

## Finding Its Way on a Foggy Moonless Night: Measuring BEPS

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# VIEWPOINT

## Finding Its Way on a Foggy Moonless Night: Measuring BEPS

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The opinions expressed in this article are those of the author.

The recently released OECD draft on BEPS action 11 attempts to measure the BEPS phenomenon. The author analyzes the BEPS phenomenon as it is defined by the OECD and highlights the main shortcomings of that restrictive definition. He suggests that measuring BEPS may in fact be an incommensurable proposition since it is a practical impossibility to distinguish between the economic and tax effects of the alleged BEPS phenomenon.

**P**ublic discussion draft “BEPS Action 11: Improving the Analysis of BEPS” (the OECD draft) was released on April 16. In the introduction, the OECD states that this draft “presents an initial assessment of the currently available data” on base erosion and profit shifting and “the data needed for analysis of BEPS and BEPS countermeasures.” Chapter 1 highlights the available data. Chapter 2 of the draft discusses potential BEPS indicators for measurement purposes. Chapter 3 briefly reviews the “available economic analyses” that relate to the alleged existence of BEPS (the BEPS phenomenon) and the measurement of BEPS.

This OECD draft on BEPS action 11 attempts to find “ways” of measuring the BEPS phenomenon. In the carefully crafted words of the OECD on page 4 of the draft (key points), “more comprehensive and more

detailed data regarding multinational enterprises is needed to provide more accurate assessments of the scale and impact of BEPS.” To that effect, paragraph 2 of the draft indicates that it “cannot be overemphasised that the results obtained from any analysis are only as robust as the data and methodology underpinning them.” Another key point of chapter 1 explains that “significant limitations of existing data sources mean that, at present, attempts to construct indicators or undertake an economic analysis of the scale and impact of BEPS are severely constrained and, as such, should be heavily qualified.” In fact, it is difficult “for researchers to disentangle real economic effects from the effects of BEPS-related behaviours,” as also stated by the OECD.

This is the starting point to measure BEPS. The OECD draft attempts to lay out the roadmap to assess the alleged existence of the BEPS phenomenon and to quantify its importance in international taxation. This article provides some general thoughts and comments on those matters regarding the OECD draft.

### What the BEPS Is BEPS?

“What the BEPS are we talking about?” the OECD indicated in 2013.<sup>1</sup> Let’s start our discussion by briefly highlighting the OECD view on that question. One of the key points on page 56 of the OECD draft summarizes:

Existing empirical analyses find BEPS occurring through multiple channels of international corporate tax avoidance: hybrid mismatch arrangements; excessive interest deductions; harmful tax practices; treaty abuse; artificial avoidance of permanent establishment; transfer pricing outcomes that are not aligned with value creation; and by

<sup>1</sup>Pascal Saint-Amans and Raffaele Russo, “What the BEPS are we talking about?” *OECD Yearbook 2013*, pp. 85-86.

the circumvention of any applicable anti-avoidance measures, such as controlled foreign corporation (CFC) rules.

According to the OECD draft on page 6, in more general terms BEPS are “practices that artificially segregates taxable income from the real economic activities that generate it.” Paragraph 67 of the draft explains that “it is important to distinguish between shifts in profits among countries that reflect changes in real economic activity and BEPS-related transfers of profits that are not in response to changes in the location of real economic factors, labour and capital, that produce the income.” The OECD’s BEPS action plan had indicated on that specific matter:

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.<sup>2</sup>

According to the OECD, the BEPS phenomenon is therefore composed of a few basic elements. The first component takes the form of a moral judgment from tax administrations. BEPS is defined by the OECD as alleged taxpayers’ behaviors aimed at minimizing their tax burdens legally. Such a definition of BEPS constitutes a direct attack on the universally accepted right of any taxpayer to minimize its tax burden. Courts of law have already affirmed this fundamental right around the world in democratic systems based on the rule of law.<sup>3</sup> Courts have also shown substantial restraint regarding these alleged “questionable” taxpayer actions in spite of recurring claims by adamant tax administrations and the OECD in the international context.<sup>4</sup>

This moral judgment embedded in the BEPS definition of the OECD also mistakenly suggests that “less than single taxation” might exist. It is a severely misguided conception of taxation from the OECD, although it is not new.<sup>5</sup> This curious assertion makes little sense, if any at all: It is solely based on the fact that taxation other than from industrialized countries is deemed to be “less valuable” taxation by the OECD.

