

Testimony of Pascal Saint-Amans
Director, Centre for Tax Policy and Administration,
Organisation for Economic Co-operation and Development (OECD)
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Chairman Wyden, Ranking Member Hatch, and Members of the Committee, thank you for inviting me to testify today regarding the work of the Organisation for Economic Co-operation and Development (OECD) on base erosion and profit shifting (BEPS).

The OECD is an international organization founded by the United States and other nations in the aftermath of World War II. The OECD includes 34 market economy democracies from North America, Europe, and Asia, and has five key partners (Brazil, China, India, Indonesia, and South Africa) among emerging economies. Officials from the levels of experts to Ministers meet at the OECD to address common problems, develop international standards, guidelines, principles, and best practices, and monitor performance through peer reviews. The common thread of our work is a shared commitment to market economies backed by democratic institutions and focused on the well-being of all citizens.

The work of the OECD is done by consensus. That is, measures cannot be adopted without the consensus of all member countries. Moreover, the results of the work at the OECD are generally tools that countries can use to address problems they themselves agreed to put on the OECD agenda. Each country ultimately must make its own policy choices. The OECD's goal is to produce better policies, in part by allowing countries to coordinate with one another, and in so doing improve the quality of people's lives.

In developing our policies, we consult with business, including through the Business and Industry Advisory Committee to the OECD, and with labor, including through the Trade Union Advisory Committee to the OECD. We also engage with civil society organizations and academic researchers.

Our commitment to external stakeholders is strong. For instance, the Committee on Fiscal Affairs (CFA), which is the forum at the OECD for addressing issues affecting taxation, has provided numerous opportunities for comment on the various discussion drafts the OECD's member countries and partners agreed to release over the last twelve months. These discussion drafts have generated more than 3,500 pages of comments, and provoked a large number of participants from all constituencies commenting at 5 public consultations. The OECD's public webcasts of these consultations and our updates on the project have attracted over 10,000 viewers.

Background

Taxation is at the core of countries' sovereignty and each country is free to set up its corporate tax system as it chooses. When independent sets of rules created by sovereign countries interact, however, it can lead to gaps where corporate income is not taxed at all, and to frictions where income is taxed by multiple countries. Since at least the 1920s, it has been recognized that the interaction of domestic tax systems can lead to overlaps in the exercise of taxing rights that in turn can result in double taxation. Countries have long worked and are strongly committed to eliminating such double taxation in order to minimize trade distortions and impediments to sustainable economic growth, while affirming their sovereign right to establish their own tax rules. However, there are gaps and frictions among different

countries' tax systems that were not taken into account in designing the existing standards and which are not dealt with by bilateral tax treaties. Thus, the modern global economy requires countries to collaborate on tax matters in order to be able to protect their tax sovereignty.

Inheriting work initiated in the 1920s, the OECD countries have worked together to elaborate standards and instruments to eliminate double taxation. Adopted by consensus, these soft law instruments provide an international framework, and include a Model Tax Convention (which serves as the basis for over 3,000 bilateral tax treaties) and Transfer Pricing Guidelines (which provide common standards for allocating taxable income among members of a group of affiliated companies). These instruments have been critical in supporting the OECD agenda to promote cross border investments and competitive tax systems. In that vein, as illustrated in the report *Tax Policy Reform and Economic Growth* (<http://dx.doi.org/10.1787/9789264091085-en>), the OECD recommends that countries favor broad bases and lower rates for corporate income taxes.

Need for International Tax Reform

Over time, the current rules have failed to keep pace with economic developments, and have begun to show weaknesses. While the key international tax standards are intended to eliminate double taxation by providing for principles to allocate taxing rights on a bilateral basis between the countries involved, they are now facilitating double non-taxation in a significant number of instances. This results from changes in the international economic environment such as the globalization of businesses and economies of countries becoming increasingly intertwined.

In the global economy of the 21st century, multinational enterprises (MNEs) represent a large proportion of global GDP, and intra-firm trade represents a growing proportion of overall trade. Globalization has resulted in a shift from country-specific operating models and a bilateral paradigm for direct investment to global models based on matrix management organizations and integrated supply chains that centralize several functions at a regional or global level. Moreover, the growing importance of the service component of the economy, and the increasing centrality of intellectual property to value creation has made it much easier for businesses to locate both productive activities and legal rights in geographic locations that are distant from the physical location of their customers. These developments have been exacerbated by the sophistication of tax planners in identifying and exploiting the legal arbitrage opportunities and the boundaries of acceptable tax planning, thus providing MNEs with more confidence in taking aggressive tax positions.

