Abstract

This study is performed to investigate the relationship between Base Erosion and Profit Shifting (BEPS) and The “Panama Papers” or other places that known as **tax haven**. The “Panama Papers” revelations have shone the light on Panama’s culture and practice of secrecy. Panama is the last major holdout that continues to allow funds to be hidden offshore from tax and law enforcement authorities. The OECD (Organization for Economic Cooperation and Development) has been leading a global crackdown on these practices since 2009, working hand-in-hand with the G20 countries. The consequences of Panama’s failure to meet the international **tax transparency** standards are now out there in full public view.

This is a literature study under qualitative descriptive method. While the “Panama Papers” data expose nefarious activities, they also show a decline in the use of offshore companies and bearer share companies, which is a testament to the incredible transformation effected in the last 7 years to establish robust international standards on tax transparency, including on beneficial ownership as a result of in-depth peer review process, the use of bearer share companies is close to being eliminated across the world, and the beneficial ownership rules have been strengthened to ensure that information is now available to tax authorities when they need it.

Establishing global standards and making commitments are just the start though. Effective implementation is the key to lifting the veil of secrecy once and for all and eradicating **tax evasion**. The time has come to make sure that no jurisdiction can benefit from failing to meet their commitments.

Keywords: Tax Haven, Tax Transparency, Tax Evasion, Anti-Corruption

Background

There is a growing perception that governments lose substantial corporate tax revenue because of international tax planning designed to shift profits in ways that erode the taxable base of developed and developing countries to locations where they are subject to a more favorable tax treatment. This type of tax planning can often lead to double non-taxation, i.e., situations where income is not taxed anywhere: not in the taxpayer's country of residence nor in the source country. The consequences of the Base Erosion and Profit Shifting (BEPS) currently achieved by some multinationals range from unintended competitive advantages for Multinational Enterprises (MNEs) over smaller or domestic companies to distortion of investment decisions to loss of substantial corporate tax revenue for governments. More fundamentally, the perceived unfairness resulting from BEPS jeopardizes citizens' trust in the integrity of the tax system as a whole, thereby undermining voluntary tax compliance.

The Study calls for the development of a comprehensive action plan to *(i)* identify actions needed to address BEPS, *(ii)* set deadlines to implement these actions and *(iii)* identify the resources needed and the methodology to implement these actions. In addition to better information and data on BEPS, the Study indicates that the action plan will include proposals to develop:

- Instruments to put an end to or neutralize the effects of hybrid mismatch arrangements and arbitrage;
- Improvements or clarifications to transfer pricing rules to address specific areas where the current rules produce undesirable results from a policy perspective. The current work on intangibles, which is a particular area of concern, would be included in a broader reflection on transfer pricing rules.
- Updated solutions to the issues related to jurisdiction to tax, in particular in the areas of digital goods and services. These solutions may include a revision of treaty provisions;
- More effective anti-avoidance measures, as a complement to the previous items. Antiavoidance measures can be included in domestic laws or included in international instruments. Examples of these measures include General Anti-Avoidance Rules (GAARs), Controlled Foreign Companies (CFC) rules, Limitation on Benefits (LOB) rules and other anti-treaty abuse provisions.
- Rules on the treatment of intra-group financial transactions, such as those related to the deductibility of payments and the application of withholding taxes.
- Solutions to counter harmful regimes more effectively, taking into account factors such as transparency and substance.

To advance the work on the action plan, three temporary focus groups were set up and all OECD Members and Participant countries in the Committee on Fiscal Affairs were invited to participate. Most delegations volunteered to provide input into these three focus groups, including China, India, Russia and South Africa. The three focus groups are:

- *Countering base erosion,* which mainly looks at anti-avoidance measures, measures to avoid the negative effects of asymmetries in tax systems (''hybrids''), and how to revamp the work on harmful tax practices.
- *Jurisdiction to tax*, which looks at issues related to how existing rules allocate the right to tax cross-border business, including controlled foreign corporation rules, residence rules, and issues relating to digital goods and services.

- *Transfer pricing*, which looks at issues related to the arm's length principle.

This study aims to present the issues related to BEPS in an objective and comprehensive manner. The study first describes studies and data available in the public domain regarding the existence and magnitude of BEPS. It then contains an overview of global developments that have an impact on corporate tax matters. The core of the study sets out an overview of the key principles that underlie the taxation of cross-border activities, as well as the BEPS opportunities these principles may create. It also analyzes some well-known corporate structures and highlights the most important issues that these structures raise.

