs concentrate core intangibles in a specific entity to avoid fragmentation across the group. This can be accomplished, for example, via contract research and development coupled with a principal business model. In this case, again, there is no "transfer" of intangibles as they have always been located with the principal company (or IP holding company). It appears, however,

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[10] TEI's comments are available at: http://www.tei.org/news/Pages/TEI-Comments-on-OECD-Revised-Intangibles-Discussion-Draft.aspx.

that in this case the OECD would "locate" the intangibles with the research and development contractor.

On the other hand, decentralised groups may enter into cost contribution arrangements or embed the value of intangibles in the transfer pricing on goods and services. In those cases, the legal and beneficial ownership of intangibles may indeed have been moved among group members. However, the question in those cases is not whether this results in base erosion or profit shifting, but rather whether the arm's length standard was met in the intangibles transfer. TEI submits that if an MNE meets the arm's length standard in such a transfer, then no base erosion or profit shifting should result because the transferee is properly compensated.

TEI agrees that a wide definition of intangibles is the proper approach. We caution, however, that the definition of intangibles should not encourage tax authorities to reallocate intangible-related return at every turn. Valuable intangibles are property that is organised and supported by clear contractual arrangements and business models within an MNE. Core intangibles of an MNE are a primary part of the MNE's group strategy and contractual organisation, which delineate how the intangibles are capitalised upon, protected, and compensated, as well as how the intangibles fit within the overall value chain of the group. Thus, there is rarely an "accidental" transfer of a valuable intangible within an MNE that goes uncompensated. The underlying questions for transfer pricing purposes, however, are whether something of value has been transferred and whether the proper amount of compensation has been received. This does not depend on whether the item transferred is described as a tangible or intangible asset (or is a service or some other form of value transfer).

In general, it is imperative that tax authorities understand an MNE's intangible asset policy and overall business model before assessing the transfer pricing aspects of an MNE's intangibles. For example, valuing intangibles on a fragmented or separate basis may result in non-arm's length pricing as MNEs often centralise and combine innovative activities to create a competitive advantage. In other words, individual intangible valuations without context are misleading.

Action 8 will also "develop[] transfer pricing rules or special measures for transfers of hard-to-value intangibles . . . ."[11] There are generally three approaches to intangibles valuation: (i) replacement cost; (ii) an income approach based upon discounted expected cash flows; and (iii) a market based approach based on a multiple of profits, sales, units, *etc.*, of the intangible itself or a similar intangible. These valuation approaches are not a substitute for transfer pricing methods. Indeed, in our experience, the income approach is often used in combination with some kind of profit split method to estimate the cash flows attributable to the intangible being valued prior to discounting those cash flows.

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[11] Action Plan, page 20.

In the context of hard-to-value intangibles, the market approach may be difficult to apply simply because of the lack of comparable data. The replacement cost approach is often poorly applied. When correctly applied, that is, where it takes into account the true economic costs including opportunity costs, it may provide useful results. However, looking to historical cost is not a solid basis for applying the replacement cost approach. The income approach is likely to be relied upon more frequently than other methods. This does not necessarily make it the best method. The key issue is to ensure that the various assumptions that are used to apply it are well grounded and supported. In the end, in our opinion, it would be ill-advised for the revised guidelines under Chapter VI that result from the Intangibles Draft to make definitive statements about the appropriateness or not of a given valuation method.

More broadly, it is inappropriate to create special rules to value intangibles merely because the valuation is "hard." Appropriate adjustments can be made under transfer pricing methods that are well-accepted and convergence can be achieved by applying more than one approach.

