Harmful Tax Competition and BEPS Action Point 5 – Been There, Done That?

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1. Introduction

1.1 What is 'harmful' tax competition?

There is no universal definition of tax competition, and a definition of *harmful* tax competition is even harder to agree on. Tax policy is set by governments, and the tax regime in any country may play a part in a potential investor's decision whether or not to invest in that country (either a domestic investor considering investing at home or abroad, or an international investor choosing the location for a new business venture). A simple definition of tax competition is therefore "competition among governments to attract investment by creating favourable tax regimes"[1].

Tax competition can be harmful if, or when, it leads to economic distortions, as tax policies skew investment decisions. This can have negative effects for a country that loses tax revenue as economic activity moves abroad, and may also be harmful on a global basis if resources are not allocated efficiently and therefore there is a reduction in total welfare. In some cases tax competition may also encourage tax evasion, if strict secrecy rules tempt taxpayers to move income or assets offshore and out of sight of other tax authorities, enabling them to under-declare their taxable income in their state of residence.

By the 1990s the OECD had formed the view that tax competition up to a certain level is positive and to be encouraged, but that some forms of competition are harmful and reduce welfare overall through distorting the allocation of resources and shifting the burden of tax onto less mobile factors of production.[2] A distinction was therefore made between acceptable tax competition and harmful tax competition.

The OECD's view of harmful tax competition, and the reason for a multilateral approach to the issue, can be understood as a type of prisoners' dilemma, where countries' ability to choose their own tax policy has resulted in a sub-optimal outcome on a global basis. Each country has the option to compete over tax policy (i.e. use its tax regime to attract investment, to the detriment of other countries), or to co-operate and not adopt harmful tax practices. As co-operation leads to a more efficient allocation of resources, global welfare is highest when countries co-operate. However, each country may individually achieve a higher payoff (i.e., the combination of economic stimulus and tax revenue deriving from investment) if it adopts a competitive tax strategy but others have not done so.

1.2 Attempts to curb harmful tax competition

This essay outlines the original proposals put forward by the OECD in 1998 in response to the issue of harmful tax competition, and examines the way in which these have developed over time. Due to both the inherent challenges in reaching a global consensus on this type of issue, and careful political intervention by both member and non-member countries, the eventual output of the project was much narrower than initially intended.

[1] Webb 2004 page 788
[2] OECD 1998 page 14

Action Point 5 of the Base Erosion and Profit Shifting ("BEPS") project currently underway at the OECD covers Harmful Tax Practices[3]. The first publications in respect of this action point are due in September 2014; however the scope of the work describes this as revamping[4] the earlier work on this subject area. Although there is a slight difference in focus between Action Point 5 and the original OECD report into Harmful Tax Competition, the basic aims are very similar, and had the 1998 report met those aims it is unlikely that this revamp would now be required – rather, it is a re-do of work which was started back in 1998.

Reaching a new international consensus is always complex, and as tax is at the heart of national sovereignty any attempt to impose tax policy on other countries will be met with resistance. The original work in the area suffered due to a lack of political will, particularly subsequent to the change in the administration of the United States ("US") following the 2001 presidential elections. As a result, the project evolved away from harmful tax competition and refocused on a transparency and exchange of information agenda, with good success.

Many of the challenges which prevented the harmful tax competition project from making significant progress the first time around are still as relevant today, so the BEPS project faces an uphill struggle to change the international consensus in this area. However, it has the benefit of experience, and significant political support (for the time being at least), so it still has a chance of success.

[3] Full details of the project are available at http://www.oecd.org/tax/beps.htm
[4] OECD 2013(b)

2. The 1998 Report on Harmful Tax Competition

The current work on harmful tax competition can be traced back to the OECD's 1998 report entitled Harmful Tax Competition: An Emerging Global Issue (the "1998 report").

2.1 Identifying harmful tax competition

The 1998 report identified harmful tax competition by looking at three situations where tax levied on income from geographically mobile activities in country A is lower than that which would be levied in country B. These were that:

a) Country A is a tax haven and imposes no or nominal tax on that income,
b) Country A's tax regime has preferential features which subject the income to no or minimal taxation (although tax revenues are raised from other types of income at higher rates), or
c) Effective tax rates are lower across the board in country A, although significant tax revenues are raised.[5]

The OECD excluded situation c) from its report on the basis that this is not harmful tax competition, but merely represents a country exercising its fiscal sovereignty and choosing to impose lower tax rates. Where the boundary lies between "nominal tax" in the situation a) and "significant revenues" in c) is, however, not made clear.[6]

In both situations a) and b) above, the OECD identified zero or low taxation as the starting point to identify such a regime. However, this itself was not considered sufficient for a country to be a tax haven (situation a) above), or for a preferential regime to be harmful (situation b) above) – the 1998 report makes clear that any regime must be assessed individually to determine if it is harmful, but identifies key factors which may indicate this.

Three factors were identified as being characteristic of a tax haven:

- No or only nominal taxation, and at least one of:
  - lack of effective exchange of information;
  - lack of transparency; or
  - no substantial activities.[7]

Similarly, harmful preferential regimes were identified by:

- No or low effective tax rates, and at least one of:
  - "Ring-fencing" of regimes;
  - Lack of transparency; or

[5] OECD 1998 para 40
[6] This is a potentially significant issue, as imposing "nominal tax" can lead a country to be characterised as a tax haven, whereas "significant revenues" imply that the regime is not considered harmful (or at least, outside the scope of the 1998 report and therefore not within the OECD's focus). For a country with a low but uniform tax rate, falling into the "nominal tax" category has a totally different outcome from being classed as deriving "significant revenue".
[7] OECD 1998 Chapter 2 Box I

- Lack of effective exchange of information.[8]

These factors underline the OECD's key concerns – that tax havens or harmful regimes may facilitate tax evasion, or may skew investment decisions and attract resources away from higher tax economies purely for tax reasons, thereby "poaching" the tax base of other governments.

In both cases, the 1998 report fails to set a clear test, but rather sets out these potential indicating factors. In addition, the report provides guidance on how it may be possible to assess whether a potentially harmful regime is in fact harmful by considering its economic impact, namely:

- whether the regime shifts activity from one country to another rather than generating new activity;
- whether the level of activity in the host country is commensurate with the level of income;
- whether the tax regime is the primary motivation for choosing the location of the activity.[9]

2.2 Recommendations to curb harmful tax competition

The 1998 report makes 19 recommendations for actions to curb harmful competition, divided into three categories – unilateral measures, bilateral measures and multi-lateral measures. The multilateral measures were acknowledged as the most difficult to adopt but were considered essential because "co-ordinated action is the most effective way to respond to the pressures created in the new world of global capital mobility."[10]

Although the recommendations of the 1998 report were broad ranging, they lacked some of the clarity required to make concrete progress. For example, Recommendation 19, "that the new Forum engage in a dialogue with non-member countries using, where appropriate, the fora offered by other international tax organisations, with the aim of promoting the Recommendations set out in this Chapter, including the Guidelines"[11] is surprisingly cautious, and could be acted upon, and dialogue take place, but with no progress made towards changing the behaviour of non-member countries.