The study concludes that, in addition to a need for increased transparency on effective tax rates of MNEs, key pressure areas include those related to:

- International mismatches in entity and instrument characterisation including, hybrid mismatch arrangements and arbitrage;
- Application of treaty concepts to profits derived from the delivery of digital goods and services;
- The tax treatment of related party debtfinancing, captive insurance and other intragroup financial transactions;
- Transfer pricing, in particular in relation to the shifting of risks and intangibles, the artificial splitting of ownership of assets between legal entities within a group, and transactions between such entities that would rarely take place between independents;
- The effectiveness of anti-avoidance measures, in particular GAARs, CFC regimes, thin capitalization rules and rules to prevent tax treaty abuse;
- The availability of harmful preferential regimes.

This study also shows that current international tax standards may not have kept pace with changes in global business practices, in particular in the area of intangibles and the development of the digital economy. For example, today it is possible to be heavily involved in the economic life of another country, e.g. by doing business with customers located in that country via the internet, without having a taxable presence there or in another country that levies tax on profits. In an era where non-resident taxpayers can derive substantial profits from transacting with customers located in another country, questions are being raised on whether the current rules are fit for purpose. Further, as businesses increasingly integrate across borders and tax rules often remain uncoordinated, there are a number of structures, technically legal, which take advantage of asymmetries in domestic and international tax rules.

More fundamentally, a holistic approach is necessary to properly address the issue of BEPS. Government actions should be comprehensive and deal with all the different aspects of the issue. These include, for example, the balance between source and residence taxation, the tax treatment of intra-group financial transactions, the implementation of anti-abuse provisions, including CFC legislation, as well as transfer pricing rules. A comprehensive approach, globally supported, should draw on an in-depth analysis of the interaction of all these pressure points. It is clear that co-ordination will be key in the implementation of any solution, though countries may not all use the same instruments to address the issue of BEPS.

What is at stake is the integrity of the corporate income tax. A lack of response would further undermine competition, as some businesses, such as those which operate cross-border and have access to sophisticated tax expertise, may profit from BEPS opportunities and therefore have unintended competitive advantages compared with enterprises that operate mostly at the domestic level. In addition to issues of fairness, this may lead to an inefficient allocation of resources by distorting investment decisions towards activities that have lower pre-tax rates of return, but higher after-tax rates of return. Finally, if other taxpayers (including ordinary individuals) think that multinational corporations can legally avoid paying income tax it will undermine voluntary compliance by all taxpayers—upon which modern tax administration depends.

Because many BEPS strategies take advantage of the interface between the tax rules of different countries, it may be difficult for any single country, acting alone, to fully address the issue. Furthermore, unilateral and uncoordinated actions by governments responding in isolation could result in the risk of double— and possibly multiple—taxation for business. This would have a negative impact on investment, and thus on growth and employment globally. In this context, the major challenge is not only to identify appropriate responses, but also the mechanisms to implement them in a streamlined manner, in spite of the well-known existing legal constraints, such as the existence of more than 3.000 bilateral tax treaties. It is therefore essential that countries consider innovative approaches to implement comprehensive solutions.

In order to address BEPS, which is fundamentally due to a large number of interacting factors, a comprehensive action plan should be developed quickly. The main purpose of that plan would be to provide countries with instruments, domestic and international, aiming at better aligning rights to tax with real economic activity. While it is useful to take stock of the work which has already been done and which is underway, it is also important to revisit some of the fundamentals of the existing standards. Indeed, incremental approaches may help curb the current trends but will not respond to several of the challenges governments face. Though governments may have to provide unilateral solutions, there is value and necessity in providing an internationally co-ordinated approach. Collaboration and co-ordination will not only facilitate and reinforce domestic actions to protect tax bases, but will also be key to provide comprehensive international solutions that may satisfactorily respond to the issue. Coordination in that respect will also limit the need for individual jurisdictions' unilateral tax measures. Of course, jurisdictions may also provide more stringent unilateral actions to prevent BEPS than those in the coordinated approach.

Introduction

This part reproduces data on corporate tax receipts over time, provides an overview of statistics on foreign direct investments, and analyzes relevant studies regarding the existence and magnitude of BEPS. It concludes that with the data currently available, it is difficult to reach solid conclusions about how much BEPS actually occurs. Most of the writing on the topic is inconclusive, although there is abundant circumstantial evidence that BEPS behaviours are widespread. There are several studies and data indicating that there is increased segregation between the location where actual business activities and investment take place and the location where profits are studyed for tax purposes.

