Base Erosion and Profit Shifting: Opportunities and Obstacles for Multinationals

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Base erosion and profit shifting (BEPS) has become a prominent issue in the world of international taxation over the last three years. The terms "base erosion and profit shifting" are used to describe the practice of shifting assets and reported profits of multinational corporations (multinationals) to jurisdictions outside the United States that have low tax rates, thus eroding the U.S. tax base and causing the U.S. government to forego large amounts of tax revenue.

BEPS did not become a prominent public issue until after the worldwide financial crisis of 2008 and the subsequent Eurozone debt crisis. The explosion of enormous budget deficits in many powerful countries such as the United Kingdom, Spain, France, Japan and the United States has raised concerns about worsening BEPS. Members of the Organization for Economic Co-operation and Development (OECD) and G20 have pushed for these countries to work on a plan to combat the issue. The members of the OECD and G20 already agreed to require constituent multinationals with €750 million ($850 million in the United States) or more in annual revenues to report income and taxes paid on a country-by-country basis beginning Jan. 1, 2017 and to automatically exchange these reports to other member countries starting in 2018 to help disseminate information regarding how and where countries shift profits.

Widespread support from the public for halting or slowing down BEPS has largely come through the media, with attacks against aggressive tax planning on the part of multinational corporations, accusing them of not paying their "fair share" of taxes in their home countries. However, a major point that may have been overlooked by the general public is that most multinationals that are engaged in BEPS do so quite legally. Tax planners for these companies have found loopholes in tax treaties that permit BEPS. This is precisely the reason that affected countries and the OECD are proposing action to curtail or limit BEPS as much as possible. This article will discuss why companies pursue BEPS, how they accomplish it and why home countries are concerned with it. In addition, the article will briefly describe OECD recommendations to member countries to limit the practice.

Why Companies Pursue BEPS

BEPS allows a company to lower its worldwide tax obligations and, as a result, maximize after-tax income and cash flow. To illustrate BEPS, the United States has a maximum marginal tax rate for corporations of 35 percent while Ireland's and Bermuda's corporate tax rates are 12.5 percent and 0 percent respectively. For a simple example, assume a U.S.-headquartered company has $1 million of income taxed at the maximum marginal rate. If the income is attributed to activities in the United States, the company will have a tax obligation of $350,000 and $650,000 remaining after satisfying that obligation. On the other hand, if the income is attributed to activities in Ireland, the company will have a tax obligation of $125,000, resulting in $875,000 of after-tax income and cash flow. The company retains 35 percent more income and pays 64 percent less tax if the income is attributed to Ireland than if it is attributed to the United States. If the income is attributed to activities in Bermuda, the same company would pay $0 in tax and retain the entire amount of pre-tax income and cash.

Common Ways BEPS is Accomplished

The most common ways that BEPS is accomplished are:

- Loans from branches located in low tax jurisdictions to branches located in high tax jurisdictions;
- Exploiting the mismatching treatments of hybrid instruments and entities;
- Transfers of income-generating intangible and tangible assets to business segments or divisions located in low tax jurisdictions; and
- Avoiding withholding taxes via derivative contracts and inversions.

A main reason multinationals are able to accomplish BEPS is that many countries' and jurisdictions' tax systems are created essentially in a vacuum, without regard to consideration of how other tax systems work. Multiple entities across multiple companies in multiple countries are often not aligned with each other and do not communicate with each other, creating vast differences in the way income might be taxed in one country versus another. For example, one country might create a tax system with largely domestic entities in mind and then depend on certain economic incentives such as foreign tax credits for taxes paid by corporations in other countries.

Loans

Controlling the jurisdiction in which the income is assigned is commonly accomplished by creating a branch in a low income tax

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jurisdiction and then allocating income to that jurisdiction. This often occurs when a company is headquartered in a country that has been granted an exemption for foreign branches through domestic law or treaties. The branch in the low tax jurisdiction loans money to the headquarters located in a high tax jurisdiction. The interest associated with the repayment of the loan is treated as deductible by the headquarters. Simultaneously, the interest becomes taxable income for the branch, but at a much lower marginal rate. The payment allows the company to lower its tax obligation by lowering taxable income in the high tax jurisdiction via the interest deduction and increasing taxable income (interest) to the lower tax jurisdiction.

Mismatching Treatments of Entities and Financial Instruments

Various countries treat certain entities differently from each other for tax purposes. BEPS can be accomplished when one country views an entity as taxable and another country views it as a "flow-through" entity. For example, suppose a branch located in Country 1 is classified as a taxable entity in that country and as a flow-through in Country 2 where the parent company is located. The branch receives a loan from its parent company. The difference in classification of the branch in Country 1 vs. Country 2 allows the group as a whole to claim a deduction for interest paid by the branch in Country 1 on a payment that is not taxed to the parent in Country 2 due to the flow-through status of the branch in that country.