Despite their limitations, the recommendations of the 1998 report had the potential to make significant changes in the way in which member states designed favourable tax regimes, and bring engagement with non-member states. Even without the participation of Switzerland and Luxembourg, who abstained from the report, the ground had been laid for a significant change in the manner in which countries used their tax systems to compete with each other for international investment.

[8] OECD 1998 Chapter 2 Box II
[9] OECD 1998 para 81-84
[10] OECD 1998 para 91
[11] OECD 1998 Appendix paragraph 19

3. Response to the 1998 Report

Following publication, the 1998 report encountered criticism from a number of sources, both close to the OECD and independent to it. As the OECD operates through consensus and was aiming to define new international norms, its work could never be wholly successful unless it engaged in debate and achieved buy-in from key stakeholder groups, a challenging task given the conflicting interest of these parties.

3.1 Response of the BIAC

The Business and Industry Advisory Committee to the OECD ("BIAC") noted in its 1999 response document that it had not been consulted during the preparation of the report.[12] This report went on to outline some serious concerns with the 1998 report, noting that the report would "if acted upon, create a cartel-like atmosphere which is in clear conflict with the concept of free trade and investment across national frontiers, and which has never proved successful over a long period of time to the countries involved."[13]

Although the BIAC represents the views of business, this comment, and the theme underlying its response, was one in support of fiscal sovereignty for small and non-member states on the basis that tax competition is a positive phenomenon, improving the efficiency of resource allocation and imposing a fiscal discipline on governments.

That the business community was supportive of tax competition was perhaps no surprise. However, given the power of the business lobby, both from the BIAC and other interest groups, it is more surprising that there was no consultation in advance of the report being published, particularly as the OECD's response showed a willingness to co-operate on this matter.

As a result of the BIAC's campaign, Jeffrey Owens, OECD Head of Fiscal Affairs, and Richard Hammer, the Chair of the BIAC's Committee of Taxation and Fiscal Policy, published a jointly authored statement entitled "Promoting Tax Competition"[14], making it clear that the BIAC had become involved in the project and was being listened to by the OECD.[15]

While the joint statement confirms the OECD's commitment to promote fair tax competition it notes that the current work stems from a concern over regimes which "distort economic behaviour and widen the avenues for non-compliance with the tax laws of a taxpayer's home country."[16] This remains consistent with the original belief behind the 1998 report that beyond a certain point tax competition has a welfare cost overall as it results in a less efficient allocation of resources.

Although the statement did not move away from the views of the 1998 report, its language was conciliatory in tone, and the statement confirmed that "the project has evolved into a more co-

[12] BIAC 1999, "A Business View on Tax Competition"
[13] BIAC 1999 page 2
[14] Hammer and Owens 2001
[15] The statement notes that since the publication of the 1998 report, the OECD's Committee on Fiscal Affairs and the BIAC "have developed an increasingly cooperative relationship to address the challenging issues, both technical and political, raised by the project."
[16] Hammer and Owens 2001

operative effort, with a particular emphasis on the elimination of tax practices and regimes that facilitate non-compliance with tax law."[17] This was a clear indication that the focus of follow-up work being done by the OECD was centered on non-transparent regimes which facilitated tax evasion, rather than preferential regimes which facilitated erosion of other states' tax bases.

3.2 Response of non-member countries

The 1998 report made clear that any response to harmful tax competition needed to involve non-member countries, both in order to alter the behaviour of those who may be considered tax havens or to have harmful preferential regimes, but also to facilitate co-ordinated responses to these regimes amongst more than just the (then) 29 OECD member states.

Some countries were quick to signal their co-operation with the project, and by the time of publication of the first update in 2000[18] a number of tax havens had already committed to eliminate harmful tax practices and comply with the principles of the 1998 report. The willingness of this group of countries to cooperate with the project led the OECD to establish a distinction between "cooperative" and "un-cooperative" tax havens, with the former being omitted from any "naming and shaming" provided that they continued to make progress towards eliminating any harmful aspects of their tax system.

However, there were a number of reasons why tax havens chose not to adapt their tax systems in response to the OECD's work. The OECD member states are, in general, large economies with significant global power, whereas many of those countries being identified as tax havens were small island nations. These countries were not in a position to deal with the OECD as equals, and many felt that they were being stripped of fiscal sovereignty. Many of these countries had, in recent decades, developed sophisticated banking or financial services industries, in an attempt to modernise their economies and drive economic growth, and the enforced change of tax policies was likely to threaten these industries and damage the economies of these small nations.

Given the small size (both geographically and in respect of their economies) of most of these countries, traditional theories of bargaining power would suggest that they had little sway over the OECD and would be unable to change the outcome of the process. Faced with a decision to either co-operate or be included on a black list of un-cooperative havens, many countries would choose to co-operate to avoid the reputational damage to their economies from being blacklisted[19]. In addition, by engaging with the OECD, these countries were given a voice in the ongoing discussions which enabled them to influence the OECD's developing approach.

Subsequent to publication of the first list of potential tax havens in July 2000, the OECD published in November 2000 a Memorandum of Understanding that outlined the commitments each tax haven would need to make in order to avoid potential blacklisting and the threat of co-ordinated action. However, as early as January 2001 the OECD's position on tax havens was wavering due to the outcome of a meeting held with Commonwealth countries, including a large number of tax havens, at which these countries showed their support for the "principles of transparency, non-

[17] Hammer and Owens 2001
[18] OECD 2000
[19] James 2002 discusses this in detail in respect of Caribbean Community countries.

discrimination and effective exchange of information on tax matters" and agreed to work with the OECD to support its work on harmful tax practices.[20]

The "no substantial activities test" set out in the 1998 report as a feature of a tax haven was not addressed by the three shared principles, and by engaging with the OECD in this manner the tax havens were able to steer the direction of the OECD's work towards the issues on which they were willing to compromise, and away from the issue of substance. The willingness of tax havens to engage in dialogue and participate in the project may have come as a surprise to the OECD, given the expectation of the 1998 report that these countries would be "unlikely to co-operate in curbing harmful tax competition"[21] as they had chosen to adopt a no/low rate of taxation and so contributed to the race to the bottom of tax rates.

However, the OECD proved willing to steer its work in the direction proposed by the tax havens, perhaps partly because the cooperation of these countries provided a clear opportunity to claim the project as a success, although the interests of member states such as the UK are also likely to have played a part.