Again, it should be noted that, although they may provide useful indications, these trends in the relationship of corporate income tax to GDP do not necessarily imply either the existence or non-existence of BEPS practices. One reason why corporate tax revenues have been maintained, before the impact of the financial crisis, despite cuts in tax rates, has been base-broadening measures such as aligning depreciation for tax purposes more closely with actual depreciation, reductions in ‘‘tax expenditures’’ (*i.e.* tax reliefs for particular activities or groups of taxpayers that are in effect equivalent to public expenditure and thus have to be financed through higher taxes elsewhere). Another reason has been an increasing share of corporate income in GDP in many countries, reflecting increased business profits and, in some countries, increased incorporation (*i.e.* more business activity being undertaken in corporate form, with its income being taxed under the corporate income tax). However, further analysis would be required to distinguish the particular factors increasing the corporate income tax base in each country.

A Review of Recent Studies Relating to BEPS

There are a number of recent studies that have analyzed MNEs’ **Effective Tax Rates** (ETRs) in an attempt to demonstrate the existence of BEPS behaviour or the absence of such behaviour. In most cases, these studies use backward-looking approaches and firm-level data. Some studies, mostly from the United States, used data from taxpayers’ returns. Other studies focused on other data, such as investment flows and positions, to investigate the extent of BEPS. The difference between statutory corporate income tax rates and ETR is often a source of misunderstanding in the public debate.

Available studies on the ETRs of MNEs are useful, but there are hardly two studies using the same methodology. Key differences relate to which taxes are taken into account in the calculation (*e.g.* cash taxes or accrued taxes), which measure of profits is used, which companies are selected, and the time period covered. In addition, for backward-looking ETRs, the steps required to achieve compatibility of numerator (tax) and denominator (pretax profit) amounts are limited by the availability of data. In fact, in some cases the analysis seems to have actually been driven by the available data rather than by an objectively reliable methodology, and the available data may simply not be sufficient to indicate the level of BEPS that actually exists. The use of different methodologies to calculate ETRs (in particular backward-looking ones) and shortcomings in the available data result in very divergent conclusions regarding the level of taxation imposed on MNEs and the prevalence of BEPS behaviors. Studies in relation to the same country or region arrive at very different, and in some cases opposite, results. In some instances, the methodology chosen and the data used seem to be driven more by the intention to support a given conclusion than to achieve a conclusion on the basis of the analysis.

Globalization is not new, but the pace of integration of national economies and markets has increased substantially in recent years. The free movement of capital and labour, the shift of manufacturing bases from high-cost to low-cost locations, the gradual removal of trade barriers, technological and telecommunication developments, and the ever-increasing importance of managing risks and of developing, protecting and exploiting intellectual property, have had an important impact on the way MNEs are structured and managed. This has resulted in a shift from country-specific operating models to global models based on matrix management organizations and integrated supply chains that centralize several functions at a regional or global level. Moreover, the growing importance of the service component of the economy, and of digital products that often can be delivered over the Internet, has made it possible for businesses to locate many productive activities in geographic locations that are distant from the physical location of their customers.

Globalization has in effect caused products and operational models to evolve, creating the conditions for the development of global strategies aimed at maximising profits and minimising expenses and costs, including tax expenses. At the same time, the rules on the taxation of profits from cross-border activities have remained fairly unchanged, with the principles developed in the past still finding application in domestic and international tax rules. In other words, the changes in business practices brought about by globalisation and digitalisation of the economy have raised questions among governments about whether the domestic and international rules on the taxation of cross-border profits have kept pace with those changes. Beyond cases of illegal abuses, which are the exception rather than the rule, MNEs engaged in BEPS comply with the legal requirements of the countries involved. Governments recognize this and also recognize that a change in this legal framework can only be achieved through international co-operation.

Literature Review

Liberalization of trade, the abolition of currency controls and technological advances have all contributed to a dramatic increase in the flows of capital and investments among countries. This has created unprecedented interconnectedness at all levels: individuals, businesses and governments. In striving to improve their competitive positions, businesses bring about the changes in investment, technological improvements and higher productivity that enable improvements in living standards. For a corporation, being competitive means to be able to sell the best products at the best price, so as to increase its profits and shareholder value. In this respect, it is just natural that investments will be made where profitability is the highest and that tax is one of the factors of profitability, and as such tax affects decisions on where and how to invest.

From a government perspective, globalization means that domestic policies, including tax policy, cannot be designed in isolation, i.e. without taking into account the effects on other countries' policies and the effects of other countries' policies on its own ones. In today's world, the interaction of countries' domestic policies becomes fundamental. Tax policy is not only the expression of national sovereignty but it is at the core of this sovereignty, and each county is free to devise its tax system in the way it considers most appropriate. Tax policy and administration influence many of the drivers of increased productivity, ranging from investment in skills, capital equipment and technical know-how to the amount of resources required to administer and comply with the tax regime.