The OECD should also consider other innovative methodologies, in particular the key game theory concepts of the "Core" and "Shapley Value."[12] Those theories can be powerful tools to set arm's length prices, especially in cases where the group's activities are integrated and unique and valuable intangibles are jointly developed among group affiliates. Game theory may be a reliable tool either as the primary approach where a solid economic analysis is feasible (which is also dependent on external market evidence) or as a back-up approach to test the reasonableness of the outcome of alternative valuation techniques. However, the lack of sophistication of some tax authorities may make the acceptance of game theory concepts difficult. Hence, it is important for the OECD to illustrate those concepts in detailed examples, which will facilitate their use by all tax authorities.

Finally, Action 8 anticipates updating the guidance under Chapter VIII of the Guidelines regarding cost contribution arrangements. In our view, the current guidance under Chapter VIII is sufficient and does not need to be updated. The concern regarding cost contribution arrangements appears to be the value assigned to intangible property when it is transferred into or out of such arrangements. TEI believes that such valuation issues should be addressed in the broader context of transfer pricing of intangibles. In the context of the deductibility of headquarters costs and management fees, cost contribution arrangements would be an ideal tool to justify the tax deductibility. Cost contribution arrangements do not challenge the purpose of such expenses nor their costs. In that case, the special point under Action 10 ("provide protection against common types of base eroding payments, such as management

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[12] For background, *see* Vögele, Gonnet, and Gottschling, *Transfer Prices Determined by Game Theory: 1 – Underlying*, Transfer Pricing International Journal (BNA) (16 October 2008).

fees and head office expenses") conflicts with the spirit of Chapter VIII and should be abandoned.

Action 9: Risks and Capital

This action will develop rules to prevent base erosion and profit shifting by transferring risks among, or allocating excessive capital to, MNE group members. The output will require the alignment of returns with value creation by adopting new transfer pricing rules or through the use of unspecified "special measures."

As a threshold matter, we note that transactions among members of a MNE group generally reflect transactions between unrelated parties. There are many transactions in the marketplace that contractually shift risks from one company to another. In addition, there are many instances where investors turn over their capital to specialised investment managers while reserving the lion's share of the return to themselves. This takes place in most (if not all) investment funds, including private equity funds, hedge funds, venture capital funds, and mutual funds. Under the logic of the BEPS project, however, the proper approach is to "align returns with value creation," and thus the returns should be attributed primarily to the investment managers and not the investors that provided the capital.

The pharmaceutical industry has a similar split between capital invested and day-to-day functions. It is routine in the pharmaceutical industry to contract out research and development to related and unrelated parties around the globe. The cost of such research often exceeds $100 million for a single product. In both cases, related and unrelated, there is no question that the principal company that funds the research owns the resulting intellectual property and is entitled to the return it generates. The OECD should outline why the allocation of returns between a capital investor and a business manager should be different when the capital is invested in the development of intellectual property as opposed to the stock market. Both transactions occur between unrelated parties and, in such cases, the bulk of the return is allocated to the capital investor.

With that as background, we view this action as a call to propose anti-abuse rules (*i.e.*, "special measures") that are wider and vaguer than those already in place in multiple jurisdictions. This would create substantial uncertainty for business, increase controversy, and result in additional double taxation.

We also note that this action, along with others, seems to reflect an underlying, but unstated, principle that the taxable profit of MNEs should be allocated to the most difficult-to-move production factors: fixed assets, employees, and sales. At the same time, little weight is given to the equally (if not more) important, but also more easily moved, production factors like intellectual property and capital that embody the entrepreneurial risk of an MNE. This is contrary to the principles of the market economy and the economics and business models of

many MNEs. In addition, separate taxes (*i.e.*, not corporate income taxes) are already levied on the difficult to move production factors of land, employment, and sales. Under the Action Plan, these factors of production would be taxed again according to the value they create. Depending on the business model in place, this approach could distort the risk profile assigned to each participant in the value chain and systematically downplay the importance and economic reward of the real entrepreneur.