<sup>2</sup>As it is reproduced from paragraph 101 of the OECD draft (p. 57) in reference to OECD (2013), “Action Plan on Base Erosion and Profit Shifting,” OECD Publishing, p. 10.

<sup>3</sup>See *Inland Revenue Commissioners v. Duke of Westminster* [1936], AC 1, [1935] All ER Rep 259, 51 TLR 467, 19 TC 490, p. 14; and *Shell Canada Ltd v. Canada*, 1999 3 SCR 622, para. 45.

<sup>4</sup>In Canada, tax treaty cases, for instance, have not provided the Canada Revenue Agency with the expected results. See *Canada v. MIL (Investments) S.A.*, 2007 FCA 236; *The Queen v. Prevost Car Inc.*, 2009 FCA 57; and *Velcro Canada Inc. v. The Queen*, 2012 TCC 57.

<sup>5</sup>This assertion is also found in the 1998 report, “The Taxation of Global Trading Financial Instruments,” Mar. 9, 1998; see pp. 28-29.

This OECD corollary to “less than single taxation” can also be found in various OECD reports released through the years.<sup>6</sup>

A second component of the BEPS definition by the OECD suggests that there is a “shift of the profits away from the domestic jurisdictions where they are created.” The artificial construction that is BEPS according to the OECD vision is therefore international in nature. But in spite of that self-evident fact, the BEPS phenomenon is actually framed by the OECD member countries in the limited space of the domestic corporate tax revenues of industrialized countries. It is indeed the way that many of the research and empirical studies listed in the bibliography of the OECD draft are designed and executed.

This is not without its own consequences. The highly symbolic three-page engagement with developing countries put in action through numerous regional meetings in February and March<sup>7</sup> rapidly pales in comparison with the staggering numbers of public discussion drafts<sup>8</sup> released since the seven OECD deliverables

<sup>6</sup>The 1998 report on harmful tax competition immediately comes to mind (see OECD (1998), “Harmful Tax Competition — An Emerging Global Issue,” Apr. 9, 1998). Some older “classics” released on thin capitalization, base companies, and conduits also come to mind (see OECD (1986), “Thin Capitalisation,” OECD Council, Nov. 26, 1986; OECD (1986), “Double Taxation Conventions and the Use of Base Companies,” OECD Council, Nov. 27 1986; and OECD (1986), “Double Taxation Conventions and the Use of Conduit Companies,” OECD Council, Nov. 27, 1986; all three are reproduced in OECD Model Tax Convention on Income and on Capital, Full version (as it read on July 22, 2010), pp. R(4)-1 to R(4)-35, pp. R(5)-1 to R(5)-34, and pp. R(6)-1 to R(6)-25).

<sup>7</sup>Before this November 2014 engagement, the OECD released OECD (2014), “Part 1 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries” (July 2014), actually released on Aug. 1, 2014; and OECD (2014), “Part 2 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries” (Aug. 13, 2014), released on Sept. 22, 2014; then came the “engagement”: OECD (2014), “The BEPS Project and Developing Countries: from Consultation to Participation,” Nov. 2014. Various “regional meetings” or “workshops” were thereafter held on December 10-12, 2014 (strategic dialogue and workshop); February 12-13, 2015 (Asia); February 26-27 (Latin America); February 27, 2015 (CREDAF); March 5-6, 2015 (Eurasia); and March 16-17, 2015 (global meeting).