Many of the tax havens listed in the 2000 report had close ties to the UK, being Overseas Territories or Crown Dependencies. The offshore financial centres of Jersey, Guernsey and the Isle of Man in particular all featured in the OECD's list and their financial sectors were already under scrutiny as the UK was facing pressure from the US and the EU to improve financial regulation and cross-border exchange of information in its overseas territories.[22] The 1998 report also called on member states with close ties to tax havens to ensure that these links are not used in a way to promote or increase harmful tax competition.[23]

The Isle of Man was relatively quick to cooperate with the OECD and reform parts of its tax system, although Jersey and Guernsey were less willing to participate. However, the UK was itself putting pressure on these countries to commit to effective exchange of information, therefore also prioritising the issue of transparency over more detailed concerns over substance. This suggests that the UK was happy for the OECD's focus to move away from issues of substance, as this less onerous approach met the UK's own priorities and enabled it to claim that its Crown Dependencies were cooperating with the project, and therefore it had met its own obligations under Recommendation 17 of the 1998 report.

The manner in which the Isle of Man agreed to co-operate with the project became significant to the OECD's ability to take actions against non-cooperative tax havens, as the commitments it made to remove harmful aspects of its tax system were conditional on any sanctions developed by the OECD for non-cooperative countries being imposed on both OECD and non-OECD members in a non-discriminatory manner[24]. In making this requirement the Isle of Man (and other havens which

[20] OECD Press Release 10 January 2001, available at http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=PAC/COM/NEWS(2001)3&docLanguage=En (last retrieved 25 August 2014)

[21] OECD 1998 para 43

[22] Christensen, J and Hampton, M, 2002 page 1659

[23] OECD 1998 Recommendation 17

[24] In its letter of 13 December 2000 the Isle of Man's commitment is conditional on a "common framework of defensive measures" being imposed on those jurisdictions, both member and non-member states, that fail to

followed suit, including Jersey and Guernsey[25]) forced the OECD's hand and ensured that non-member countries did not need to adapt their tax regimes until Switzerland and Luxembourg were willing to do the same.

By engaging in dialogue with the OECD and by acting together to strengthen their position, the tax havens had a more substantial impact on the outcome of the project than expected, in particular on narrowing the focus of the OECD's project to exchange of information and transparency, with the substantial activities criterion eventually turning into an issue of non-discrimination.

Webb argues that the success of many small countries in putting pressure on the OECD to move away from dictating global tax policy and adopt a more collaborative approach was due to the use of normative arguments to highlight objections to the principles of the harmful tax competition project, in particular the double standards being imposed – tax havens were being asked to change their tax regimes, while Switzerland and Luxembourg, having abstained from the 1998 report, were under no obligation to adapt their own systems.[26] Given the OECD's own acceptance that action was needed at a multi-lateral level, this was an obvious point of contention.

3.3 Change of US administration

President Clinton's Administration had been a strong supporter of the OECD's work on harmful tax competition[27]. However, soon after President Bush took office in January 2001, his Administration voiced its concerns over the project. In May 2001 the Secretary of the Treasury, Paul O'Neill, expressed his initial concerns about the project, noting that he shares

> *"many of the serious concerns that have been expressed recently about the direction of the OECD initiative… [and is] troubled by the underlying premise that low tax rates are somehow suspect and by the notion that any country, or group of countries, should interfere in any other country's decision about how to structure its own tax system"*[28]

This concern led to a significant shift in policy, with the Bush administration going on to pressure the OECD to change the focus of its work in this area. In a statement before the Senate Committee on Governmental Affairs, Secretary O'Neill outlined his belief that the US should:

> *"attempt to refocus the OECD project on its core element*[29]*: the need for countries to be able to obtain specific information from other countries upon request in order to prevent non-compliance with their tax laws."*[30]

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make equivalent commitments or otherwise satisfy the standards of the 1998 report. While the OECD could have imposed defensive measures on an asymmetric basis, and treated the Isle of Man as an uncooperative jurisdiction, there would have been no justification for such a route.

[25] The list of jurisdictions making such commitments, and the letters by which they did so, can be found at http://www.oecd.org/countries/isleofman/jurisdictionscommittedtoimprovingtransparencyandestablishingeffectiveexchangeofinformationintaxmatters.htm (retrieved 25 August 2014)

[26] Webb 2004 page 810

[27] See, for example, the statement of Treasury Secretary Summers available at http://www.treasury.gov/press-center/press-releases/Pages/ls735.aspx

[28] Statement of Secretary O'Neill 10 May 2001

[29] The OECD has never suggested that exchange of information on request was the core element of the project – rather, Secretary O'Neill seems to have adopted this language to mask the fact that he is turning away from

It is clear from this that the US's interest was to secure exchange of information with tax havens in order to reduce tax evasion. Indeed, Secretary O'Neill went on to comment that "this objective is too important to allow the OECD project to stray into other areas that could distract or hinder success in this objective."[31] His earlier statement of May 2001 makes it clear however that the US's lack of support for the other aspects of the project was not solely due to a fear that these would hinder progress on exchange of information, but that this was also due to ideological objections.

Given the OECD's premise that, for non-haven countries at least, there would be an overall welfare gain if harmful preferential regimes were eradicated, the US's change of opinion is interesting. The US has generally high tax rates, so as well as suffering from tax evasion it was also subject to pressures of tax competition attracting investment away from domestic markets. It is possible that the sheer size of the US economy was sufficient to provide it with some degree of insulation, and that domestic investment was less sensitive to competition from lower tax regimes elsewhere.

It is difficult to gather strong economic evidence on this point – lobbyists at the Centre for Freedom and Prosperity (a pro-market think-tank whose top priority is to preserve tax competition)[32] claim that the US is a net beneficiary from tax competition, and stood to lose economically if the recommendations of the 1998 report were enacted.[33] In contrast, Webb rejects the argument that the change in the US administration's attitude related to a different perspective on the benefits for the US in the OECD's project, but argues that this was due to the free market ideology of the incoming administration, as well as to pressure from interest groups.[34]

3.4 Summary of responses

The responses to the 1998 report were not coordinated – the key players as identified above all had different agendas and different reasons to object to the proposals. However, these agendas had a common theme – the promotion of fiscal sovereignty and the ability of states to use their tax systems as a means of competing in the global economy.

There was general support for the need to exchange information and improve transparency, and by 2001 it was clear that the other aspects of the project, both in terms of harmful preferential tax regimes and tax havens, were being side-lined in favour of these aims.

Clearly, the US's evident lack of support for the project will have played large part in influencing the route taken, but even had the Bush administration been supportive of the original project's aims, these would still have encountered implementation difficulties. The lack of unanimous support within the OECD provided non-member countries with a strong bargaining tool to force the OECD's hand – it is not surprising that the OECD found it unpalatable to impose defensive measures against its own members who had not adopted the recommendations of the 1998 report, but this forced it to accept reduced commitments from non-member countries.

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the OECD's initial aims of the project, and the Clinton administration's acceptance of these. His statement of May 2001 first uses this language to call for a refocus on "the core element that is our common goal", noting at that stage his view that the project in its current form was too broad.

