Making Sense of BEPS: The Latest OECD Assault on Tax Competition

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Executive Summary

The Organization for Economic Cooperation and Development (OECD) is directing considerable resources toward development of a new framework for taxation of multinational enterprises.

According to tax bureaucrats at the OECD, the G20, and finance ministers from large welfare states, base erosion and profit shifting (BEPS) is a serious problem that requires drastic action. Without input from the United States Congress and other elected national bodies, they are rushing to rewrite the rules of global commerce.

Available data does not support the contention that BEPS is a serious concern. Nevertheless, the OECD's sweeping proposals to combat BEPS would create a privacy nightmare and stifle economic growth. Even if there were a problem, better policy responses are available. The simplest and most powerful being adoption of pro-growth tax rates.

To make sense of the sudden push for a massive, multinational undertaking where costs are likely to be significant and benefits small at best, if they exist at all, the OECD's project on BEPS must be viewed in the context of the organization's long-standing war on tax competition.

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Introduction

Under direction of the G20, the Organization for Economic Cooperation and Development (OECD) began two years ago a major initiative on "base erosion and profit shifting" (BEPS). The project has garnered little interest from domestic policymakers to date, yet its ever expanding scope and profound implications for the global economy should demand their attention.

In a communiqué following their June 2012 Summit in Los Cabos, Mexico, G20 leaders announced that: "We reiterate the need to prevent base erosion and profit shifting and we will follow with attention the ongoing work of the OECD in this area."[1] In February 2013 the OECD released a report titled, "Addressing Base Erosion and Profit Shifting" (BEPS Report), declaring that, "Base erosion constitutes a serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike." The OECD followed up with a plan in July 2013, "Action Plan on Base Erosion and Profit Shifting" (Action Plan), that identified 15 specific areas to address.

In September 2014 the organization released interim reports on seven items, with the remaining eight expected in September 2015. The initial round of reports dealt with topics such as so-called treaty abuse, transfer pricing documentation, and a multilateral instrument for implementation. The next round of reports will include mandatory disclosure of so-called aggressive tax planning, more onerous CFC rules, limiting erosion via interest deductions, and additional work on transfer pricing, among other topics.

Through the BEPS project, the OECD is continuing its war against tax competition. Its proposals would enable endless global fishing expeditions and provide cover for governments to choke the economy with new taxes.

1 "G20 Summit communiqué: full text," *Telegraph,* June 20, 2012. http://www.telegraph.co.uk/finance/g20-summit/9343250/G20-Summit-communique-full-text.html

The Threat to the Economy

The OECD and other supporters of the BEPS initiative argue that there are economic benefits to preventing legal tax avoidance techniques. Namely, they contend that activity undertaken in response to tax policy represents a market distortion. In the narrow sense this is accurate, but as a justification for the OECD's current activities it falls short. The U.S. wouldn't seek to prevent Texas from lowering taxes, for instance, just because it is benefiting from companies moving from higher-tax states like California.

Typically ignored in the BEPS discussion are the broader implications of proposed reforms on the political economy. If all differences in tax policy were successfully minimized, to some extent it would indeed reduce profit-shifting aimed at suppressing tax burdens. So too would reducing taxes to zero, but policymakers have a variety of objectives to weigh and ought not elevate ending profit-shifting above all other national interests.

Appeals to market inefficiencies, such as the resources dedicated to minimizing tax burdens, are further unconvincing as justification because they would simply be replaced by new ones, like increased enforcement costs. It would also lead to an overall higher tax environment as politicians freed from the pressures of global tax competition inevitably raise rates to levels last seen in the early 1980s, when reforms by Reagan and Thatcher sparked a global reduction in corporate tax rates that has continued to this day. Through tax competition, the average corporate tax rate of OECD nations declined from almost 50% in 1981 to 25% in 2015.[2]

Taxes themselves distort the market by shifting resources away from market driven activities and toward politically driven activities, and higher rates, all else being equal, increase the effect of the distortion.[3] Poorly designed tax systems – the global norm – introduce yet more distortions through the common practice of double taxing capital, which is of particular importance when discussing BEPS given that corporate taxes are often identified as the most