The arm's length principle should be sufficient to ensure that the returns are shared in appropriate proportions between capital owners and capital managers. The language in this action regarding "special measures" can be seen as a justification to abandon the arm's length principle. Such deviations are generally not welcome, but may be generally justified for purposes of simplicity and transparency. Safe harbour rules are one example. Thus, to the extent the OECD finds it necessary to abandon the arm's length principle in limited situations, it should adopt these simplified rules as its primary approach.

Action 10: Other high-risk transactions

For this action, the OECD will adopt transfer pricing rules or special measures to prevent base erosion and profit shifting by MNEs who engage in transactions that would not, or only rarely, occur between unrelated parties. Such rules or measures will: (i) clarify when tax authorities may recharacterise transactions; (ii) clarify the application of transfer pricing methods (particularly profit splits) in the context of global value chains; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses.

It appears that this action acts as a "catch-all" for base erosion or profit shifting that is not curbed by other actions in the Plan. In that regard, if the BEPS project results in bright line rules, clarity, certainty, and predictability, there will be less need for the measures described in this action. Thus, the OECD should strive to prescribe fair and administrable rules under the other actions.

Tax authorities should be permitted to recharacterise transactions only in cases of abuse. Certainty and predictability are crucial for business, which should be able to rely on the transactions as they structure them so long as they reflect the economic reality of the business. The ability for tax authorities to recast taxpayer transactions only breeds uncertainty and unpredictability, which inevitably leads to controversy and impedes business decision making. Further, the OECD's Business Restructuring Project extensively addressed the question of recharacterisation and resulted in paragraphs 9.161 through 9.164 of the Guidelines. It is unclear why the OECD now feels the need to revisit the subject. If the OECD intends to change or clarify the Guidelines, then it should delineate the base eroding and profit shifting

transactions that are subject to recharacterisation and identify what constitutes a proper recharacterisation.

With respect to "transactions that would not or only very rarely occur between third parties," TEI submits that the OECD should clearly identify these transactions and why it believes they take place only within MNEs and not among unrelated parties. MNEs exist because of the synergies and advantages that they create, and they should not be required to act and transact business as if they were not a MNE group. Further, because of the inherently unique aspects of intellectual property, it is sometimes difficult to find comparable transactions outside the MNE group to use for transfer pricing purposes, but that does not mean that such transactions would not otherwise occur.

The Intangibles Draft has attempted to clarify use of the profit split method. Unfortunately, the language used in the Intangibles Draft will result in a wider use of the profit split method by tax authorities. While theoretically acceptable, the profit split method is more difficult to apply in practice because determining the proper "split" is challenging. It is a matter of economic judgment that relies on sophisticated techniques that may seem odd or arbitrary to many tax authorities. A broader use of the profit split method will result in differing views across jurisdictions, possible double taxation, and increased controversy. The current practice to benchmark the least complex party with a traditional method or the transactional net margin method if that party does not own unique or significant intangibles should be continued as much as possible. Further, the profit split method is not generally appropriate for contract research, routine research and development, or distribution services. If this method is to be used more extensively, administrative procedures should be in place to ensure that the profit allocation consequences that result from the application of this two-sided method will be accepted by the relevant jurisdictions to provide certainty to taxpayers. Further, countries should enable easily applied, year-end adjustment mechanisms that are based on financial reporting standards (*e.g.*, IFRS, U.S. GAAP, *etc.*). These mechanisms should not result in other, adverse tax consequences (*e.g.*, customs duties, withholding taxes, *etc.*).

Finally, we disagree with the characterisation of management fees and head office expenses as "common types of base eroding payments." In practice, MNE's are often caught between tax authorities with respect to these payments. On the one hand, the tax authority of the headquarters company argues that more costs should be charged to the local affiliate; on the other hand, the tax authority of the affiliate argues the opposite. Rarely is the argument over whether or not such costs should be charged at all, as the OECD implies, although some jurisdictions believe that there is no "benefit" to the service recipient.