[30] Statement of Secretary O'Neill July 2001

[31] Ibid

[32] See http://freedomandprosperity.org/about/#mission (retrieved 18th June 2014)

[33] Woodward 2004 page 11

[34] Webb 2004 page 814

Indeed, as Kudrle notes, there was a shift on the OECD's approach to the tax haven issue before Secretary O'Neill had voiced his opinions. Whilst the 1998 report identifies tax havens as potentially harmful if they do not require activities to be "substantial", the initial update published in 2000 adapted this criteria to say that a regime is viewed as harmful if it has no requirement for activities to be substantial **or** provides ring fencing from the domestic economy. By the end of 2000, this had almost completely morphed in to a ring fencing test alone[35], and as the OECD extended dialogue with the tax havens in 2001 this test was side-lined in favour of improved exchange of information and greater transparency.

[35] Kudrle 2008 page 7

4. The Eventual Output

As outlined above, the 1998 report generated a strong response from key stakeholders both inside and outside the OECD. Due to the need for a consensus solution (both in terms of taking multilateral action, and also due to the way in which the OECD itself operates) these responses had a significant impact on the work done following the 1998 report, and changed the course of the project.

Whereas the initial goals were broad ranging, the eventual output of the project focused on two areas – a review of preferential regimes within member countries, and an increase in exchange of information and improved transparency within tax havens.

4.1 Review of preferential regimes

The 2006 progress report concludes the OECD's work on harmful preferential regimes in member countries, declaring that this part of the project has "fully achieved its initial aims".[36] Of the 47 potentially harmful regimes identified in 2000, 13 were deemed to be not harmful following closer review, 20 were abolished, and 13 were amended. One regime, the Luxembourg 1929 Holding Company regime, was considered to be harmful but remained in force (although Luxembourg disagreed with this conclusion)[37].

On first glance these figures show a high level of success - of the 34 harmful regimes identified, 97% had either been abolished or amended (although it is interesting to note that the project was deemed to have "fully achieved" its initial aims despite the continued existence of a harmful preferential regime within a member country). However, the manner in which the review was undertaken was conducive to this outcome.

In accordance with the guidelines issued in the original 1998 report, member countries committed to review their existing policies which may constitute harmful tax practices, and remove those harmful features in a phased manner ending on 31 December 2005. To achieve this aim, the Forum on Harmful Tax Practices first asked each member country to review its own policies, and then instigated a peer review process for each reported preferential regime to determine whether it was in fact harmful.

Given the close ties between many of the OECD countries, and the similarities in some of the preferential regimes reported, it is difficult to assess how thorough the review process was. Additionally, the conclusion as to whether a regime was in fact harmful was based on an examination of the regime in practice, not a view on the policy decisions underlying the regime.[38] While this is consistent with the initial approach proposed in the 1998 report (of establishing basic principles which might indicate a harmful regime, but leaving an assessment of whether it is harmful to the facts surrounding the regime), it leaves a mixed message. Two regimes, the Australian Offshore Banking Unit regime and the Canadian International Banking Centre regime seem to have been declared not harmful

[36] OECD 2006 page 6

[37] Luxembourg's 1929 Holding Company regimes was later found to be incompatible with the EU Code of Conduct on Taxation, and was abolished, with a transitional regime being in force until 31 December 2010.

[38] OECD 2004 page 11

> *"on the basis that they do not appear to have created actual harmful effects. This determination was made on specific facts relating to the current limited nature and reduced scope and size of the regimes."*[39]

On a policy level this indicates that even 6 years after the publication of the initial report, there were a number of member states which still had preferential regimes with the hallmarks of harmful practices. Although these were small enough in size not to generate actual harmful effects at that point in time, it suggests that member states had not fully embraced the aims of the project.

4.2 Engagement with non-member states

Following early commitments made by some tax havens to eliminate their harmful tax practices, these countries were excluded from the initial list of tax havens published in the 2000 report. This list named 35 countries which met the tax haven criteria as outlined in the 1998 report. These 35 countries were the potential targets of co-ordinated defensive measures, however the OECD was keen to engage in dialogue with these countries, and therefore recommended that defensive measures were only applied to those countries which remained on its list of Uncooperative Tax Havens when this was published in 2001 (giving these tax havens a 12 month period in which to make a commitment to eliminate their harmful tax practices and therefore become a "cooperative" tax haven).

By the time the 2004 report was published, only 5 countries remained on the list of uncooperative tax havens, as the vast majority of countries had made commitments to remove their harmful practices and had become "participating partners" in the project.

As the OECD was forced to concede that defensive measures would not apply to non-member countries any earlier than to member countries, and given the refusal of member states such as Switzerland and Luxembourg to commit to information exchange, the defensive measures proposed were, even in 2004, still a theoretical rather than practical threat.

The fact only 5 non-cooperative tax havens remained in 2004 from a starting point of 35 countries meeting the tax haven criteria must therefore be testament to the negative consequences of "blacklisting" on these countries, and so their desire to cooperate with the project, rather than as a consequence of the sanctions imposed. However, the shift in the OECD's approach to focus solely on transparency and effective information to determine whether jurisdictions are considered to be cooperative, and ignore the original test of a substantial activities criterion, will also have helped reduce the number of jurisdictions which were labelled un-cooperative.

The work with these participating partners was carried out through a working group known as the "Global Forum Working Group on Effective Exchange of Information", which has now become the Global Forum on Transparency and Exchange of Information for Tax Purposes (the "Global Forum"). This Forum has made real progress in reaching international agreements on exchange of information through bilateral agreements, through promoting the multilateral convention on Mutual Administrative Assistance in Tax Matters, and through the launch of a peer review process to monitor how effective the exchange of information process is in each jurisdiction.

[39] OECD 2004 page 10

4.3 Success?

Although the Global Forum has done much to improve transparency and information exchange, this only targets one of the aspects which the 1998 report initially addressed. Improved transparency will reduce tax evasion, by making it more difficult for taxpayers to hide income and assets offshore and out of sight of their own tax authorities. However, it does little (or nothing) to change the behaviour of tax payers who declare all their foreign income and assets, but use attractive offshore regimes to reduce their overall tax burden.

One of the major criticisms of the work which followed the 1998 report is this shift in focus and the manner in which the OECD's original intentions became side-lined. Easson comments that the 1998 report

> *"claims to focus on geographically mobile activities, and... the tax treatment of interest on cross-border savings instruments, particularly bank deposits, is not considered (in the first stage of the project)... Yet, as we have seen, the issue of exchange of information has come to dominate the entire tax competition project."*[40]

This focus on exchange of information is certainly what Secretary O'Neill was keen to promote (see section 3.3. above), as this would assist the US in reducing tax evasion where passive investment income was hidden from the tax authority. However, for other countries that were also interested in the work around tax policy and preferential regimes, this reduced scope may mean the project is only seen as a partial success.

There is also conflicting evidence on the success of the project in reducing the flow of mobile capital to tax advantaged regimes. Kudrle argues that despite being an early adopter of the OECD's project (making an advance commitment to eliminating their harmful tax practices in June 2000[41]) and committing to effective exchange of information, the Cayman Islands have seen little noticeable impact on inwards investment.[42] This suggests that the use of tax havens may not have declined despite the improvements in transparency which were achieved. It is possible that compliance has improved, which would itself be a sign of success for the project, but it seems unlikely that centres with a reputation for their use as a tax haven would retain such a high degree of investment if they could no longer be used to evade taxes.