2 OECD Tax Database, Table II.1 – Corporate income tax rates, accessed June 6, 2015. http://www.oecd.org/tax/tax-policy/tax-database.htm

3 See Christina D. Romer and David H. Romer, "The Macroeconomic Effects of Tax Change: Estimates Based on a New Measure of Fiscal Shocks," NBER Working Paper No. 13264, July 2007. http://www.nber.org/papers/w13264

destructive form of capital taxation,[4] as even OECD affiliated economists have acknowledged.[5]

Governments necessarily need taxes to fund essential functions, but ideally should seek to minimize the economic footprint of taxation as much as possible. Political incentives, however, often work in opposition of this goal. Politicians face pressure to demonstrate to constituents that they are performing, or to please special interests that posses the resources to help them win re-election, both of which encourages increases in public spending. That in turn encourages taxes to rise above and beyond the level of optimum growth, or where new spending no longer provides net economic benefits.

Tax competition thus provides one of the main sources of push-back against the drive to spend and tax. According to Professor Philip Booth and Dr. Richard Wellings, competition acts "as a deterrent to predatory politicians who wish to raise tax rates to highly damaging levels. Policymakers know that, if they set tax rates too high, business activity will shift to lower tax jurisdictions. The point at which tax increases no longer result in additional revenue to governments is therefore shifted downwards by competition from [International Financial Centers]. This means tax rates will tend to be closer to the optimal rate for economic growth."[6]

Tax collectors and finance ministers have inordinate say in the activities of the OECD, so it's expected that the BEPS initiative would represent their views above all else. The Action Plan thus considers the benefits of tax competition to be the real problem, explaining that "there is a reduction of the overall tax paid by all parties involved as a whole."[7] The prospect of there being less money to be spent by politicians is perceived as a problem to be solved, rather than as a positive for the global economy.

4 William McBride, "What is the Evidence on Taxes and Growth?" *Tax Foundation*, Special Report No. 207. December 18, 2012. http://taxfoundation.org/article/what-evidence-taxes-and-growth

5 Åsa Johansson, Christopher Heady, Jens Arnold, Bert Brys, Cyrille Schwellnus, and Laura Vartia, "Tax and economic growth," OECD Economics Department Working Papers No. 620, 2008. http://www.oecd.org/tax/tax-policy/41000592.pdf

6 Professor Philip Booth & Dr. Richard Wellings, "IFCs – Keeping the Wolf from the Door," *IFC Review,* September 1, 2013. http://ifcreview.com/restricted.aspx?articleId=6674

7 OECD, *Action Plan on Base Erosion and Profit Shifting*, 2013, 15. http://www.oecd.org/ctp/BEPSActionPlan.pdf

The Threat to Privacy

Several BEPS action items raise serious privacy concerns. Proposed recommendations for transfer-pricing documentation and country-by-country reporting, for instance, feature broad reporting requirements that go far beyond what is required for purposes of tax collection.

Guidance for Action 13 recommends a three-tiered approach to transfer-pricing documents consisting of a master file, a local file, and a country-by-country (CbC) reports. The master file would feature an assortment of information about all members of a multinational enterprise (MNE) – like an organizational chart, consolidated statements, drivers of business profit, and descriptions of supply chains – not directly related to the tax needs of tax authorities in any particularly jurisdiction. It requires disclosure of proprietary information that, were it to be made public, would likely aid competitors. The local file contains specifics of the transactions of the local taxpayer entity, while the CbC reports contain information on the global allocation of an MNE's income, taxes, and other economic indicators. The CbC reports are filed with the residence country of the multinational group parent, whereas the local and master files are submitted directly to each tax jurisdiction by the taxpayer.

Information contained in the local and master files are particularly vulnerable, since it would take a breach in only a single jurisdiction for it to be exposed. The OECD makes assurances for the confidentiality of these reports, but they are empty promises. Such government assurances of privacy protection are contradicted by experience and the long history of leaks of taxpayer information. In the United States alone tax data has frequently been exposed thanks to inadequate safeguards, or even released by officials to attack political opponents.