<sup>8</sup>The list of recent public discussion drafts is comprehensive: “BEPS Action 10: Proposed Modifications to Chapter VII of the Transfer Pricing Guidelines Relating to Low Value-Adding Intra-Group Services” (Nov. 3, 2014, to Jan. 14, 2015), Nov. 3, 2014; “BEPS Action 10: Discussion Draft on the Transfer Pricing Aspects of Cross-Border Commodity Transactions” (Dec. 16, 2014, to Feb. 6, 2015), Dec. 16, 2014; “BEPS Action 4: Interest Deductions and Other Financial Payments” (Dec. 18, 2014, to Feb. 6, 2015), Dec. 18, 2014; “BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)” (Dec. 1, 2014, to Feb. 6, 2015), Dec. 19, 2014; “BEPS Action 7: Preventing the Artificial Avoidance of PE Status” (Oct. 31,

(Footnote continued on next page.)

of September 16, 2014,<sup>9</sup> all wary of industrialized countries' interests regarding the BEPS phenomenon. We are talking here about more than 2,000 pages of "guidance." These latter drafts systematically put front and center the preoccupations of the industrialized countries with the noticeable exception of the eight-page public discussion draft "BEPS Action 10: Discussion Draft on the Transfer Pricing Aspects of Cross-Border Commodity Transactions," released on December 16, 2014, which is mostly of interest to developing countries.

The logical route of the OECD is quite simple to comprehend at this stage. If the inclusion of developing countries in the international tax system was indeed more than symbolic, the sole existence of the BEPS phenomenon as a policy issue would immediately be jeopardized. In fact, how could the OECD ever speak of "profit shifting" and "base erosion" if every country on Earth was considered as an equal participant in the international tax system, that is, with territorial sovereignty of its own tax mix and tax base?

Truth be told, BEPS as defined by the OECD has its *raison d'être* only because it is a concept of industrialized countries. From the start, BEPS has been a typical "us" (industrialized countries) versus "them" (developing countries) issue in international tax. And the latter includes the alleged perpetrators of harmful

tax competition, countries in which citizens intend to thrive as much as citizens of industrialized countries.

Moreover, in its most obtuse and self-interested sense, BEPS is still not defined in the same fashion in every industrialized country. Obviously, what is deemed as an alleged loss of tax revenues by a given country is in fact a gain for another country, although this gain may take form other than simple tax revenues. More importantly, the gain attached to the new economic activity in the recipient country creates direct and indirect economic and tax benefits for that country. This phenomenon is widely and regularly encountered by every country, industrialized and developing alike, that aggressively competes to attract or retain foreign direct investment.<sup>10</sup> Every country that has already taken unilateral steps on one of the 15 actions of the BEPS initiative demonstrates that BEPS is not created equal nor perceived through the same set of lenses in every industrialized or developing country.

A third and more insidious component of the BEPS definition advocated by the OECD is the highly theoretical idea that "real economic activities" in the 21st century arise solely from "real economic factors," that is, labor and capital (both meant here in the economic sense of the terms), which generate the income (and profits). This amazingly restrictive definition of "real economic factors" is, to put it mildly, inaccurate. It belongs in a Marxist textbook of the 19th century.<sup>11</sup>

Granted, for a long time "real economic activity" was in essence measured with land cultivation and livestock farming. Trade clearly had a lesser role. In the 19th and part of the 20th centuries, real economic activity was mostly related to the mechanization of the production processes whether, simply put, by the rearrangement of the production chain or the implementation of machines. Trade started to play a more significant role and new services started multiplying. During all this time, both labor and capital, in the classical economics sense of those terms, played a major role in explaining "real economic activities."