Using a different methodology, Avi-Yonah argues that the OECD's project has been a success overall, as corporate income tax revenues have remained relatively stable in OECD countries (a decline in headline tax rates has been met by a broadening of the tax base), whereas non-OECD countries have seen a decline in revenues over the same period. This evidence, he argues, shows that the work of the OECD to eradicate harmful tax competition has enabled governments to retain this revenue stream, whereas non-member countries who have not been so vigilant in this area have suffered accordingly. [43]

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[40] Easson 2004 pg 1071

[41] The letter making this commitment can be seen at http://www.oecd.org/ctp/harmful/1903543.pdf (retrieved 19 July 2014)

[42] Kudrle 2008 pg 15

[43] Avi-Yonah 2009 pg 792

This conclusion appears to be overly simplistic – even if tax revenues in OECD countries have remained stable, they may have risen if efforts to curb tax competition had been more successful. Similarly, the decline in tax revenues in non-OECD countries is blamed on targeted tax incentives, without any indication of whether these incentives meet the criteria of harmful tax competition. If they are accompanied by full transparency, the criteria of the 1998 report may deem them to be not harmful. While this does not prove that they have been beneficial to the governments who offered them, it does indicate that the 1998 report may have been overly simplistic in the way it identified harmful tax practices, casting doubt on the value of the subsequent work undertaken.

4.4 The Financial Crisis

Although the OECD considered the project to have been completed in 2006, events in 2008 and subsequent years drew attention back to the issues of transparency and harmful tax practices, and showed that the work done had not fully resolved these problems.

Alongside the exchange of information process introduced by the OECD, the US had enacted domestic legislation in 2001 which introduced a Qualifying Intermediary program in which financial institutions were encouraged to participate. Under this program, participating institutions committed to withhold tax from, and report to the IRS on, US source payments received by clients offshore, unless they were in possession of appropriate documentation to certify the availability of reduced rates of withholding under double tax treaties.

Revelations around offshore tax evasion emerged in 2008, including activities of Lichtenstein banks and the Swiss bank UBS in enabling and encouraging US citizens to hide income and assets offshore[44]. The US Senate Permanent Sub-Committee on Investigations held a hearing in July 2008 to gather evidence around these practices, where the scale of the banks' activities became clear. It also emerged that UBS was enrolled in the Qualifying Intermediary ("QI") program, but did not report to the IRS on all accounts held by US persons as the QI program only covered US source income, and therefore allowed US persons to hold offshore accounts with non-US assets, without disclosure to the IRS.

This showed that, despite the OECD's work in this area, and the US's own domestic legislation, banking secrecy was still allowing significant amounts of tax to be evaded by US citizens, and shed the light on problems of enforcement. The Senate report concluded that the scandals:

> *" Illustrate the scope of the problems facing by [sic] countries trying to enforce their tax laws. They also demonstrate the need to strengthen existing international tax initiatives."*[45]

In response to these revelations the US introduced further domestic legislation through the Foreign Accounts Tax Compliance Act ("FATCA"), which aimed to strengthen reporting and withholding requirements, but was also willing to engage in multilateral action to address the issue.

At a similar time, the global economy entered into financial crisis, followed by a long period of "fiscal austerity" in many developed countries, from which recovery remains fragile. As government

[44] These are described in detail in the 2008 senate report available at http://www.hsgac.senate.gov//imo/media/doc/071708PSIReport.pdf

[45] United States Senate 2008, page 36

spending was cut significantly as part of austerity measures, tax revenues also came under pressure. Tax authorities were scrutinised as taxpayers wanted to know that financial burdens were being shared equally.

Against this backdrop it emerged that many (predominantly US headquartered) multinationals were paying exceptionally low effective tax rates. For example, Google's effective tax rate on its non-US profits was reported to have been just 2.4% in 2009, while Apple's was even lower at 2.2% in 2010 and 1.9% in 2011[46]. Tax planning strategies used by these companies, and other multinational groups, gathered significant press attention and were widely criticised. In the UK, the Public Accounts Committee heard evidence from Amazon, Google and Starbucks as part of an investigation into tax avoidance by multinationals[47], drawing attention to the structures used by these companies to achieve low tax rates.

Criticism was levied at these companies for not paying their "fair share" of tax, but was also aimed at governments for creating a tax system which allowed multinationals to operate in this way. As a result, there was a consensus among many developed countries that the international tax system was not fit for purpose, and could not deal effectively with the way in which multinationals do business in a globalised and digital economy.

Although the issues raised were broader than tax competition (for example, the permanent establishment threshold allows companies to operate distribution warehouses in a country without creating a taxable presence, which has allowed companies such as Amazon to locate their valuable activities in different jurisdictions from their customers), the tax practices of some OECD member states have contributed to the situation.[48]

Barely 5 years after the OECD concluded that its work on harmful tax practice had been completed successfully, it was therefore evident that there were significant problems with the global system, as a lack of transparency continued to facilitate tax evasion, and pro-competition policies introduced by governments were being used by corporate tax payers to reduce the effective tax rates they suffered below socially acceptable levels. This made it clear that the earlier work of the OECD in this area had not achieved its aims, and that tax competition continued to distort resource allocations and erode tax revenues.

[46] De Graaf 2013 page 108
[47] Summary available at http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/71605.htm (retrieved 23 August 2014)
[48] For example, The Netherlands has come under scrutiny because evidence given by Starbucks to the UK's Public Accounts Committee (see note 47 above) included reference to a favourable tax ruling that it had received from the Dutch tax authority, but Starbucks refused to disclose the terms of this ruling due to a confidentiality clause imposed by the Dutch tax authority.

5. The BEPS Agenda – Action Point 5

Although the Global Forum on Transparency and Exchange of Information continued its peer review process, and the exchange of information program continued to expand, there had been little substantive progress on the issue on harmful preferential regimes or other harmful tax practices from the 2006 report until public and governmental concern over the tax affairs of multinationals led to a surge in political support for a wholescale review of the international tax system. This caused both the EU and the OECD to begin work to look at issues of double non-taxation, and the G20 also became interested in the area. The scope of the OECD's work widened to include cases of no or low taxation arising from the segregation of income from the activities that generate it, in particular through erosion of the tax base and the artificial shifting of profits between group companies within multinational corporations.

Following an initial report to the G20 on its work on these issues[49] (which became known as Base Erosion and Profit Shifting or "BEPS"), the OECD produced an action plan to address the areas requiring detailed work. The issues under scrutiny through the BEPS project are not limited to harmful tax practices; however the incentive to shift profits into another tax jurisdiction relies on receiving more favourable tax treatment elsewhere, so tax competition remained critical to the OECD's agenda.