For instance, Propublica reported that it received from the IRS nine supposedly confidential applications for conservative groups during the time that the IRS was targeting such groups for extra scrutiny.[8] The IRS also admitted wrongdoing and paid $50,000 in a settlement with the National Organization for Marriage for leaking confidential information from the organization's tax returns to its political opponents.[9] In May 2015, the IRS reported that data on

8 Kim Barker and Justin Elliott, "IRS Office That Targeted Tea Party Also Disclosed Confidential Docs From Conservative Groups," *ProPublica*, May 13, 2013. http://www.propublica.org/article/irs-office-that-targeted-tea-party-also-disclosed-confidential-docs

9 "IRS agrees to $50,000 settlement in leaking of conservative group's donor records," *Fox News*, June 24, 2014. http://www.foxnews.com/politics/2014/06/24/irs-agrees-to-50000-settlement-in-leaking-conservative-group-donor-records/

100,000 taxpayers was stolen by "organized crime syndicates" who exploited an application on the IRS website to view the past returns of victims.[10] Numerous IRS officials have even been jailed for various criminal schemes that took advantage of their access to private taxpayer information.[11]

Even without malicious intent, governments are ill equipped to protect sensitive information from outside access. According to the Treasury Inspector General for Tax Administration, 1.6 million American taxpayers were victimized by identity theft in the first half of 2014, up from just 271,000 in 2010.[12] Chinese hackers were blamed for a breach that exposed the data of four million current and former federal employees,[13] and the massive new collection effort and reporting system being established to enforce the Foreign Account Tax Compliance Act has also been faulted for its insufficient privacy safeguards.[14]

The IRS has been repeatedly found by auditors as lacking sufficient security to protect sensitive information. Despite years of reports calling for improvements at the IRS, the GAO in 2015 found that "weaknesses in [information security] controls limited their effectiveness in protecting the confidentiality, integrity, and availability of financial and sensitive taxpayer data."[15]

As poor as the United States has proven at protecting privacy, there are likely to be nations even more vulnerable. Through the master file and other reporting mechanisms, BEPS will demand of corporations propriety information and other sensitive data that they have every right to keep private and out of the hands of competitors. When it takes a breach of only a single national government to expose this information, there will no longer be such expectation of privacy.

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10 Jada F. Smith, "Cyberattack Exposes I.R.S. Tax Returns," *New York Times*, May 26, 2015. http://www.nytimes.com/2015/05/27/business/breach-exposes-irs-tax-returns.html

11 J.D. Tuccille, " Your Tax Returns Are Hacker Bait," *Reason*, April 10, 2014. http://reason.com/archives/2014/04/10/your-tax-returns-are-hacker-bait

12 Brianna Ehley, "GAO: IRS Still Botching Security of Taxpayer Data," *The Fiscal Times*, March 20, 2015. http://www.thefiscaltimes.com/2015/03/20/GAO-IRS-Still-Botching-Security-Taxpayer-Data

13 David E. Sanger and Julie Hirschfeld Davis, "Hacking Linked to China Exposes Millions of U.S. Workers," *New York Times*, June 4, 2015. http://www.nytimes.com/2015/06/05/us/breach-in-a-federal-computer-system-exposes-personnel-data.html

14 See Brian Garst, "FATCA Reporting System Leaves Taxpayer Data Vulnerable," *Cayman Financial Review*, Issue No. 39, April 2015. http://www.compasscayman.com/cfr/2015/04/22/FATCA-reporting-system-leaves-taxpayer-data-vulnerable/

15 GAO, *Information Security: IRS Needs to Continue Improving Controls over Financial and Taxpayer Data*, GAO-15-337, March 2015. http://www.gao.gov/assets/670/669108.pdf

Is BEPS a Serious Problem?