But this no longer provides any semblance of a complete picture. "Real economic activity" since the middle of the 21st century is clearly more complex

2014, to Jan. 9, 2015), Oct. 31, 2014; "Follow Up Work on BEPS Action 6: Preventing Treaty Abuse" (Nov. 21, 2014, to Jan. 9, 2015), Nov. 21, 2014; "BEPS Action 10: Discussion Draft on the Transfer Pricing Aspects of Cross-Border Commodity Transactions" (Dec. 16, 2014, to Feb. 6, 2015), Dec. 16, 2014; "BEPS Action 14: Make Dispute Resolution Mechanisms More Effective" (Dec. 18, 2014, to Jan. 16, 2015), Dec. 18, 2014; "BEPS Action 12: Mandatory Disclosure Rules" (Mar. 31, 2015, to Apr. 30, 2015), Mar. 31, 2015; "BEPS Action 3: Strengthening CFC Rules" (Apr. 3, 2015, to May 12, 2015), Apr. 3, 2015; and "BEPS Action 11: Improving the Analysis of BEPS" (Apr. 16, 2015, to May 8, 2015), Apr. 16, 2015, which is the main subject of this article.

<sup>9</sup>The seven OECD deliverables are OECD (2014), "Addressing the Tax Challenges of the Digital Economy" (BEPS action 1), OECD/G-20 Base Erosion and Profit Shifting Project, OECD Publishing; OECD (2014), "Neutralising the Effects of Hybrid Mismatch Arrangements" (BEPS action 2), OECD/G-20 Base Erosion and Profit Shifting Project, OECD Publishing; OECD (2014), "Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance" (BEPS action 5), OECD/G-20 Base Erosion and Profit Shifting Project, OECD Publishing; OECD (2014), "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances" (BEPS action 6), OECD/G-20 Base Erosion and Profit Shifting Project, OECD Publishing; OECD (2014), "Guidance on Transfer Pricing Aspects of Intangibles" (BEPS action 8), OECD/G-20 Base Erosion and Profit Shifting Project, OECD Publishing; OECD (2014), "Guidance on Transfer Pricing Documentation and Country-by-Country Reporting" (BEPS action 13), OECD/G-20 Base Erosion and Profit Shifting Project, OECD Publishing; and OECD (2014), "Developing a Multilateral Instrument to Modify Bilateral Tax Treaties" (BEPS action 15), OECD/G-20 Base Erosion and Profit Shifting Project, OECD Publishing.

<sup>10</sup>In Europe, the European Commission has been on a mission lately to aggressively "combat" any form of "prohibited state aid" by its member countries. Where this will lead is still up for debate.

<sup>11</sup>It is noteworthy that the public discussion draft, released on December 16, 2014, and titled "BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains" (Dec. 16, 2014, to Feb. 6, 2015), makes an abundant use of those two "real economic factors" for profit-split purposes. It is difficult not to read into this line of reasoning the birth of a forthcoming global formulary apportionment system, as we wrote at the time in answer to that draft (for more detail, see "Comments Received on Public Discussion Draft BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains," Feb. 10, 2015).



than what it used to be. It is regrettable to observe that the OECD seems incapable of defining the term “real economic factors” for BEPS purposes that would be somewhat aligned with the times we are living in.

Perhaps a second look at *Interconnected Economies — Benefiting from Global Value Chains*<sup>12</sup> is required to get a better understanding of what “real economic factors” are in the 21st century. This may also enable the OECD member countries to comprehend that a thorough value chain analysis does not end up with the analysis of traditional 19th-century supply chain factors.

“Real economic factors” are not solely composed of labor and 19th-century-like capital anymore. We live in an era in which robotics, electronics, and virtuality have redefined most of the manufacturing processes around the world. They have significantly redefined the meaning of capital. In an era in which financial engineering might also play a significant role in the profitability, or lack thereof, of many businesses, for better or worse as the lessons of the financial crisis of 2008-2009 may have taught us, this contrived definition of the term “real economic factors” is puzzling. In an era in which marketing activities, brands, and trademarks, to name a few, are permeating our daily lives, “real economic factors” that create “real economic activities” have more often than not the characteristic of being “intangible” in nature. In short, more than ever before, “real economic factors” that create enduring economic value may not have the size and shape that they used to have.