<u>5.1 The 2013 Action Plan</u>

The Action Plan on Base Erosion and Profit Shifting ("the Action Plan") notes that "the underlying policy concerns expressed in the 1998 Report as regards the "race to the bottom" on the mobile income tax base are as relevant today as they were 15 years ago"[50], and Action 5 of the Action Plan, entitled "Counter harmful tax practices more effectively, taking into account transparency and substance", is to

> *"Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework."*[51]

This is a clear admission by the OECD that the work that followed the 1998 report did not reach a satisfactory solution to the problem of harmful tax competition. Although Action 5 is to "revamp" this initial work, many of the aims are familiar from the earlier project – preferential regimes have already been evaluated, and the whilst the 1998 report did not use the term "holistic", its methodology, focusing on the overall impact of a regime rather than a tick-box approach, is certainly similar. Equally, engagement with non-OECD member states is nothing new, and has already been undertaken, albeit with mixed success, as part of the earlier work on this subject.

[49] OECD 2013a
[50] OECD 2013b page 17
[51] OECD 2013b page 17

The revamp therefore feels more like a "re-do" than a fundamental re-think of the original work done in this area, although there are slight differences in the language used.

5.2 The substantial activities test

No progress reports have yet been released by the OECD on Action 5, so its likely output and eventual success are still a matter of conjecture. Although the work has many similarities to that of the 1998 report, there is one potentially significant difference in the attitude to ring-fencing and "substantial activities".

Whereas the 1998 report was concerned over the level of substance that tax havens required before allowing taxpayers to benefit from their systems, this was not considered to be a relevant factor in identifying harmful preferential tax regimes, where the concern was over ring-fencing from the domestic economy. As discussed in Chapter 3 above, where the substantial activities test was initially proposed as a criteria to identify tax havens, this proved to be impossible to implement in practice, and within a short period the substantial activities test had been dropped and both sets of criteria looked at ring-fencing from the domestic economy to identify harmful practices.

The Action Plan notes that the "race to the bottom" of which the 1998 report warned us now "takes less the form of traditional ring-fencing and more the form of across the board corporate tax rate reductions on particular types of income."[52] Even the most vocal of supporters of the OECD's work would struggle to argue that this reflects the success of the 1998 report in removing ring-fencing: if preferential regimes are still considered harmful despite not being ring-fenced from the domestic economy, this must be a sign that the initial report misunderstood the significance of the substantial activities requirement.

The aim of the Action Plan in this context is to create a closer link between economic substance and the taxation of profits, following concerns that multinational businesses find it too easy to generate profits in a different jurisdiction from that where most of their "real" business takes place – and that if the link between profits and physical activity is lost, profits become highly mobile. Although the economic substance language may be a slight change from the 1998 report, the aim of the project is clearly very similar. The ability of businesses to shift profits into different jurisdictions is considered harmful because competition among states encourages businesses to shift mobile income streams to a jurisdiction with lower tax rates, preventing governments from collecting the tax revenues they would otherwise be due.

In his comments on the work on tax havens that followed the 1998 report, Secretary O'Neill noted that "application of the "no substantial activities" criterion proved difficult"[53], and it was therefore decided to move to a ring-fencing test to identify a harmful tax haven. The challenges facing the OECD over a decade ago remain in place today, and are likely to be exacerbated by the political climate. In looking at a "substantial activities" test for a tax haven, the OECD was largely passing judgement on tax regimes of non-member states. However, preferential tax regimes have flourished in the 16 years since publication of the 1998 report, and are common within OECD member states themselves as well as elsewhere. Any benchmark of "substantial activities" which will now be agreed

[52] OECD 2013b page 17
[53] Statement of Secretary O'Neill July 2001

will affect many OECD member states themselves, and given as these preferential regimes are designed to attract economic activity, each member state will surely believe that its own preferential regime does align taxation with economic substance, and is not harmful.

There are therefore a number of challenges to be overcome before a political consensus can be reached. Additionally, the OECD faces the prospect of integrating any substance requirement with existing transfer pricing principles, which have long been established as the method by which profit should be allocated between jurisdictions. These principles have not been sufficient to relieve concerns over the shifting of profits within multinational groups, and while the principles are also under review as part of the Action Plan, the OECD has been keen to state that it does not envisage a departure from the arm's-length standard on which they are based.

The Action Plan also does not differentiate between tax havens and harmful preferential regimes – the references are only to harmful preferential regimes, although it is not clear whether this reflects an intention to only focus on harmful preferential regimes as understood by the 1998 report (i.e. those regimes in countries where other parts of the tax system generate significant revenue), or if this term has been re-defined and also includes tax havens where there are no or nominal taxes across the board.

5.3 Non-member countries and interest groups

One of the reasons why the initial work on harmful tax competition failed to deliver on its initial goals was the manner by which non-OECD member states engaged with the project – using their collective bargaining power to ensure that some of the initial demands on tax havens were watered down before implementation. The BEPS Action Plan has been endorsed by the G20, and non-member countries who are members of the G20 have been invited to participate in the project on an equal basis to OECD members.[54]

Through this wider engagement, and by avoiding the “them and us” distinction which was implicit in the 1998 report, the Action Plan starts with greater chances of true international engagement, and therefore a better chance of agreeing a widely accepted solution. However, as with any such political project, different participators will have different interests. US Treasury official Robert Stack has already cast doubt on the success of the project, suggesting that 2015 will be a year of significant negotiations as participants engage in “horse trading” to reach agreements that suit their own priorities in different areas of the Action Plan[55].

As the work of the 1998 report showed, harmful tax competition is an area where there are clear incentives for some participants to delay changing their practices (or to continue them unchanged), and with clear winners and losers it could be an area which is least likely to reach multilateral agreement.

In revamping its earlier work, the OECD now has an opportunity to put right any mistakes which it may have made the first time around. One criticism which has been made of the earlier work was the tactical approach taken, in particular the combative attitude and lack of consultation.[56] In

[54] http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm retrieved 18 July 2014
[55] Quoted in Stewart 2014a
[56] Easson 2004 page 1066

contrast, the OECD has been keen to engage in dialogue and consultation around the BEPS project, and have released discussion papers on many of the action points before taking a final decision. However, Action Point 5 seems to be an exception here, where the work is being undertaken privately, with very little engagement from outside.

Peter Merrill of PricewaterhouseCoopers LLP has commented that the OECD views harmful tax competition as “a matter for governments to address [as a result of which] we don’t have a lot of insight into what is going on.”[57] While governments may be more likely to reach a consensus if they do not consult (and that consensus may be a more radical solution), this lack of consultation increases the risk that the tentative agreement reached is later derailed by lobbying (either for self-interest, or if the agreement reached has genuine flaws which create challenges in implementation). The OECD’s earlier experience of this is clear evidence of the risks faced, where lobbying from all sides, including the OECD’s own BIAC, meant that the language of the 1998 report was being clarified and watered down within a short period from publication.

The ability of the OECD to implement any proposals arising from the work done under Action Point 5, in particular establishing a common substance requirement, will be highly dependent on political willpower amongst the OECD and G20 member states.