In addition, differences may exist between countries in the way they treat financial instruments for tax purposes. For example, suppose Multinational 1 sells a financial instrument to Multinational 2. In Multinational 1's tax jurisdiction, the instrument is treated as equity, while in Multinational 2's jurisdiction, it is treated as debt. Therefore, a payment from Multinational 2 to Multinational 1 is treated as a debt payment and the interest expense deducted in Multinational 2's tax jurisdiction while being treated as a receipt of dividend by Multinational 1 in its jurisdiction where dividends are largely tax exempt. As a result, neither company is subject to tax on the distribution, resulting in "double non-taxation" of the distributed profits.

Movement of Income-Generating Assets

Multinational companies may accomplish BEPS by moving income-generating intangible and tangible assets from a high tax jurisdiction to a branch in a low tax jurisdiction. The branch in the low tax jurisdiction then licenses certain intellectual and intangible property to the other branches in high tax jurisdictions. The profits from the license agreements are taxed in the low tax jurisdiction, and the license fee expenses are deducted in the higher tax jurisdictions reducing taxable income. A branch in a low tax jurisdiction can also provide services using tangible assets to other branches and re-allocate profits to the more favorable (low) tax jurisdiction. These services and intellectual property are often difficult to value, therefore making it difficult for taxing authorities to dispute the transfer pricing of the service of intellectual property. Many multinationals price these services high to allocate more income to the lower tax jurisdiction and then value intellectual property low to avoid recognizing income from the transfer in the high tax jurisdiction.

Avoidance of Withholding Tax

Some multinationals also employ strategies to avoid withholding tax requirements. Withholding tax is a tax levied on the income of a nonresident or foreign-headquartered entity. Interest and dividend income is often subject to withholding tax, so many companies use the fees associated with derivative contracts rather than loans to shift profits between branches. Instead of loaning money between branches, derivatives are sold between branches with fees attached to the contract. The branch buying the derivative is typically in the higher tax jurisdiction and able to deduct the fees while the other branch in the lower tax jurisdiction recognizes the fees as income.

Other multinationals perform an inversion to try to avoid controlled foreign corporation (CFC) withholding requirements. An inversion occurs when a company engages in a transaction in which a parent company of the organization located in a higher tax jurisdiction with CFC withholding requirements is replaced by another company in a lower tax jurisdiction without CFC withholding requirements. In an inversion, a foreign company (lower tax jurisdiction) buys assets or equity ownership of another company (higher tax jurisdiction). The assets of the company are then owned by the foreign company with a lower marginal tax structure. The shareholders benefit by trading their stock in a company located in a high tax jurisdiction for stock in a company located in a lower tax jurisdiction. In essence, the legal location of the company changes through a corporate inversion from the United States to another country without changing the operational structure or functional location of a company.

The United States government recently took action to curb companies from performing inversions. The U.S. issued updates to treasury regulations for Internal Revenue Code (IRC) sections 385 and 7874. The regulation for section 385 limits the benefits of inversions by reducing the amount of debt the U.S. subsidiary can issue to the foreign parent. Previously, following an inversion, a newly acquired U.S. company could issue debt as a dividend distribution and then the parent company could transfer the debt to a low tax jurisdiction. This series of transactions allows the former U.S.-headquartered company to receive the benefits described above in the loans section. The newly issued regulation treats these distributions now as stock in order to limit the benefits a company gains from inversions and stop companies from receiving the benefits associated with loans to related parties in low tax jurisdictions.

The regulation for section 7874 limits a foreign-headquartered company's use of funds from a stock issuance connected with the previous acquisition of a U.S. company in a transaction that will be treated as an inversion under current tax law. To accomplish this, the regulation excludes stock of the foreign company that can be attributed to the assets of an American company acquired within three years prior to the signing date of the latest acquisition when calculating the foreign parent's ownership percentage to determine whether an acquisition is treated as an inversion.

Why the OECD is Concerned with BEPS

The OECD has stated it believes BEPS poses "serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and nonmembers alike." OECD member countries assert that the avoidance of tax revenues should be limited and that multinationals in their countries should pay their "fair share" of tax. Economic studies surrounding BEPS show that preventing BEPS will not substantially raise tax revenues as a percentage of total tax collected. The semi-elasticity of the profits being shifted has been estimated to be at most 13 percent and as low as 4 percent for every 10 percent drop in tax rate. The average member country of the OECD in 2011 raised 8.8 percent of its total revenues from taxes on corporate profits. Even 13 percent of that 8.8 percent would only be equivalent to 1.14 percent of total revenues. However, the absolute monetary number shows why a country such as the United States would be concerned about BEPS. A 1.14 percent increase in tax revenue is estimated to amount to over $26 billion.