The OECD's website describes BEPS as “tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid.”[16] The BEPS Report further claims that, “it may be difficult for any single country, acting alone, to fully address the issue.”[17] Or as the website more succinctly describes, BEPS “is a global problem which requires global solutions.”[18]

No significant evidence for these assertions is provided, however. The OECD's BEPS Report itself undercuts the argument that there is a pressing need for a global response when it acknowledges that “revenues from corporate income taxes as a share of GDP have increased over time.”[19] Likewise, the Action Plan admits when discussing hybrid mismatch that “it may be difficult to determine which country has in fact lost tax revenue.” Nevertheless, they somehow know that action must be taken.

Academic research on the impact of BEPS is far less certain than the rhetoric of the G20 and the OECD. As globalization has increased, it's expected that opportunities to move between jurisdictions would have increased as well. This is reflected by some studies, such as Klassen and Laplante's 2012 comparison of U.S. firms over two separate five-year periods.[20] The later period saw $10 billion more leave the U.S., a relatively small figure considering the percentage of expected tax revenue it would produce and the size of the federal budget. Their definition of shifting is also vague and fairly broad, defined as “a plan or structure that causes relatively more income to be earned in lower tax rate jurisdictions than would otherwise be expected based on the company’s worldwide asset allocation,” and which may or may not reflect activity that should be of concern to policymakers.

On the other hand, Dyreng and Lindsey concluded, “On average, profitable firms with material operations in tax haven countries do not report lower federal tax liabilities on foreign

16 "About BEPS," *OECD*, accessed June 6, 2015, http://www.oecd.org/tax/beps-about.htm

17 OECD, *Addressing Base Erosion and Profit Shifting*, February 2013, http://dx.doi.org/10.1787/9789264192744-en

18 "About BEPS," *OECD*.

19 OECD, *Addressing Base Erosion and Profit Shifting*, 16.

20 Kenneth J. Klassen and Stacie K. Laplante, “Are U.S. Multinational Corporations Becoming More Aggressive Income Shifters?,” *Journal of Accounting Research* Vol. 50, no. 5, December 2012. http://areas.kenan-flagler.unc.edu/Accounting/TaxCenter/taxdoctoral2015/Documents/Klassen%20Laplante.pdf

income than firms without operations in tax haven countries. This result appears contrary to the concerns expressed by policy makers that tax havens enable U.S. firms to avoid federal taxation of foreign income."[21]

The strongest analysis yet to date comes from Dhammika Dharmapala, whose survey of the literature finds that more recent studies, using better data and refined techniques, tend to find lower levels of shifting than earlier works.[22] It also challenged arguments that "point to the fraction of the income of MNCs that is reported in tax havens or to various similar measures as self-evidently demonstrating *ipso facto* the existence and large magnitude of BEPS." Simply identifying money in other jurisdictions, even those with low tax rates, is not evidence of a BEPS problem. It should be expected to see more money being earned where tax policy is less hostile.

Part of the reason there exists little evidence of a significant global BEPS problem is that domestic policy solutions are already available to address legitimate areas of concern when they arise. A primary focus of BEPS related work is on transfer pricing, which describes the prices of goods or services sold between controlled or related entities within an enterprise, but nations already have complete control over their own transfer pricing rules and frequently adjust them to account for changing conditions. More importantly, the best solution available for preventing base erosion is the adoption of a competitive tax code. Pro-growth tax policy that eschews double and worldwide taxation not only won't cause capital flight, but will attract investment instead.

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21 Scott Dyreng and Bradley P. Lindsey, "Using Financial Accounting Data to Examine the Effect of Foreign Operations Located in Tax Havens and Other Countries on US Multinational Firms' Tax Rates," March 25, 2009, http://papers.ssrn.com/abstract=1326602

22 Dhammika Dharmapala, "What Do We Know About Base Erosion and Profit Shifting?" CoaseSandor Institute for Law & Economics Working Paper No. 702, 2014. http://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=2385&context=law_and_economics

Broader Aims of the OECD

To fully understand the significance of the BEPS effort and why the OECD seeks a seemingly inordinate amount of information above and beyond what tax collectors require, it's necessary to place the current agenda within the broader context of the OECD's work in recent decades. In a comprehensive analysis, Andrew P. Moriss and Lotta Moberg trace the OECD's metamorphosis from an organization created "to promote global economic and social well-being" into one that seeks "to restrain both member and non-member countries from lowering taxes and to encourage lower tax jurisdictions to raise their rates."[23]