If a regime is considered preferential and within the scope of the work, four key factors and eight other factors are used to determine whether a preferential regime is potentially harmful. The four key factors are: *(i)* no or low effective tax rate; *(ii)* ring-fencing of the regime; *(iii)* lack of transparency; and *(iv)* lack of effective exchange of information. The eight other factors are: *(i)* an artificial definition of the tax base; *(ii)* failure to adhere to international transfer pricing principles; *(iii)* foreign source income exempt from residence country taxation; *(iv)* negotiable tax rate or tax base; *(v)* existence of secrecy provisions; *(vi)* access to a wide network of tax treaties; *(vii)* the regime is promoted as a tax minimization vehicle; *(viii)* the regime encourages purely tax-driven operations or arrangements.

In order for a regime to be considered potentially harmful the first key factor, ''no or low effective tax rate'', must apply. This is a gateway criterion. However, an evaluation of whether a regime is potentially harmful should be based on an overall assessment of each of the factors and on its economic effects. Where a preferential regime has been found harmful, the relevant country will be given the opportunity to abolish the regime or remove the features that create the harmful effect. Where this is not done, other countries may then decide to implement defensive measures to counter the effects of the harmful regime, while at the same time continuing to encourage the country applying the regime to modify or remove it. It is worth mentioning here that the recent past has witnessed major progress in relation to one of the four key factors, namely tax transparency. The Global Forum, which since 2000 has been the multilateral framework within which work in the area transparency and exchange of information has been carried out, was fundamentally restructured in 2009 to respond to a G20 call for action in this area. Since then more than 800 agreements that provide for the exchange of information in tax matters in accordance with the internationally agreed standard have been signed, 110 peer reviews have been launched and 88 peer review studys have been completed and published. The peer review outputs include determinations regarding the availability of any relevant information in tax matters (ownership, accounting or bank information), the appropriate power of the administration to access the information and the administration's capacity to deliver this information to any partner which requests it. Moreover, since the 2012 update of article 26 of the OECD Model Tax Convention, the standard on exchange of information clearly includes group requests. Finally, in the context of **Foreign Account Tax Compliance Act** (FATCA) agreements, a growing number of countries are moving towards automatic exchange of information. Needless to say, these developments provide opportunities to obtain better and more accurate information on BEPS instances that in the past were often not available.

Corporate Governance and Taxation

A key determinant of shareholder value under current corporate studying standards is **Earnings per Share** (EPS). An important element of EPS is tax, which means that the net effect of having an ETR of 30% is that any earnings are reduced by 30%. In other words, the ETR significantly impacts EPS and therefore has a direct impact on shareholder value. Although excluded from **Earnings Before Interest, Tax Depreciation and Amortization** (EBITDA), the ETR also has an impact on other financial indicators used by corporate analysts, such as the Return on Equity (ROE) or the **Weighted Average Cost of Capital** (WACC), and therefore on stock valuation.

The comparison between an MNE's ETR and that of its direct competitors often generates questions and therefore increased pressure on the MNE's tax department. At the same time, increased attention is being paid to risk, including tax risk, for financial studying purposes. For example, under United States **General Accepted Accounting Principles** (GAAP), tighter accounting for uncertain tax positions under FIN 48 means that provisions for uncertain tax positions have to be made if it is more likely than not that the tax administration would not accept the position taken, assuming that it was in possession of all the facts. An exposure draft on income tax was published by the **International Accounting Standards Board** (IASB) in March 2009 (ED/2009/2). It proposes that ''an entity shall disclose information about the major sources of estimation uncertainties relating to tax, including: a description of the uncertainty. . .''. To the extent that financial accounting rules may increasingly require similar forms of disclosure, this means that adopting an aggressive tax position is unlikely to have a positive impact on the ETR and the profits available for distribution that can be studyed in the published accounts of the corporation in the near term. As a result, the aggressive tax position does not enhance shareholder value immediately and does increase risk, including the reputational risk, if the tax planning becomes public, for example because the issue is the subject of litigation.

Several countries have recently taken a number of steps to address aggressive tax planning and rules requiring such schemes to be disclosed to the administration have been adopted by a number of them. As a result, aggressive tax strategies can be detrimental to shareholders' interests, particularly in the medium-tolong term, because they are high risk and the costs of failure can be significant, also from the point of view of reputation. Furthermore, for some years now there has been a clear trend in the relationship between tax administrations and large businesses away from a purely adversarial model towards a more collaborative approach. At the basis of these co-operative compliance programmes there is an exchange of transparency for certainty, for both parties. Increased stringency of the accounting rules governing provisions for uncertain tax positions has only served to underline the commercial value of certainty.