5.4 What might Action Point 5 propose?

While Action Point 5 is framed as an attempt to counter harmful tax practices, early indications are that the focus of the work will be on the substantial activities requirement. As the fundamental aim of the BEPS project is to prevent multinational companies from moving their profits around the group to gain tax advantages, this link between the activities which take place in a state and the profits being taxed there is key not just to Action Point 5, but to the whole of the BEPS project.

Whilst Action Point 5 covers any preferential regimes, the most well-known of these, and perhaps most important given the value chains of the largest multinational businesses, relate to intellectual property (“IP”) regimes. The OECD is currently undertaking a review of preferential regimes in member states, which is expected to focus largely on IP regimes such as patent boxes. This type of regime has become increasingly popular in recent years, as governments seek to attract high quality investment that will bring skilled jobs to their domestic economies. However, some of these regimes have attracted criticism as the qualification criteria are very generous and may allow taxpayers to arrange their affairs such that income generated from IP is allocated to a country where it benefits from a preferential tax rate, without having a strong link to that country.

The OECD is likely to suggest criteria to determine a minimum level of substance required to connect income being taxed in a country to the activities that generate the income. In this context, two different approaches to measuring substance appear to be under discussion – one, more closely linked to the existing transfer pricing approach, would be to require certain functions to take place in a state to reach sufficient substance for IP income to be allocated to, and taxed in, that state. The second, known as the nexus approach, would limit the amount of IP income which qualifies for any

[57] Quoted in Stewart 2013b

preferential regime based on the proportion of expenditure on generating the IP which was incurred in that state.[58]

Both these options have weaknesses. By listing functions which must occur in a state, companies will remain able to relocate activities in order to ensure that minimum substance requirements are met. If the requisite functions involve the management of IP rather than its generation, there will still be a disconnect between the jurisdiction where the value was created and the jurisdiction where associated profits are taxed. Conversely, it would be very far removed from any commonly accepted norms to use this functional analysis approach to test substance but choose functions which are separate from the management of the IP assets which generate income. For example, one possibility is that substance is interpreted as headcount and significant people functions, to borrow OECD jargon – but if the location of employees does not correlate with the management of the IP, this would not sit easily with existing transfer pricing principles.

The nexus approach would definitely involve a significant departure from existing transfer pricing principles, which seems an unlikely outcome given the strong message coming from the OECD that

> *"adoption of alternative transfer pricing methods... would require development of a consensus on a number of key issues (which countries do not believe to be attainable in the short or medium term) and could also raise systemic problems which could result in even more damaging problems for countries' revenues. Accordingly, it is believed that it will be most productive to focus on addressing specific issues arising under the current arm's length system at the present time"*[59]

Unsurprisingly, countries with generous patent box regimes such as the UK are supportive of a more generous substance test built on existing transfer pricing grounds, whereas opponents of these regimes such as Germany are arguing for the nexus approach to be used. As the OECD will need to deliver a consensus-based judgement on these harmful preferential regimes, it is likely that both parties will be required to make compromises and a final substance test will be delivered which has minimum requirements for activity in the patent box country, but does not require the associated research and development to have taken place in that country.[60]

The OECD will deliver its verdict on member state regimes in September 2014, when it will then look to reach out to non-member states, and deliver a proposed strategy on expanding participation in September 2015. The final output from the Action Plan is expected to be the revision of existing substance criteria, in December 2015.[61]

This ability to deliver on these actions will be a key differentiator in the success of the Action Plan when compared to the 1998 report. The 1998 report never reached a clear definition of a harmful regime, and the output was simply guidelines on identifying factors. Without a clear line in the sand to demarcate a factor that makes a tax regime harmful, it has been possible for governments, both

[58] Stewart 2013b
[59] http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm retrieved 18 July 2014
[60] Any output proposed by the OECD can only be implemented in member states of the EU if it is compatible with EU law. Whilst the final proposals for implementation have not been determined, there are concerns that adoption of the nexus approach would breach the fundamental freedoms enshrined within EU law, which further suggests that this is an unlikely outcome of the project.
[61] OECD 2013b Table A1

OECD member and non-member states, to continue to use their tax regimes as a competitive tool in ways which may not be acceptable to their neighbours but which do not break any clearly established principles.

5.5 Will this outcome be different?

Although a revised substance criteria would be a positive step forward, the proposed output from Action Point 5 remains both limited in ambition and vague in scope – a review of member countries' regimes does not commit to any change in these regimes, and similarly, even if existing criteria are revised, there is no indication of the strategy by which this revision will be adopted or enforced. It is not clear if this stems from loose drafting, or a lack of project clarity.

Englisch and Yevgenyeva view the revamped work as "a new attempt to reach the initial objectives", rather than the launch of a new goal, but comment that the "vagueness in formulations of "expected output", as well as the absence of any measurable goals and explicit political commitments towards them, makes the outcomes of Action 5 highly dependent on political support within and beyond the OECD member countries."[62] They also highlight the possibility that the drafting may be intentionally vague in order to give the OECD flexibility in implementation, which may have been particularly appealing if at the time of writing there was uncertainty over the political support behind this action.

One of the reasons (or perhaps the main reason) for the failure of the initial attempt at this work following the 1998 report to make any meaningful changes in this area is the self-interest of the participating governments – this was seen clearly in the actions of the US, as well as abstainers such as Luxembourg and Switzerland, but the lack of real progress towards changing the tax practices of the other member states is also a clear indication that these states themselves were not fully committed to this aspect of the project.

The proliferation of preferential regimes since 1998, most clearly in respect of IP, is further evidence that governments are still keen to use their tax regimes as a competitive tool. There is still no consensus on where the boundary is drawn between harmful and "fair" competition, as is illustrated by the decision of the EU Code of Conduct group to review all IP tax regimes within the EU to determine whether they breach the EU Code of Conduct on taxation, in particular in respect of economic substance requirements.[63] While this action by the EU is separate to the OECD's work, the inability of the EU (a smaller and more closely integrated group of countries than the OECD) to agree on these boundaries highlights the challenges the OECD will face.

At present, the BEPS project has significant political support from the main players in the OECD, however this is unlikely to last forever. With the final deliverables from Action Point 5 being due in December 2015 , the UK will already have seen a general election which could bring a new government, and the US will also be gearing up for the 2016 presidential elections. The incoming Bush administration in 2001 showed how political support can disappear very quickly, and were a Republican administration to take power in 2016 the same may occur again.

Given the complexities in implementing any output of the BEPS project, there is little chance that the project will be completed before the end of 2016. It is therefore possible that not only are the next

[62] Englisch & Yevgenyeva 2013 page 636
[63] http://www.pwc.co.uk/finance/tax/patent-box-code-of-conduct-review.jhtml Retrieved 18 July 2014

couple of years spent re-doing the work initially proposed in the 1998 report, but that the output of the project could be side-lined in the same way as it was previously. In order to ensure that this does not happen the G20 and OECD will need to keep focused on the benefits which will arise from the realignment of taxation with substance, and not let the agenda be driven by the anti-competition movement as occurred previously.

