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BEPS

BEPS is an old story with a new acronym.

At the heart of the matter is a conflict over whether governments should impose a corporate income tax, and if imposed, whether the tax is viable or easily avoided so that eventually it will repeal itself. A purpose of the BEPS initiative is to "establish international coherence of corporate income tax" but this purpose is in conflict with much of the work on corporate tax that has been undertaken by the OECD for two decades.

OECD research has found that the corporate income tax is inefficient because of capital mobility and tax competition. This has been endorsed explicitly or implicitly in certain quarters in the US as well (for example the 2005 tax reform panel).

The corporate tax can be eroded by moving the source of corporate income, which is highlighted by BEPS, and by movement of the

business activity. Economists project models with certain assumptions about the economy and then speak eulogies at the funeral of the corporate tax but curiously (for these economists) even in countries with robust consumption taxes, corporate taxes contribute a remarkably stable proportion of revenues to the fisc. During the financial crisis that proportion dipped, but now it is coming up again.

The assumptions upon which the models that say corporate taxes are unsupportable are built are perfect capital markets, perfect capital mobility and immobile labor markets. As we all know from the financial crisis (if not before) capital markets are far from perfect.

The question of the source of profits in corporations also has tax implications, whether it's the risk free return, return on risk and return on rents. The consensus is at least that the risk free return shouldn't be taxed, but there's no agreement on how to measure that, and how to tax the other two forms of return.

So although economic literature supported by the OECD shuns the corporate tax, in practice it may be that the assumptions underlying the

models are unrealistic, and in practice governments haven't been able to give up the reliable revenue coming from the corporate tax. On the contrary, in the wake of the financial crisis, NGOs, mostly European, and the press, focused on studies showing that multi national companies avoided a large amount of tax especially in less developed countries, with the clear implication that this is a tax that should be preserved. In addition, EU members had falling revenues and increasing obligations, and the average working person was suffering budget cuts and their consequences and the press was saying multi national companies make lots of profits from our economies and don't pay their fair share. The arguments were more in the nature of equity rather than purely economic. Multi national companies were using profit shifting to concentrate as high a proportion of their profits in tax free or low tax jurisdictions as possible, paying as little tax as possible in both developed and developing countries.[1]

In the US we have flexibility on the size of the deficit and can use it as a way of managing the economic cycle, but in Europe the permitted

[1] OECD (2013), *Addressing Base Erosion and Profit Shifting*, OECD Publishing

proportion of GDP in deficit is rigid, and relatively marginal amounts of revenue can be important.

Within Europe there was considerable conflict between the needs of the member countries. Despite resistance to coming to a consensus, pressure kept mounting. The G20 decided that the international tax standards needed to be fixed. So in 2013 BEPS was born.

The achievement of BEPS is the statement of mea culpa: a system that was built to avoid double tax has ended without even a single level tax. Most problems arise from the nature of OECD guidelines which are drafted in general language and private practitioners interpret the rules according to their own needs. What's needed is detailed, prescriptive guidance for all participants in world trade and most urgently for less developed countries. But the OECD avoids that kind of drafting - they like general principles. There are 34 countries with different agendas and the way they fudge the differences is by writing vague principles that can be interpreted in whichever way you want.

One way (but not the only way) to divide the BEPS discussion is into (1) hybrid instruments and entities etc; (2) transfer pricing and profit shifting and (3) treaties[2]. They are somewhat different problems with different countries and interest groups focused on them in different degrees.

So despite the conflicts amongst the countries and with the research the OECD itself has sponsored, the OECD is starting a discussion when 2 years ago they were claiming nothing was wrong and is trying to reach agreement as to how the rules of the game should change. There's a push to collect taxes and a resistance to change. Those countries that resist change, such as Switz and Lux have been forced to move on a number of other issues: such as the exchange of information. The EU has opened up an investigation on unfair competition.

And the pressure for change continues from outside sources such as NGOs and less developed countries.

[2] OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing.

And from an entirely different quarter, the IMF released a study in response to the OECD with the ultimate conclusion that international tax planning is not a zero sum game - the untaxed penny in one country is ALSO untaxed by someone else. The global outcome of planning has negative externalities; total public investment that's lost. As one earth, there's less tax paid, less investment in education, infrastructure, etc. The IMF has framed the issue as a global responsibility - examining the public investment in the world economy, and especially in common resources.[3]

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[3] International Monetary Fund (2014), *Spillover in International Corporate Taxation*, Washington: International Monetary Fund

[4] OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing.

In transfer pricing, intangibles are still the greatest issue and the US has sophisticated rules in this area and is much more advanced than the OECD. The interaction between the US economic substance principles and transfer pricing is a promising area for other countries to watch. When economic substance is more fully deployed by the IRS it will have implications for the other questions of hybrid instruments and hybrid entities here too. The contours of economic substance are still being worked out.

All this leads to the question of changing the US tax law. The debt equity rules aren't going to change much. There will always be new cases and rulings for TRUPs and contingent convertibles and their progeny; but we're not going to change the unknowability of the boundaries between the two and or the deductibility of interest and the structure of the DRD. All of this has been heavily criticized and yet is still with us. As to check the box and the associated tax planning, the future of that will depend on international tax reform, which is one of the lynchpins of all reform discussions. There is great interest in using

repatriation to pay for cherished things like highways, but repatriation also means making tough decisions elsewhere in the tax system.

So Congress is certainly not going to follow any OECD guidelines just because they're there. Although I haven't read any studies on this, I'm guessing it is much harder to get law change here than for any of our trading partners. Congress is a very deliberative body and Treasury is quite deliberative too. Despite all the press on inversions we haven't had anything pass through Congress to prevent it happening . Any change tends to be incremental and is often only partially effective.

So, the corporate tax is still with us despite its mixed reputation and even if its share of revenues declines it's not a de minimis tax. And the debt equity distinction is with us as is the immense gulf between the taxation of corporations and passthroughs. That doesn't mean these will never change. It just means that change will be after protracted discussion and a great deal of compromise. And whatever happens with the OECD and BEPS, the end result will still be a corporate tax, a debt

equity distinction and a difference between passthroughs and corporations. I'll bet my career on those predictions.