The OECD provides a recommended approach for countries to address possible differing funding structures by multinationals. It recommends that countries use a fixed ratio rule. The rule will limit an entity's net deductions for interest and for other payments equivalent to interest to a specific percentage of its earnings before interest, taxes, depreciation and amortization (EBITDA). The OECD believes this rule should apply to at least the entities in multinational groups. Understanding that not every country is in the same situation, the OECD recommends ratios that range between 10 percent and 30 percent. The organization believes this range will ensure that countries apply a ratio that is low enough to combat BEPS while allowing countries to apply a percentage they feel is fair for the businesses in their countries.

Because the fixed ratio rule does not take into account the fact that groups in different industries may require differing amounts of leverage, the OECD also proposes a group ratio rule. An entity with net interest expense exceeding a country's fixed ratio percentage would potentially be allowed to deduct interest up to the percentage of the net interest to EBITDA ratio of its worldwide group under the group ratio rule. The OECD also recommends countries allow up to a 10 percent increase to the ratio of the group's net third party interest expense when double taxation would occur without the increase.

The OECD also addresses the situation in which a capital-rich branch provides funding for other branches and the headquarters of the multinational corporation but performs few other activities. If this capital-rich branch does not control the financial risks associated with the loans and provides cash without considering the risks, then the profits from interest will not fully be allocated to the capital-rich branch and will instead be allocated to both branches, with the capital-rich branch only recognizing profits at an amount not exceeding the expected return of a risk-free investment (ex., the return for U.S. Treasury Bills) and possibly less if the transaction is not commercially rational. A transaction is not commercially rational if it is overly risky compared to a company's historical transactions.

Examples include the following. Branch A in Country 1, the debtor branch, has an EBITDA of $1 million. Branch B in Country 2, the creditor branch, loans Branch A in Country 1 $10 million at 7 percent interest. Country 1 currently employs a fixed ratio rule of 20 percent. Branch A may only deduct up to $200,000 of the $700,000 of interest it owes to Branch B from its taxable income.

Under the group ratio, the allowed interest deduction varies based on the overall consolidated group net interest to EBITDA

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ratio. Assume the same facts as the previous example, except that Country 1 employs the group ratio rule. Branches A and B belong to Consolidated Group X, which currently has a net interest to EBITDA ratio of 0.6 or 60 percent. Under these facts, Country 1 would allow Branch A to deduct $600,000 of the $700,000 of interest it owes to Branch B from its taxable income. The extra 10 percentage rule would apply if Branch A had borrowed from a third party outside of the country instead of from Branch B. Under this rule, the ratio would be 70 percent (60 percent plus 10 percent), which would allow Branch A to deduct all $700,000 it owes in interest to that third party.

To illustrate the capital-rich provision, assume that Branch B is a capital-rich branch that loans Branch A money at the behest of their parent company without assessing or documenting the risks associated with the determination of the amount and interest percentage of the loan. In this scenario, Branch A can only deduct the interest up to the amount of the expected return of a risk-free investment, in this case a U.S. Treasury Bill with a 3 percent return. This means Company A can only deduct up to $300,000 of the $700,000 of interest it owes to Branch B. However, if the business of Branch A is overly risky and no party would reasonably loan money to it, Country 1 can rule that only an amount less than 3 percent such as 0.5 percent can be deducted. This ruling would limit Branch A's deduction to $50,000.

Mismatching Treatments of Entities and Financial Instruments

The OECD has not provided specific guidance regarding mismatching entities, but rather takes the position that entities should be viewed on a case-by-case basis. In this regard, the OECD proposes to include a new provision with detailed explanations in the OECD Model Tax Convention to ensure that benefits of tax treaties are granted in appropriate cases, but also that such benefits are not granted in cases in which neither country treats the income of an entity as the income of one of its residents.

To combat the use of mismatching financial instruments, the OECD recommends linking rules that align the tax treatment of an instrument with the tax treatment in the counterparty jurisdiction but otherwise do not tamper with the commercial outcomes of the instrument. These rules automatically apply by default, and the OECD provides an order for rules to be considered starting with a primary rule and then a secondary or defensive rule. The primary rule will first be applied in a situation of mismatching instruments. However, if the primary rule is not employed, then the counterparty jurisdiction will apply a secondary or defensive rule to effectively garner the same results. The rules cannot be used simultaneously. This prevents more than one country from applying the rule simultaneously and avoids double taxation.