It seems beyond argument that these costs are always incurred for legitimate business reasons. Thus, a paragraph should be added to the Guidelines or elsewhere in the OECD's BEPS output confirming that headquarters costs and management fees (even if incurred in high

cost countries) should be deductible if allocated directly or indirectly to affiliates using objective criteria. In that case, the point in this action to "provide protection against common types of base eroding payments, such as management fees and head office expenses" should be abandoned.

Action 11: Establish methodologies to collect and analyse data on BEPS

This action's primary goal is to "[d]evelop recommendations regarding indicators of the scale and economic impact of BEPS and ensure that tools are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis."

We applaud the OECD's effort to collect and analyse the necessary data on BEPS. The BEPS report was rather forthright about the quality of the evidence of base erosion and profit shifting by MNEs, stating that "it is difficult to reach solid conclusions about how much BEPS actually occurs" and "[m]ost of the writing on the topic is inconclusive . . . ."[13] Indeed, by many accounts, much of the evidence supporting the need for the OECD to address base erosion and profit shifting is anecdotal. The OECD should be commended for recognising that a more comprehensive data set is necessary for supporting, and assessing the success of, the BEPS project.

We recommend that the OECD provide taxpayers access to the information developed in this action. The information could be provided on an industry-wide or transaction-type basis to protect confidentiality. This disclosure would promote taxpayer compliance and increase transparency between taxpayers and tax authorities. Because the BEPS project will address many difficult issues, a widely available set of data should minimise compliance costs and uncertainty.

To the extent this action gathers micro-level data based on financial statements and tax returns, the OECD should take into account how the information reported on tax returns differs across jurisdictions, as well as competing financial reporting standards (*e.g.*, GAAP, IFRS, *etc*.). We approve of the statement in this action that there is a need "to respect taxpayer confidentiality" and to take into account "administrative costs for tax administrations and businesses." Finally, we recommend that this action be coordinated with Action 13 regarding transfer pricing documentation.

Action 12: Require taxpayers to disclose their aggressive tax planning arrangements

Here, the OECD aims to provide recommendations for "the design of mandatory disclosure of rules for aggressive or abusive transactions, arrangements, or structures" taking

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13 BEPS Report, page 15.

into account the administrative burden and other factors. A focus of this action "will be international tax schemes, where the work will explore using a wide definition of 'tax benefit' in order to capture such transactions."

As with other actions in the Plan, the primary difficulty presented by this action is definitional. What is an "aggressive" or "abusive" transaction, and what constitutes a "tax benefit?" Unless the OECD happens to get these definitions just right, the resulting disclosure recommendations will inevitably be either over or under inclusive. Since the OECD recognises that tax competition is essential to the market economy and should be preserved, it should clearly state as a principle that lower tax rates or other tax incentives (*e.g.*, IP boxes, research and development credits, accelerated depreciation schemes, *etc.*,) do not constitute an abuse by themselves and should not be challenged as such by other jurisdictions. Similarly, rulings obtained by taxpayers from tax authorities are by definition not part of aggressive tax planning arrangements and should be accepted by other jurisdictions.

To balance the need for information against the compliance and administrative burden, we recommend that disclosures be required only for clear cases of abuse. We also recommend that this work be coordinated with the work on Action 5 regarding harmful tax practices.

We support the statement in the Action Plan that potentially useful measures include co-operative compliance programs between taxpayers and tax administrations. We emphasise, however, that this cooperation should be two-sided and not come just from the taxpayer. The tax compliance risk management approach employed by HM Revenue & Customs in the United Kingdom is a good example of a program that strikes the right balance between taxpayers and tax authorities and could be used as a model by the OECD.