The international tax rules similarly do not have an overall principle of coherence. In the domestic context, coherence is usually achieved through a principle of matching: a payment that is deductible by the payer is generally taxed in the hands of the recipient unless it is explicitly exempted. The lack of a similar principle to address the interaction between tax systems at the international level creates opportunities for cross-border arbitrage by taxpayers in which income can be made to disappear for tax purposes.

As a result, the current set of rules has proven to create unforeseen opportunities to artificially reduce taxable income or to shift profits to low-tax jurisdictions for base erosion and profit shifting (BEPS) by MNEs. BEPS relates chiefly to instances where the interaction of different tax rules leads to double non-taxation or less than single taxation. It also relates to arrangements that achieve no or low taxation by shifting profits away from the jurisdictions

where the activities creating those profits take place.

Non- or low-taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the various activities that generate it. In other words, what creates tax policy concerns for countries participating in the BEPS project is that, due to gaps and frictions in the interaction of different tax systems, and in some cases because of the application of bilateral tax treaties and transfer pricing rules, income from cross-border activities may go untaxed anywhere, or be subject to unduly low taxation.

As a result, the current consensus-based international framework is at risk.

First, it no longer fully meets its objectives of allocating taxing rights between countries where companies operate. Instead, it facilitates the divorce between the location of the profit and the location of value creation. The consequence is that the existing international tax system in many cases allows structures and tax results **that no longer pass a basic test of common sense.** For example, as taxpayers increasingly rely on intangible assets as a value-driver, it has become easier for taxpayers to rely on existing principles to transfer legal ownership of those intangible assets to “cash boxes” in low-tax jurisdictions that receive a large share of profit but perform no or hardly any activity. Trillions of untaxed dollars are now located in such entities, in compliance with the existing rules. It is hard to imagine that this is what was intended when these rules were designed. Another striking example is where the features of a bilateral treaty cause investments in one country to be channeled through a particular jurisdiction by third-country investors. For example, as shown in IMF data, more than one quarter of direct investment into India was from Mauritius between 2010 and 2012.

Second, the current situation creates an uneven playing field in which some businesses, such as those which operate cross-border and have access to sophisticated tax expertise, receive unintended competitive advantages compared with enterprises that operate mostly at the domestic level or that use less aggressive tax planning techniques. This uneven playing field leads to an inefficient allocation of resources by distorting investment decisions towards activities that may have lower pre-tax rates of return, but higher after-tax rates of return. This also encourages resources to be spent on tax planning rather than productive business operations that could lead to job creation and innovation. These phenomena are by no means limited to U.S. multinational corporations: 74% of the Fortune Global 500 companies are non-U.S.-headquartered companies.

Third, these flaws in the current system undermine the sovereign right of countries to set tax policy. Countries must be able to set their own tax policy in the way they consider appropriate, in order to respond to their particular revenue needs. An international tax system that allows for unjustifiable results undermines this ability to exercise policy autonomy. BEPS activities threaten the tax bases of countries around the world. In the U.S., for example, a recent Congressional Research Service study reported that BEPS activities are estimated to reduce U.S. corporate tax revenue by \$10-60 billion annually.

Finally, the fact that tax planning that complies with the technical tax rules can reach results that defy common sense has led to increased tax controversy and litigation with tax administrations frustrated with the implementation of the current rules. The increased number of international tax disputes also makes it harder for taxpayers to anticipate tax results, and can result in taxpayers being subjected to double taxation. This is exacerbated in some cases by the increasing prominence of emerging economies that did not participate in

the development of the existing rules because they are not members of the OECD. The weaknesses of these rules make it harder for these countries to join the international consensus, which further increases uncertainty for taxpayers.

As a result of this growing concern over BEPS activities, many countries have considered action to protect their tax bases. Protecting the tax base is one of the recurrent features of corporate tax reform proposals in many countries, including the United States.

Unilateral action by countries on an uncoordinated basis, however, has the potential to replace the problem of non-taxation with the proliferation of uncoordinated legislative measures that will lead to excessive compliance costs for MNEs, as well as the potential for double or multiple taxation of the same income, undermining the existing consensus-based standards and replacing them with chaos. It also has the potential to encourage protectionist measures that would be detrimental to international trade.

In addition, the fact that BEPS arises from the interaction between different countries' tax systems means that unilateral action by individual countries is incapable of fully addressing the problem. If only a small number of countries attempt to solve BEPS, they may in fact further jeopardize their tax base as businesses move to jurisdictions that have not yet implemented preventive measures or that choose not to do so in order to gain a competitive advantage.