The right to tax is traditionally based on a factor that determines connection to a jurisdiction. Jurisdiction to tax is exercised on an entity by entity basis, not on a group-wide basis, subject to the exception of the availability of domestic group consolidation regimes. In broad terms, tax systems are often divided into worldwide and territorial ones. A worldwide taxation system generally subjects to tax its residents on their worldwide income, i.e. derived from sources within and outside of its territory (including the income earned through controlled foreign subsidiaries) and nonresidents on the income derived from its territory. On the other hand, a territorial system generally subjects to tax both residents and nonresidents only on the income derived from sources located in its territory. In the majority of countries, neither the worldwide nor the territorial system is employed in a pure form and no two tax systems are exactly the same.

The interaction of domestic tax systems sometimes leads to an overlap, which means that an item of income can be taxed by more than one jurisdiction thus resulting in double taxation. The interaction can also leave gaps, which result in an item of income not being taxed anywhere thus resulting in so called ‘‘double nontaxation’’. Corporations have urged bilateral and multilateral co-operation among countries to address differences in tax rules that result in double taxation, while simultaneously exploiting difference that result in double non-taxation.

Domestic and international rules to address double taxation, many of which originated with principles developed by the League of Nations in the 1920s, aim at addressing overlaps that result in double taxation so as to minimise trade distortions and impediments to sustainable economic growth. Whilst there are significant differences between the more than 3,000 bilateral tax treaties currently in force, the principles underlying the treaty provisions governing the taxation of business profits are relatively uniform. Under the rules of tax treaties, liability to a country’s tax first depends on whether or not the taxpayer that derives the relevant income is a resident of that country. Residence, for treaty purposes, depends on liability to tax under the domestic law of the taxpayer. A company is considered to be a resident of a State if it is liable to tax, in that State, by reason of factors (*e.g.* domicile, residence, incorporation or place of management) that trigger the widest domestic tax liability. Most if not all treaties provide that any resident taxpayer may be taxed on its business profits wherever arising (subject to the requirement that the residence country eliminate residence-source double taxation) whilst, as a general rule, non-resident taxpayers may only be taxed on their business profits when certain conditions are met.

Treaty rules for taxing business profits use the concept of permanent establishment as a basic nexus/threshold rule for determining whether or not a country has taxing rights with respect to the business profits of a non-resident taxpayer. However, some categories of profits may be taxed in a country even though there is no permanent establishment therein. These include: *(i)* profits derived from immovable property, which, in all or almost all treaties, may be taxed by the country of source where the immovable property is located; *(ii)* profits that include certain types of payments which, depending on the treaty, may include dividends, interest, royalties or technical fees, on which the treaty allows the country of source to levy a limited tax based on the gross amount of the payment (as opposed to the profit element related to the payment); *(iii)* under some treaties, profits derived from collecting insurance premiums or insuring risks in the source country; *(iv)* under some treaties, profits derived from the provision of services if the presence of the provider in the country of source meets certain conditions. The permanent establishment concept also acts as a source rule to the extent that, as a general rule, the only business profits of a non-resident that may be taxed by a country are those that are attributable to a permanent establishment.

Transfer Pricing

The issue of jurisdiction to tax is closely linked with the one of measurement of profits: once it has been established that a share of an enterprise's profits can be considered to originate from a country and that the country should be allowed to tax it, it is necessary to have rules for the determination of the relevant share of the profits which will be subjected to taxation. Transfer pricing rules perform this function. The internationally accepted principle underlying transfer pricing determinations is the arm's length principle, which requires that for tax purposes, related parties must allocate income as it would be allocated between independent entities in the same or similar circumstances.

When independent enterprises transact with each other, the conditions of the transaction are generally determined by market forces. When associated enterprises transact with each other, their relations may not be directly affected by market forces in the same way. The objective of the arm's length principle is for the price and other conditions of transactions between associated enterprises to be consistent with those that would occur between unrelated enterprises for comparable transactions under comparable circumstances. In transactions between two independent enterprises, compensation usually will reflect the functions that each enterprise performs, taking into account assets used and risks assumed. Therefore, in determneeded to ensure that the economically relevant characteristics of the situations being compared are sufficiently comparable. One of the key factors in that comparability analysis is a functional analysis to identify and compare the economically significant activities and responsibilities undertaken, assets used and risks assumed by the parties to the transactions.