Exemplifying this mission creep, in 1998 the OECD declared war on tax competition with a report entitled, "Harmful Tax Competition: An Emerging Global Issue." Its authors worried that, among other things, tax competition "may hamper the application of progressive tax rates and the achievement of redistributive goals." [24] The report found a practice to be "harmful" if a country was "poaching" investment through use of attractive tax policies, leading Morris and Moberg to explain that "central to the OECD critique of tax competition was the claim that attracting investment was an illegitimate criterion for evaluating tax policy, even though creating an attractive investment climate was often treated as a legitimate goal in other policy areas by the OECD."[25]

The organization was eventually forced by political opposition to back away from explicit condemnations of all tax competition, but has not abandoned its views. Rather, it has adopted new tactics toward the same end. To make this point clear, the Action Plan favorably references *Harmful Tax Competition* as justification for its recommendations.[26] It also repeats a popular but baseless theory among left-wing academics and politicians about tax competition – that it promotes a 'race to the bottom.'

The 'race to the bottom' theory has claimed for decades that tax competition would force zero rates on mobile capital. It hasn't happened. A review of common such claims finds: "there

23 Andrew P. Morriss and Lotta Moberg, "Cartelizing Taxes: Understanding the OECD's Campaign against 'Harmful Tax Competition'," October 27, 2011, *Columbia Journal of Tax Law*, Vol. 4, No. 1, 2013, 3. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1950627

24 OECD, *Harmful Tax Competition: An Emerging Global Issue*, 1998. http://www.oecd.org/tax/transparency/44430243.pdf

25 Morris and Moberg, "Cartelizing Taxes," 45.

26 OECD, *Action Plan*, 17.

can be little doubt that history has proven wrong the prediction of a complete erosion of capital tax revenue. Comparative data on corporate and capital tax rates demonstrate that governments in all economies continue to tax mobile sources of capital, effective capital tax rates have not changed much compared with the mid-1980s, when tax competition was triggered by the 1986 US tax act, and tax systems are as varied as countries and political systems themselves, with no visible sign of converging."[27] Rates have declined, but revenues have not. Moreover, a nation's competitiveness is determined by much more than just its tax policy. Efficient regulatory regimes, access to highly skilled labor, developed infrastructure, and numerous other factors all contribute to attract business, allowing for pursuit of competitiveness through a number of different approaches that can include different levels of capital taxation.

Nevertheless, the BEPS report notes: "In 1998, the OECD issued a report on harmful tax practices in part based on the recognition that a 'race to the bottom' would ultimately drive applicable tax rates on certain mobile sources of income to zero for all countries, whether or not this was the tax policy a country wished to pursue."[28] Reality, essentially, is an unwarranted intrusion on the desire of policymakers to act without consequence. The BEPS report goes on: "It was felt that collectively agreeing on a set of common rules may in fact help countries to make their sovereign tax policy choices."[29] Unless, that is, their sovereign choice involves something other than raising taxes.

Nations that opt for little to no taxes on capital are a problem for this quixotic theory of sovereignty – where the rest of the world must be brought to heel in order to ensure that politicians ought not have to consider the economic consequences of their policies – hence why the primary indicator for determining whether a nation is to be identified as "potentially harmful" is that it has "no or low effective tax rates." Other factors are said to be considered, but without clear indication of how they are to be weighted any calculation will be arbitrary and open to excessive emphasis on the "gateway criterion" that is a low tax rate. When a low-tax scourge is identified, the OECD benevolently provides that, "the relevant country will be given the opportunity to abolish the regime or remove the features that create the harmful effect."[30] To

27 Vera Troeger, "Tax Competition and the Myth of the 'Race to the Bottom': Why Governments Still Tax Capital," Chatham House, The CAGE-Chatham House Series, No. 4, February 2013, 2. http://www.chathamhouse.org/publications/papers/view/188967#

28 OECD, *Addressing Base Erosion and Profit Shifting*, 28.

29 Ibid, 29.

30 Ibid.

make perfectly clear that this is the sort of offer a nation cannot refuse, they warn: “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.”[31]