In the aftermath of the financial crisis, however, worldwide attention has been focused on international tax avoidance at the highest political levels and in many countries at the level of the man on the street. In some cases, this focus has increased pre-existing tensions, as individual companies have found themselves scrutinized by the media and by the public. **This increased focus, however, has also created a unique opportunity to modernize global standards, restore their coherence, and renew worldwide commitment to principled, consensus-based rules.**

A Coordinated Approach to Reform: The BEPS Project

Recognizing the threat to the existing standards for relieving double taxation, the OECD published its report, *Addressing Base Erosion and Profit Shifting*, in February 2013, which provided results of an in-depth analysis of BEPS identifying the problems and the different factors that cause them. The report was discussed at the February 2013 G20 meeting of finance ministers, who expressed strong support for the work done and urged the development of a comprehensive action plan.

In response to this request from the G20, the OECD published an Action Plan on Base Erosion and Profit Shifting in July 2013, which was fully endorsed by G20 finance ministers and G20 Leaders. The objective of the Action Plan, approved by consensus, is to restore coherence and common sense to the international tax system, keeping the overall approach, but updating it so that it continues to function in the modern context in which countries impose tax locally but businesses act globally. In this way, the fundamental goals of eliminating double taxation and providing certainty for business remains at the core of the work of the OECD in tax matters.

In order to achieve this objective, **the BEPS Project brings together 44 countries, comprising 90% of the world's economy, working on an equal footing:** all OECD members and accession countries as well as the 8 non-OECD G20 countries, i.e. Argentina,

Brazil, People's Republic of China, India, Indonesia, Russia, Saudi Arabia, and South Africa. In addition, over 80 developing countries and other non-OECD/non-G20 economies have been consulted and their input has been fed directly into the BEPS process. This broad participation is aimed at reaching as broad a consensus as possible, creating a level playing field among countries so that countries that implement the measures do not risk losing their tax base to those that do not, or finding their MNEs placed at a competitive disadvantage. In this way, the work can restore the sovereign taxing rights of countries, giving them the tools to preserve their tax base.

The Action Plan is designed to take a principled, holistic approach to addressing BEPS. This is not a “revenue grabbing” exercise but one intended to fix existing deficiencies of the current standards. It focuses on ensuring the *coherence* of corporate tax systems in a cross-border environment, introducing *substance* requirements in the area of tax treaties and transfer pricing, and ensuring *transparency* while promoting certainty and predictability.

Recognizing that any discussion of tax changes raises uncertainty, **the Action Plan focuses not only on closing gaps that have led to tax avoidance, but also on improving dispute resolution** to ensure that new double taxation is not created and existing frictions are reduced. The worldwide and U.S. business community, as well as civil society and academics, have been extensively consulted throughout the process so far. This engagement will continue throughout the BEPS Project.

Addressing BEPS is critical for countries and must be done in a timely manner to be useful. Indeed, before the launch of the BEPS project, countries around the world had begun to explore ways to address BEPS unilaterally. Many have put those unilateral actions on hold in favor of participating collaboratively in the BEPS work. Failure to deliver concrete results in a timely manner thus would create a risk of unilateral actions, which would not only fail in many cases to address the core of the BEPS issue, but would lead to a risk of increased double taxation of businesses around the world. **This is why countries agreed to deliver on the Actions within a two-year time frame.** If it is important to come up quickly with detailed principles, it is also important to take some more time to provide detailed guidance for the implementation, so that technical quality and certainty are maximized. It is recognized that after guidance is developed, governments and taxpayers will need time for implementation.

The Action Plan takes the form of 15 actions, and calls for a series of concrete deliverables in response to these actions. A first set of deliverables is due in 2014, with a second set due in 2015. The 2014 deliverables are due to be delivered in September 2014, and will represent substantial progress toward providing countries with tools they can use to address BEPS.

The 2014 deliverables will help ensure the coherence of corporate income taxation at the international level by providing draft recommendations for new international tax and treaty standards to neutralize hybrid mismatch arrangements. They will show progress made in relation to work to tackle harmful tax practices. They will also help to restore the intended effects and benefits of international standards by providing recommendations to prevent the abuse of tax treaties and to address transfer pricing issues in the key area of intangibles. They will help to ensure better transparency and promote increased certainty and predictability by providing draft recommendations for improved transfer pricing documentation and a template for country-by-country reporting to be provided to tax administrators for high-level risk assessment. In addition, the 2014 deliverables will include a report on addressing the tax challenges of the digital economy, as well as a report on the feasibility of developing a

multilateral instrument to amend bilateral tax treaties and enable swift implementation of treaty measures developed in the course of the BEPS work.