Anti-Avoidance

Measures that negate or reduce the tax benefit sought, as well as initiatives aimed at influencing taxpayer's and third parties' behaviours, are of obvious relevance in the area of corporate tax planning. In practice, there are a variety of anti-avoidance strategies that countries use to ensure the fairness and effectiveness of their corporate tax system. These strategies often focus on deterring, detecting and responding to aggressive tax planning. Deterrence strategies generally aim at counter behaviour perceived as inappropriate but also to influence future behaviour. In other words, antiavoidance measures are fundamental policy prohibitions to engage in certain planning and/or to obtain certain results. The most relevant anti-avoidance rules in domestic tax systems include:

- General anti-avoidance rules or doctrines, which limit or deny the availability of undue tax benefits, for example, in situations where transactions lack economic substance or a non-tax business purpose;
- Controlled foreign company rules, under which certain base eroding or ''tainted'' income derived by a non-resident controlled entity is attributed to and taxed currently to the domestic shareholders regardless of whether the income has been repatriated to them;

- Thin capitalisation and other rules limiting interest deductions, which disallow the deduction of certain interest expenses when, *e.g.* the debt-toequity ratio of the debtor is considered to be excessive;
- Anti-hybrid rules, which link the domestic tax treatment with the tax treatment in that foreign country thus eliminating the possibility for mismatches;
- Anti-base erosion rules, which impose higher withholding taxes on, or deny the deductibility of, certain payments (*e.g.* those made to entities located in certain jurisdictions).

Anti-avoidance rules are also often found in bilateral tax treaties, so as to reduce the risk of abuse of treaties by persons who were not intended to benefit from them, e.g. through the use of conduit companies. Some countries expressly include in their treaty provisions that aim at counteracting this type of abuse. Typical provisions include those specifically aimed at denying the benefits of the treaty to certain entities, provisions which are aimed at particular types of income, provisions which are aimed at preferential regimes introduced after the signature of the treaty and provisions designed to protect the tax base of countries concluding treaties with low-tax jurisdictions. For EU members, additional issues arise as witnessed by the numerous decisions of the European Court of Justice on tax matters and the recent work done by the EC Commission in the area of double non-taxation.

Key Principles and BEPS Opportunities

While the specific goals will vary among MNEs, in particular with respect to companies headquartered in different jurisdictions, broadly speaking BEPS focuses on moving profits to where they are taxed at lower rates and expenses to where they are relieved at higher rates. Specific strategies may also be put in place to make use of existing ‘‘tax attributes’’ such as tax credits, losscarry forwards, etc.**Tax planning strategies** on tax attributes generally involve strategies aimed at securing, increasing and/or accelerating tax relief and are very dependent on specific country rules. Regarding tax planning on tax attributes, a recent OECD study describes a number of aggressive tax planning schemes on losses (OECD, 2011, *Corporate Loss Utilisation through Aggressive Tax Planning*). These schemes aim at achieving a variety of results, such as the rules on the recognition or treatment of losses, shifting losses to a profitable party or profits to a loss-making party, circumventing restrictions on the carry-over of losses, creating artificial losses and pursuing the dual/multiple use of the same loss.

These generic goals are often achieved in a way that aligns with the overall management of the treasury operations of the group, *e.g.* in terms of cash management, management of foreign exchange risks and efficient repatriation strategies. The following paragraphs describe some typical BEPS opportunities created by the existence and interaction of rules based on the key principles described above.

Jurisdiction to Tax

Every jurisdiction is free to set up its corporate tax system as it chooses. States have the sovereignty to implement tax measures that raise revenues to pay for the expenditures they deem necessary. An important challenge relates to the need to ensure that tax does not produce unintended and distortive effects on crossborder trade and investment nor that it distorts competition and investment within each country by disadvantaging domestic players. In a globalized world where economies are increasingly integrated, domestic tax systems designed in isolation are often not aligned with each other, thus creating room for mismatches. As already mentioned, these mismatches may result in double taxation and may also result in double nontaxation. In other words, these mismatches may in effect make income disappear for tax purposes. This leads to a reduction of the overall tax paid by all parties involved as a whole. Although it is often difficult to determine which of the countries involved has lost tax revenue, it is clear that collectively the countries concerned lose tax revenue. Further, this undermines competition, as some businesses, such as those which operate crossborder and have access to sophisticated tax expertise, may profit from these opportunities and have unintended competitive advantages compared with other businesses, such as small and medium-sized enterprises, that operate mostly at the domestic level.