The initial premise of the 1998 report was that harmful tax competition will eventually have detrimental effects for all participants, as tax rates trend to zero. In the years since the publication of this first report we have seen a gradual lowering of tax rates and broadening of the base, in order to promote completion and boost economic growth. However, from this lower starting point, there is less room to manoeuvre before rates become so low that governments are unable to provide the necessary public services. The political will may therefore be stronger this time to reach a collective agreement to eliminate the more harmful policies in place.

However, there is a risk that governments will lose patience with the multilateral process and take unilateral action on the issues that most affect their economies before the BEPS output can be implemented. There is already some evidence that this is taking place, such as new rules in France to deny interest deductions on hybrid financing arrangements.[64] In addition, the US is considering wholescale corporate tax reform, in order to make its tax system (which is characterised by high tax rates but a tax base which is narrowed by many complex reliefs) simpler and more competitive. Recent corporate inversions have further highlighted domestic concerns over the tax system and increased pressure on the US government to amend domestic laws.[65] Although President Obama's administration may not have the political power to make significant changes before the 2016 elections, this type of pressure increases the chance that the US will act unilaterally rather than waiting to implement the output of the BEPS project.

While the BEPS project is expected to draw to a close by December 2015, the timetable does not allow for any period of negotiations as to how the recommendations are implemented in practice. It is plausible that the reports will be finalised in late 2015, but that then further time will be required to test the feasibility of the proposed solution, in particular the mechanism by which any multilateral instrument will be adopted. Any delays such as this will only increase the chances that governments lose patience or enthusiasm for the process, and that any proposals are only implemented by a select group of countries rather than on a broad multilateral basis.

[64] Action 2 of the BEPS action plan is to "Neutralise the effects of hybrid mismatch arrangements", the output of which is expected to include recommendations regarding the design of domestic rules in September 2014; France acted ahead of this in September 2013 in changing its domestic legislation. The interest in the solutions proposed by the OECD will diminish as more countries take unilateral action in this manner.

[65] This concern led to a Senate Hearing on tax reform in July 2014, detailed at http://www.finance.senate.gov/hearings/hearing/?id=5a23092e-5056-a032-5264-b5147118d6be, at which Senator Hatch noted that "whilst BEPS negotiations are important, the most high-profile international tax issue today is corporate inversions".

6. Where Now?

The 1998 report and the BEPS action plan are both attempts to reach agreement on fundamental principles of the international tax system, namely the type of competitive practice which governments can use to attract investment, and those practices which should not be adopted. Perhaps the biggest issue facing both projects is the fact that tax is a matter of national sovereignty, and only subject to international rules where governments agree to subject themselves to these (for example, by entering the EU, or by agreeing tax treaties which adopt OECD rules on transfer pricing). Reaching an agreement on these issues is therefore reliant on co-operation between governments, and the power of the common good taking priority over individual agendas.

The fact that the OECD has included tax competition as an Action Point within the BEPS Action Plan makes it obvious that the 1998 report did not lead to long term solutions. What is clear from the detail of Action Point 5 is that much of the work proposed now repeats the work which was intended to follow the 1998 report, suggesting that not only did the 1998 report not achieve a long term solution, but it also did not reach a satisfactory outcome to the issues within its scope. With this as precedent, the BEPS project can only be expected to succeed in this area if conditions have changed.

In the 15 years between publication of the 1998 report and the Action Plan, the world has become ever more connected through international trade, and the digital economy has become increasingly important.[66] As a result, taxpayers will be participating in an increasing number of international transactions, and business has become increasingly mobile, increasing both the risks and rewards for governments from tax competition.

In the same period, the global economy has seen a financial crisis which has put pressure on government revenues across the world. Defending and increasing tax revenues are increasingly important to tax authorities. While this has led to the launch of the BEPS project, it does not mean that every country's interest is now aligned and international agreement will be easy to reach.

Political interests are just as prevalent today as they were on publication of the 1998 report, and there is still no agreement on where the line is drawn between "fair" and "harmful" tax competition. As noted, if this debate is still ongoing within the EU it is difficult to see how the broader range of countries involved in the BEPS project will reach a conclusion.

In an interview published by Bloomberg BNA[67] David Ernick of PricewaterhouseCoopers LLP observes that the BEPS project covers a number of areas where the OECD has already done significant work, not just on harmful tax competition. Ernick notes that "the earlier work should be instructive [to the conclusions now reached], but there are now political pressures and revenue concerns which weren't as acute earlier". These may lead to different conclusions, although Ernick believes that there is no appetite for a fundamental reallocation of taxing rights between source and residence

[66] Action 1 of the BEPS Action Plan relates to the digital economy, and work on this is well under way. The response to the discussion draft published has concluded that the digital economy cannot be ring fenced, and is in fact, simply, an integral part of the economy.

[67] Available at http://www.pwc.com/us/en/tax-services/publications/oecd-beps-transfer-pricing.jhtml retrieved 20 July 2014

countries. Ernick also suggests that the issue of BEPS may be one of perception rather than an underlying problem, and that the OECD is working to address this perception issue.

Although the message from the OECD is clearly that BEPS is about more than perception, political pressure among member states means that governments may be keen to claim the project as a success in order to win public support, even if there is little tangible change. The push for transparency is a clear example of this, where Action 5 could be marked as a success if additional transparency standards are agreed, even without any fundamental change in the use of competitive measures. In this way, the BEPS project may suffer the same fate as befell the 1998 report.

Although tax competition only forms one of the 15 BEPS action points, it is evident that it underlies the whole project. While base erosion may occur without the promise of a lower tax rate elsewhere, the incentive to shift profits around the globe relies on receiving a more favourable tax treatment in another jurisdiction. Other BEPS action points cover certain elements of this or focus on the methods used, for example through the way in which intangible assets are owned and exploited, and the type of documentation required to support transfer pricing policies, but tax competition is at the heart of the agenda. Transparency and documentation is only helpful in enforcing rules – if those rules are not fit for purpose then having clear evidence is still not enough to solve the problem

The incentive for governments to make real progress in this area is therefore high, and while the BEPS project has significant political momentum the chance of success remains. Whether the work can be undertaken sufficiently quickly to capture this momentum before other pressures take priority will be key to the success of the project. If new governments are elected with different agendas before the project is completed, then the work on tax competition may suffer the same fate as seen before.

Although the OECD has in effect been given a second chance to take action on harmful tax competition, this is likely to be its last opportunity. If international agreement is not reached through the BEPS project, or that agreement is sufficiently weak that issues of tax evasion and harmful tax practices still persist, governments will take action themselves to preserve their tax bases. Emerging players in the global economy may continue to reject OECD transfer pricing principles in favour of their own methods, such as those seen in Brazil, while some EU member states are calling for closer integration through the Common Consolidated Corporate Tax Base, relying on a formulary apportionment mechanism to allocate profits between states. If the OECD wishes to maintain its role as the primary international tax organisation, it must show governments the benefits of the multilateral approach to designing international tax rules.

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