The recommended primary rule provides that countries deny a taxpayer's deduction for a payment up to the amount it is also deductible in another country or up to the amount the payment fails to be included in the recipient's taxable income in the counterparty jurisdiction. When the primary rule is not applied, the counterparty jurisdiction can generally apply a secondary or defensive rule. Depending on the nature of the mismatch, the secondary or defensive rule will require the deductible payment to be included in income or deny the duplicate deduction.

To illustrate the primary rule, assume that a specific instrument is viewed as a debt instrument in Country 1 and an equity instrument in Country 2 where approximately 70 percent of earnings from equity instruments are deducted or exempted from taxable income. Branch B in Country 2 makes a payment associated with a particular financial instrument to Branch A in Country 1 of $1 million. Under the current rules, Branch A's payment of $1 million to Branch B would be fully deductible by Branch A as an interest payment while Branch B would only be taxed on $300,000 since the payment would be classified as a dividend. Under the primary rule, Branch A would only be able to deduct up to the amount Branch B is forced to recognize as income for tax purposes. That means Branch A can only deduct $300,000 of the payment while Branch B would still be taxed on $300,000. The rule ensures that the company does not gain the benefit of deducting the additional $700,000 of the payment while not being forced to pay taxes on that amount.

Movement of Income-Generating Assets

The OECD makes clear that for intangible assets, legal ownership alone does not necessarily generate a right to the return that is generated by the use of the intangible asset. The group of companies performing important functions, controlling economically significant risks and contributing assets rather than the company owning the intangible asset will be entitled to an appropriate return from such assets reflecting the value of their contributions.

Also, the OECD recommends a "nexus-approach" to limit BEPS through the movement of income-generating assets. The organization developed this approach to combat the abuse of intellectual property (IP) regimes, which is a special tax regime used by several countries to incentivize research and development by taxing patent revenues differently from other commercial revenues. The approach limits the amount a taxpayer can benefit from an IP regime to the extent that the taxpayer incurred the research and development expenditures that produced the income generated by the use of the IP. The approach tracks expenditures as a measurement for activity. The OECD believes that a "substantial activity" requirement will guarantee that the entities benefiting from IP regimes actually engaged in the R&D activities, and incurred the expenditures associated with the research and development associated with the IP. The "nexus-approach" can also be applied to other income derived from transferred tangible property.

Avoidance of Withholding Tax through Derivatives and Inversions

To prevent BEPS, fee payments associated with derivatives can be treated the same way as loans for tax purposes since they are classified as payments economically equivalent to interest. The payments will then be included in the calculation for the fixed or group ratios.

The OECD lays out six building blocks that will help decrease the incentives for a company to perform an inversion:

(1) The organization begins by defining a Controlled Foreign Company (CFC) as a foreign company that is controlled by shareholders in the parent jurisdiction.
(2) The OECD recommends that CFC rules only apply to controlled foreign companies that have effective tax rates that are meaningfully lower than those applied in the parent jurisdiction.
(3) It recommends that countries define CFC income for which CFC rules apply.
(4) It recommends that countries use the rules and definitions of the parent jurisdiction to compute the CFC income to be attributed to shareholders. The OECD also recommends that CFC losses should only be offset against the profits of the same CFC or other CFCs in the same jurisdiction.
(5) The OECD recommends the amount of attributed income to a jurisdiction should be calculated by reference to the proportionate ownership or influence located within that jurisdiction when possible.
(6) The OECD emphasizes the importance of both preventing and eliminating double taxation, and it recommends, for example, that jurisdictions with CFC rules allow a credit for foreign taxes actually paid, including any tax assessed on intermediate parent companies under a CFC regime. It also recommends that countries consider relief from double taxation on dividends on and gains arising from the disposal of CFC shares where the income of the CFC has previously been subject to taxation under a CFC regime.

These recommendations will help countries implement effective CFC rules resulting in a lower number of developed countries without CFC withholding requirements. Also, if a multinational relocates to countries where it does not have substantial economic activity, the OECD recommendations regarding the movements of assets will limit the amount of income shifted to these countries without substantial economic activity. These recommendations, if implemented, will help decentivize companies to perform inversions to avoid CFC withholding tax, as multinationals will have fewer countries in which to relocate their headquarters to avoid tax.

A Step in the Right Direction

BEPS is clearly an issue that affects the tax revenues of countries across the world. The recommendations of the OECD to curb the acts of BEPS have taken a step in the right direction. Whether these recommendations will be implemented by OECD members into domestic law and/or tax treaties has yet to be determined.

Although many countries such as the United Kingdom and United States have expressed keen interest in implementing these recommendations, implementation will take time. The United States has even already taken actions to limit the opportunities for and benefits of U.S.-headquartered companies performing inversions. However, OECD member countries will surely continue to provide recommendations to combat BEPS in the future as new strategies to exploit loopholes in the international tax environment are employed by multinationals. ■

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