Considering how tax systems interact with each other is therefore relevant not only to eliminate obstacles to cross-border trade and investment, but also to limit the scope for unintended non-taxation. Further, double tax treaties, which are bilateral tools that countries use to co-ordinate the exercise of their respective taxing rights, may also create opportunities for taxpayers to obtain tax advantages in the form of lower or no taxation at source and/or lower or no taxation in the state of residence of the taxpayer. Although the most immediate way to achieve low or no taxation at the level of the recipient is to shift income to an entity in a low-tax jurisdiction, the same results may be achieved in a number of other ways, also between high-tax countries. These alternatives, although more complex, often entail additional tax benefits, *e.g.* in terms of claiming a full deduction at the level of the payer, the potential reduction or elimination of (withholding) taxes at source, and the nonapplicability of anti-avoidance rules in the source or residence country (*e.g.* because these rules may only target strategies using low-tax jurisdictions).

The paragraphs below describe ways in which the current rules can be applied to achieve low or notaxation, mostly in relation to financing:

- Low-taxed branch of a foreign company: a company can be set up in what is ostensibly a high tax jurisdiction, but can achieve a low effective tax rate on the income received by providing loans (licences or services) through a foreign branch that is subject to a low-tax regime. In general, this requires that the country in which the ‘‘head office’’ is set up operates an exemption system for foreign branches, either under domestic law or under double tax treaties. The low-tax in the branch can be achieved in different ways: *(i)* the country of the branch levies a low or zero tax rate on the income; *(ii)* unlike the country of the head office, the country of the branch regards the activities carried on therein as not being sufficiently significant to create a taxable presence of the foreign company; *(iii)* unlike the country of the head office, the country of the branch gives a deduction for deemed interest on the branch’s capital.
- Hybrid entities: low taxation at the level of a finance (or IP) company that operates purely in high-tax countries can be achieved through the use of hybrid entities. A hybrid entity is an entity that is treated as a taxable person in one country but as ‘‘transparent’’ in another country (*i.e.* in the other country the profits or losses of the entity are taxed/deducted at the level of the members). For example, assume that an entity organized in Country B receives a loan from its parent company in Country A. The entity in Country B is treated as non-transparent in Country B while it is treated as transparent in Country A. This mismatch in treatment allows the group to claim a deduction in Country B for a payment that is not taxed in Country A (because that country sees no income at the level of the recipient). It should be kept in mind that double taxation could occur in this situation if the treatment of the entity had been inversed in the two countries.

- Hybrid financial instruments and other financial transactions: Similar results can be achieved through the use of hybrid instruments. These are financial instruments that present features typically connected with debt but also features typically connected with equity. Assume that a company in Country A buys financial instruments issued by a company in Country B. Under Country A's tax laws, the instrument is treated as equity, whereas for Country B's tax purposes the instrument is regarded as a debt instrument. Payments under the instrument are considered to be deductible interest expenses for the company under Country B tax law while the corresponding receipts are treated as dividends for Country A tax purposes and therefore exempt therein. Other financial transactions including those involving captive insurance or derivatives can give rise to similar outcomes of payments being deductible in one country, but not being taxed in another country.

Further, country taxation at source can often be reduced or eliminated through the interposition of intermediate entities in treaty jurisdictions so as to claim the benefits of the relevant tax treaty or when certain items of income, such as derivative payments, are not taxed at source:

- **Conduit companies**: the fact that the owner of the income-producing asset (*e.g.* funds or IP) is located in a low-tax jurisdiction means that in most cases where income is derived from other countries the taxing rights of the source State will not be limited by any double tax treaty. The interposition of a conduit company located in a State that has a treaty with the source State may allow the taxpayer to claim the benefits of the treaty, thus reducing or eliminating tax at source. Further, if the State of the conduit company applies no withholding tax on certain outbound payments under its domestic law or has itself a treaty with the State of the owner of the incomeproducing asset that provides for the elimination of withholding tax at source, the income can be repatriated to the owner of the incomeproducing asset without any tax at source. Taxation of the income from the funds or IP in the State of the conduit company does not take place, since the income will be offset by a corresponding deduction for the payments to the owner of the income-producing asset in the lowtax jurisdiction.
- **Derivatives**: Certain derivative instruments may be used to reduce or eliminate withholding taxes on cross-border payments. For example, fees for derivative contracts, such as forwards or interest rate swaps, may economically replace interest payments and thus avoid withholding tax at source, either because the relevant domestic law does not subject these payments to tax at source or because the relevant double tax treaty may prevent the country from taxing the income at source.

CONCLUSIONS

In practice any international tax planning will need to incorporate a number of co-ordinated strategies, which often can be broken down into four elements:

- Minimization of taxation in a foreign operating or source country (which is often a medium to high tax jurisdiction) either by shifting gross profits via trading structures or reducing net profit by maximising deductions at the level of the payer;
- Low or no withholding tax at source;
- Low or no taxation at the level of the recipient (which can be achieved via low-tax jurisdictions, preferential regimes or hybrid mismatch arrangements) with entitlement to substantial nonroutine profits often built up via intra-group arrangements; and
- No current taxation of the low-taxed profits (achieved via the first three steps) at the level of the ultimate parent.