The OECD's previous aggressions against low-tax jurisdictions in pursuit of its quest to abolish tax competition make clear just what “defensive measures” it has in mind, and how its members will go about trying to “encourage” compliance. In the years that followed release of *Harmful Tax Competition*, the OECD used threats of blacklists, peer pressure, and intimidation to cajole low-tax jurisdictions into adopting various policies presented under the auspices of increasing tax transparency and combating evasion.[32] In practice the changes were intended to undermine the attractiveness of low-tax jurisdictions and protect high-tax nations from base erosion due to capital flight.

Of particular relevance for understanding the BEPS initiative is the pattern demonstrated by the OECD during the course of this campaign. After each recommendation was widely adopted – typically under duress in the case of low-tax jurisdictions – the OECD immediately pushed a new requirement that was more radical and invasive than the last. First was a call to adopt a certain number of Tax Information Exchange Agreements and a standard of information exchange upon request, then a peer-review process whereby tax policies are judged according to the standards of high-tax welfare states. Then, after years of meetings and costly compliance efforts, the old standard for information exchange upon request was replaced with a call for global automatic exchange.

If the OECD's past efforts were successful in solving the supposedly urgent problems used to justify the current agenda, then it wouldn't need to keep coming up with new solutions. The fact that the OECD is always ready with a new policy after one is implemented suggests either that the organization's goal is not merely what is stated, or that it is horribly ineffective. In either case it should serve as a blow to its credibility and a reason to question its work on BEPS.

31 Ibid.

32 See Morriss and Moberg, “Cartelizing Taxes,” 2011.

Conclusion

Without regard to serious privacy concerns, the OECD is engaging in a global fishing expedition at the expense of the private sector. Rather than merely developing a standard for best practices, tax bureaucrats have concocted a massive and expensive undertaking with the goal of drastically expanding data collection to cover a wide swath of confidential business information. Given the history of the OECD and the stated motivations of its membership, it's easy to surmise that they are collecting this information in the hopes not merely of enforcing current tax law, but for use in creating yet more destructive taxes on businesses.

German Finance Minister Wolfgang Schäuble, one of the participants of the Los Cabos G20 meeting that precipitated the BEPS project, makes clear the OECD's aims in an opinion article titled, "Why Taxation Must Go Global." After repeating the canard that "states are losing revenue that they urgently need in order to fulfill their responsibilities," Schäuble condemned "a 'beggar-thy-neighbor' taxation policy, by which one country pursues tax policies at the expense of other." He warned that competition "leads to misallocations," with the unspoken but clear understanding that the worst such misallocations are not economic in nature, but political – namely, that which prevents any desired resources from reaching the hands of Schäuble and his comrades.[33]

Were the OECD merely a research institution, its work could be dismissed simply as a bad idea that no nation need adopt. Unfortunately, Europe's dominant welfare states use the OECD's work as a benchmark when coercing other nations through use of political and economic leverage. For the low-tax jurisdictions, and now multinational businesses, caught in the OECD's crosshairs, the ride truly never ends. The BEPS project is a continuation of the OECD's well-documented effort to eliminate tax competition, and will likely follow the same pattern of consistently moving goalposts.

It is an affront to modern principles of political representation and good governance that the OECD should exercise such power while being so far removed from ordinary political processes. Modern governmental systems recognize that policy must weigh and balance a wide array of competing concerns. That is not the case with the OECD, which is largely removed from

33 Wolfgang Schäuble, "Why Taxation Must Go Global," *Huffington Post,* November 3, 2014. http://www.huffingtonpost.com/wolfgang-schauble/taxation-global-wolfgang-schauble_b_6076876.html

ordinary political systems and whose membership is narrowly focused on a singular goal: collecting as much tax as possible.

The BEPS project began at the behest of a tiny few, without open and public debate regarding the assumptions motivating the effort, its goals, or the most appropriate methods to achieve them. There is a lack of accountability, reflected in the activities of the BEPS initiative, that can only be rectified through real public debate and direct political oversight.