### How to Measure BEPS?

BEPS is defined by the OECD. But its definition lacks any coherence with the modern world. As it is presented by the OECD industrialized countries, the BEPS phenomenon is an international taxation mirage. It thus comes as no surprise that the measurement challenges of that mirage are ultimately incommensurable.

To its credit, the discussion in paragraphs 12-15 of the OECD draft on “potential criteria for BEPS research” acknowledges the usefulness of “separating real economic effects from tax effects.” Even with all the shortcomings underlined above on the actual definition of BEPS by the OECD, this warning seemingly gives the measurement of some form of BEPS a fighting chance. But the draft then mostly ignores its own caveat. It drifts toward a somehow technical discussion that highlights the impossible dream of BEPS measurement, that is, as it is ill-defined by the OECD industrialized countries.

The necessity of “separating real economic effects from tax effects” mostly takes the shape of a pointless statistical dissertation that possesses little, if any, value in spite of its apparent mathematical prowess. Indeed, less mathematically inclined readers should not be un-

duly impressed by the equations included in the draft. Actually, they do not add any analytical value to the text itself.<sup>13</sup>

Chapter 2 of the OECD draft refers to “potential BEPS indicators.” Chapter 3 is about “methodologies for measuring BEPS.” Both these chapters claim to increase the scientificity and rigor of the BEPS measurement processes and methods. The OECD draft explains on page 25 that “while no single indicator is capable of providing a complete picture of the existence and scale of BEPS, a collection of indicators or a ‘dashboard of indicators’ may be constructed to help provide broad insights into the scale and economic impact of BEPS and provide assistance to policymakers in monitoring changes in BEPS over time.” This statement raises various method issues about the actual “measurements” of the purported BEPS phenomenon.

For instance, the “future path of BEPS measurement” as it is offered on page 28 of the draft is decidedly naïve, if not simply misguided. From the use of “indicators” in the “current state,” the reader is led to believe that in a “future state” of blissful awareness, “refined indicators” and “refined analyses of BEPS” will be possible through the availability of “better data.” This idyllic vision of the challenge is regrettably aligned with the “fatal conceit” of statistical analysis, to reprise F.A. Hayek’s words, if there is ever one in modern economics, which confidently pretend to measure (and even predict) the true effects of any social phenomenon. After all, this is what the alleged BEPS phenomenon is about.

On a somber note, it is absolutely extraordinary to observe that every “potential BEPS Action 11 indicator” offered on page 30 of the draft, without a single exception, is essentially related to some form of “benchmarking” analysis. The presence and materiality of BEPS, as it is defined by the OECD, is measured by matching the profits of an MNE with those of other MNEs, certain economic aggregates, or various types of arbitrary measurements or ratios.

On the one hand, every one of these potential BEPS indicators is purely formulaic in nature. It renders a diagnosis of the alleged existence of the BEPS phenomenon based on a method that is connected to the global apportionment of an MNE’s profits. What ever happened to the arm’s-length principle and the comparability analysis? Should it not be relevant to the assessment of the BEPS phenomenon as it is for the determination of transfer pricing? Since the BEPS dashboard is purportedly expected to tell tax administrations how arm’s-length profits “ought” to be “apportioned,” should it not be based on some arm’s-length indicators instead of a series of global formulary apportionment-like tests? There is cause for concern indeed.

<sup>12</sup>OECD (2013), “Interconnected Economies: Benefiting from Global Value Chains,” OECD Publishing.

<sup>13</sup>Unfortunately, this is a common fact of many modern-day economic papers. But the whereabouts of that specific criticism will be developed on another day.