Action 13: Re-examine transfer pricing documentation

TEI submitted detailed comments regarding the OECD's White Paper on Transfer Pricing Documentation on 30 September 2013 (White Paper).[14] With respect to this action in particular, TEI supports the use of a common template to submit transfer pricing documentation across multiple jurisdictions. Regrettably, a requirement that businesses provide their "global allocation of the income, economic activity and taxes paid among countries" would provide countries with a roadmap to formulary apportionment. If this is the OECD's intention, then it should say so explicitly and explain why it believes this is necessary, especially in light of the Action Plan's statement that "moving to a system of formulary apportionment of profits is not a viable way forward . . . ."[15]

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[14] TEI's comments are available at: http://www.tei.org/news/Pages/OECD-Transfer-Pricing.aspx.

[15] Action Plan, page 14.

The aim of the White Paper and the proposed global transfer pricing documentation model was to simplify and standardise transfer pricing compliance, while ensuring tax authorities receive sufficient information and reducing the compliance burden on MNEs. Introducing a global country-by-country reporting template under this action, however, would only increase the compliance burden. In our view, the OECD should approach this issue by stating that transfer pricing documentation is the tool jurisdictions use to conduct transfer pricing risk assessment, which is better served by adopting clear, brief, and concise documentation requirements. We also strongly recommend that the OECD coordinate this action with Action 11 to avoid duplicative reporting.

On 3 October 2013, the OECD released a Memorandum on Transfer Pricing Documentation and Country by Country Reporting (Memorandum). The Memorandum lists questions and issues the OECD believes are relevant to the development of a workable country-by-country reporting template under action 13 and asks for business input. The primary issues addressed include the types of information that should be required and the mechanisms that should be developed for reporting and sharing country-by-country data. While we strongly support the OECD's efforts to seek input from businesses to define a feasible and mutually acceptable solution, we suggest limiting information requested to data readily available to MNEs. The collection, processing, and compiling of data under the varying standards of different jurisdictions imposes significant costs on MNEs.

TEI will provide its input on questions raised in the Memorandum in due course. Nevertheless, we urge the OECD to limit the required information to data that is both (i) relevant for transfer pricing risk assessment purposes, and (ii) generally collected by MNEs for their own purposes (*e.g.*, annual and quarterly reports).

We urge the OECD not to introduce a worldwide country-by-country reporting template as part of a global or local transfer pricing documentation system. This level and quantity of information is generally not available to local affiliates. MNEs sometimes operate in dozens of countries. Coordinating data collection across those countries and among hundreds of legal entities, conducting business in various functional currencies, to provide country-by-country reporting would be a complex and burdensome task. The increased cost of compliance would raise the importance of tax considerations in business decision making and discourage MNEs from entering additional markets. Should the OECD introduce this requirement, then it should be accompanied by an emphasis on the need for countries to devote enhanced resources to the MAP process. TEI supports transparency between taxpayers and tax authorities, but there must be an open dialogue between the parties and a means to resolve disputes across jurisdictions. Supplying all tax authorities with summary information on an MNE's country-by-country tax and income position in the absence of knowledge of the business model of the MNE as a whole could be used by tax authorities to single out taxpayers for unprincipled assessments and lead to double taxation.

The OECD should also consider recommending that tax authorities permit businesses to submit transfer pricing documentation in English, a simplification measure that the business community has long sought. Translating the same transfer pricing documentation into multiple languages is a significant expense and creates the risk that imperfect translation will lead to unnecessary confusion and controversy. The traditional counter argument that local tax authorities lack the necessary English proficiency becomes less and less persuasive as time passes.

Finally, taxpayers should have a right to know what countries have asked for and received information about an MNE's transfer prices. This transparency will ensure a more level playing field when an MNE engages with tax authorities during the compliance process.

Conclusion

TEI appreciates the opportunity to comment on the OECD's BEPS Report and Action Plan. These comments were prepared under the aegis of TEI's European Direct Tax Committee, whose Chair is Alexander Kölbl. If you have any questions about the submission, please contact Mr. Kölbl at +41 58 158 88 97, Alexander.Koelbl@gdels.com, or Benjamin R. Shreck of the Institute's legal staff, at +1 202 638 5601, bshreck@tei.org.

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