Further, effective cash repatriation strategies may be an issue where for instance, dividends need to be funded and of course, ‘‘permanent’’ foreign reinvestment of low-taxed cash will be relevant to allow booking of a particular tax rate for EPS purposes. Any analysis of BEPS therefore needs to be cognisant of the inter-connection of these elements and the overall drivers of the tax planning strategy. The structures described in this annex have been given wide coverage in the specialised and mainstream press. They have been selected because they encapsulate a number of the corporate tax planning opportunities described above and all appear to be perfectly legal under the tax systems of the countries in which they have been put in place. They may therefore constitute a useful paradigm to identify key pressure areas from a tax policy perspective.

Company A is a company that is organized in Country A and that initially developed technology and intangibles supporting its business through research conducted primarily in Country A. Company A is the parent of a multinational group of companies. Under the tax planning structure of the Group, rights to technology developed by the parent, Company A, are licenced or otherwise transferred to Company C under a cost sharing or cost contribution arrangement. Company C is an unlimited liability company organized (*i.e.* registered) under the laws of Country B but managed and controlled in Country C, and so tax resident in Country C. Under the cost sharing arrangement, Company C agrees to make a ‘‘buy in’’ payment equal to the value of the existing technology transferred under the arrangement and to share the cost of future enhancement of the transferred technology. The buy-in payment would be fully taxable in Country A and could take the form of a single lump-sum payment or a running royalty over time. Ongoing research expense would be shared on the basis of the relative anticipated benefits from the intangibles being developed. The cost sharing arrangement would typically be established early in the life of Company A, before development of a significant track record of sales in the markets allocated to Company C under the agreement.

Company C licences all of its rights in the technology to Company D in exchange for a running royalty. Company D is a company organized, managed and controlled in Country D. Company D in turn sublicences the technology to Company B. Company B is organized, managed and controlled in Country B. Company B employs several thousand people in its operations in Country B. Country B imposes corporate income tax on taxable profit of Company B. However, the taxable profit of Company B is less than 1 per cent of its gross revenues. This is because in calculating its income in Country B, following the OECD transfer pricing principles Company B deducts the full amount of the royalty it pays to Company D for the search and advertising technology. The royalty payment made by Company B to Company D is free of withholding tax in Country B. Country B would impose a withholding tax on payments directly to a company tax resident in a country like Country C. However, under the law of Country B, applying the EU Interest and Royalties Directive, because the royalty payments are made to a company which is organized and subject to tax in a country that is a member of the European Union, the royalties qualify for exemption from Country B withholding tax.

Country D imposes corporate income tax on the profits of Company D. However, taxable profit is reduced by the deductible royalty payments made by Company D to Company C. Accordingly, corporate income tax is imposed in Country D only on the small amount of royalty ‘‘spread’’ between Company D’s royalty receipts from Company B and its royalty payments to Company C. The spread between royalty receipts and royalty payments is very small because Company D engages only in a flow-through transaction. Company D, unlike Company B, performs no functions and holds no assets. It also bears little or no risk with regard to the royalty flows. Under the arm’s length principle, it is therefore entitled to very little income. Typically a tax ruling would be obtained in Country D defining the amount of income subject to tax in Country D, thereby providing Group A with certainty regarding the results of its tax planning structure.

Country D does not levy withholding tax on royalty payments under its domestic law. The payments made by Company D to Company C are, therefore, not subject to withholding tax in Country D. Company C is managed and controlled in Country C. Country C does not impose a corporate income tax. Country B does not impose tax on Company C because it has no presence in Country B, is centrally managed and controlled in Country C and its income arises from sources outside of Country B. Accordingly, the royalty income received by Company C is not subjected to tax in Country D, Country C or Country B. Under some circumstances, Country A’s CFC rules might tax royalty payments received by either Company D or Company C as passive income. However, it is probable that Company A will file a check-thebox election with respect to Company D and Company B. Under such an election, these companies would be disregarded for Country A tax purposes, and the income of Company B and Company D would be treated as having been earned directly by Company C. The royalty transactions between the disregarded entities would similarly be disregarded, meaning that they would be deemed not to exist for Country A tax purposes. For purposes of applying the Country A CFC rules, Company C would therefore be treated as if it had earned the fees and revenues directly through active business operations. Such active business income could be structured in such a way that it would not be subject to tax under the Country A CFC regime.