On the other hand, the subsidiary “quantitative analysis” put forward by the OECD draft on pages 32-47 on the relevance of those BEPS indicators is somehow awkward from an economist’s perspective. Frankly, it reminded me of a young mind that “discoverers” the correlation between early morning and the rise of the sun and suddenly proclaims that he can predict the future since he now understands the singularity at stake. If any of these indicators has intrinsic value to measure the alleged BEPS phenomenon as it is defined by the OECD, that is, a social phenomenon, we could expect that specific indicator to encompass at least a 25-year period. Any adept statistician knows that a five- to seven-year time frame in social phenomenon measurement is “statistical noise,” clearly not a “signal,” to echo the OECD draft. In layman’s terms, as may have been candidly declared by the security guard doing his outside hourly round, is that a light that I see through that fog or the reflection of my own flashlight?

### Conclusion

Contrary to the purported belief on page 4 of the draft that the tax affairs of high-profile MNEs shed light on the existence of BEPS, I would dare contend that the state of affairs in international taxation, in much broader terms, highlights the fact that corporate taxation has been the source of a considerable amount of inefficiencies all around the world in the last 30 years.

Corporate taxation has not evolved with the economic growth and the spectacular increase of economic diversity in economic activities that has arisen since the early 1980s. This is unfortunate. Such a lack of understanding of this precise phenomenon by the states, including the OECD industrialized member countries, goes directly against the noteworthy evolution that can be observed in individual taxation regimes around the world. Income tax structures, tax deductions, tax credits, and fiscal expenses, to name a few, have all evolved with modern society and the individual behaviors of citizens.<sup>14</sup>

The measurement of some sort of BEPS phenomenon, if it is possible and actually useful to policymakers, is not about the loss of tax revenues by industrialized countries. It belongs in the much larger realm of both domestic and international economic activities. Based on that broader perspective, there are no such things as OECD-flavored BEPS, which chiefly pressed forward with the industrialized countries’ interests.

But playing along, assuming the existence of these corporate “practices” that lead to the OECD-flavored BEPS, a few questions may still be worth considering by policymakers:

- Were there any durable economic benefits to the consumers all around the world, who are all the citizens of those states, in the last 30 to 40 years derived from the availability of alleged “less than single taxed” products and services and hence “cheaper” priced products and services?
- Shouldn’t the fact that global value chain management is only available to businesses with larger-scale commercial operations be worrisome to serious modern-day policymakers wary of the economic welfare of their citizens?
- From that latter perspective, why should the compliance burden be magnified on every commercial activity instead of having the tax burden simply end up on the actual bearers, that is, consumers, employees, and ultimate shareholders?

Nowadays, economic value is mostly developed through technological processes and, in some cases, financial engineering processes. The former are composed in the wider notion of intellectual property (or “intangibles,” according to the OECD). Whichever specific characterization that we may give to these activities, the value that they generate is then ultimately transferred, or immediately transferable, to shareholders, consumers, and employees, all of whom are then taxed or could be taxed accordingly. We fail to see the wrongdoings of such a simple taxation model that taxes income at its final “resting place” as coined by Richard A. Musgrave.<sup>15</sup>

Said otherwise, does any OECD economist, accountant, or lawyer seriously think that any increase of the tax burden on any commercial activity does not ultimately end up on the shoulders of the consumers, the employees, or the shareholders?

Sadly, based on the plurality of “public discussion drafts” being issued, we have little doubt that the BEPS final deliverables will end up as piecemeal designs of new formulaic apportionment mechanisms of corporate profits to industrialized countries that are all noticeably eager to get a bigger share of the tax revenue pie than what is offered by the proper and principle-based application of the arm’s-length principle.

It will indeed lead to a new growth in the amount of tax litigation and number of cases of double taxation around the world. ♦

<sup>14</sup>These modern tax regimes have also added unnecessary complexity to the subject but this is not the appropriate space to comment on that matter.

<sup>15</sup>Musgrave, *The Theory of Public Finance*, McGraw-Hill, New York (1959), p. 230.