The need to provide certainty and limit the cost of compliance to businesses while providing useful instruments to countries is at the core of the work and has been fully taken into consideration. Country by country reporting is a good illustration of possible risks and tensions but also, at the same time, of the benefits of a multilateral approach. For several years now, many have advocated the need for more transparency in the reporting of MNEs. A number of countries, starting with the United States, have already enacted legislation to improve such reporting or intend to do so in the future. While this type of reporting increases the compliance burdens for MNEs, a common agreed framework is likely to limit this burden by taking a consistent approach that reduces the differences between country-specific requirements. Indeed, a number of countries have agreed to limit the scope of information requested from MNEs in order to pursue a multilateral approach that will guarantee efficient reporting while maintaining confidentiality. As a result of the multilateral approach, countries will run a more efficient reporting mechanism and businesses will face less burdensome compliance costs.

Completion of the work under the Action Plan will give countries the tools they need to ensure that profits are taxed where the economic activities generating the profits are performed and where value is created. It will also give businesses greater certainty. Finally, the international tax framework will make more sense, thereby strengthening consensus and reinforcing the ability of governments to eliminate double taxation.

Conclusion

Taxation remains at the core of national sovereignty, and each country must ultimately make its own tax policy choices. The BEPS Project developed out of the recognition that opportunities for BEPS arise from the interaction of different countries' tax systems, making it impossible for a single country acting unilaterally to effectively address BEPS. BEPS opportunities impair the ability of countries to achieve their tax policy goals, effectively undermining their sovereignty. Uncoordinated, unilateral action by individual countries to exert taxing rights over cross-border activity would only make the problem worse, resulting in double or multiple taxation, increasing disputes for business and among governments, and harming economic growth. The work on BEPS is intended to produce tools that countries can use to address BEPS, in order to ensure that the international tax system continues to function, and that a broader, more robust consensus to eliminate double taxation can be established.

The OECD has long recommended that countries reduce the distortive impacts of their tax regimes, and thus improve economic growth, by broadening the tax base (in which measures to address BEPS can be an important part) and lowering the rate. We hope that our work, including the work on BEPS, can support the ongoing tax policy reform discussions around the world and in the United States. BEPS is an important issue no matter what direction US international tax policy takes.

I would like to thank the Committee for the opportunity to provide testimony on this important work, and I look forward to answering your questions.

Annex: The BEPS Action Plan

The measures contemplated in the Action Plan will ensure the *coherence* of the international tax system by providing recommendations to neutralize “hybrid mismatch” arrangements that take advantage of differing treatment of entities or instruments in multiple jurisdictions to generate multiple deductions for the same payment, or deductions in one jurisdiction with no taxable income in another jurisdiction (**Action 2**). Coherence will be further improved by providing recommendations for the design of effective controlled foreign company (CFC) rules that tackle the issue of large amounts of untaxed income being routed through offshore affiliates in no-tax jurisdictions (**Action 3**), and for rules to prevent base erosion via excess interest deductions and other financial payments (**Action 4**). The work will also help jurisdictions counter harmful tax practices more effectively, particularly in the area of IP regimes, based on the recognition that tax competition through harmful preferential tax regimes left unchecked could ultimately lead to a “race to the bottom” that would drive tax rates on mobile sources of income to zero for all countries (**Action 5**).

The Action Plan is also intended to realign taxation with the *substance* of the activities of taxpayers. “Treaty shopping” by third country investors through shell companies in jurisdictions with broad tax treaty networks, along with other forms of treaty abuse, have allowed treaties to be used to generate double non-taxation. To prevent this abuse and allow tax treaties to serve their intended function of relieving double taxation, the Action Plan therefore calls for model treaty provisions to prevent the abuse of tax treaties (**Action 6**) and to prevent the artificial avoidance of taxation by abusing the permanent establishment standard used to determine taxing jurisdiction (**Action 7**). It will restore substance in the area of transfer pricing by ensuring that profits cannot be separated from the location in which economic activity occurs and value is created, in the key areas of intangibles (**Action 8**), risks and capital (**Action 9**), and other high-risk transactions (**Action 10**).

The Action Plan is also intended to ensure increased *transparency* in several respects. The work will recommend methodologies for collecting and analyzing data on the scale and effects of BEPS and on the impact of the actions to address it (**Action 11**). To ensure that tax administrations have access to comprehensive and relevant information on tax planning strategies, recommendations will be developed regarding the design of mandatory disclosure rules for aggressive or abusive tax structures (**Action 12**). In addition, the quality of information provided to tax administrations will be improved by developing improved and better coordinated transfer pricing documentation (**Action 13**). Finally, to ensure that actions to counter BEPS do not detract from certainty and predictability for business, solutions to ensure effective dispute resolution between jurisdictions will be developed (**Action 14**).

In addition to work in these three key areas, the work will address the cross-cutting issue of the tax challenges raised by the digital economy (**Action 1**). Recognizing the need for a way to implement agreed changes quickly and uniformly, particularly in the area of tax treaties, a multilateral instrument to enable jurisdictions to implement measures developed in the course of the BEPS work and to amend bilateral tax treaties will be developed (**Action 15**).