HM Treasury

HM Revenue & Customs

Tackling aggressive tax planning in the global economy:

UK priorities for the G20-OECD project for countering Base Erosion and Profit Shifting

March 2014

HM Treasury

HM Revenue & Customs

Tackling aggressive tax planning in the global economy:

UK priorities for the G20-OECD project for countering Base Erosion and Profit Shifting

March 2014

Any enquiries regarding this publication should be sent to us at public.enquiries@hm-treasury.gov.uk.

You can download this publication from www.gov.uk

ISBN 978-1-909790-89-6
PU1651

Contents

		Page
Foreword		3
Executive summary		5
Chapter 1	Introduction	7
Chapter 2	2014 Actions	15
Chapter 3	2015 Actions	23
Chapter 4	HMRC operational / compliance efforts	37
Chapter 5	Conclusion	39

Foreword

When this Government took office, the UK had suffered the most damaging financial crisis in generations, and we inherited the largest deficit since the Second World War. We adopted a long-term plan that ensured economic stability, and laid the foundations for the UK's economic recovery. The plan is working. The UK had the fastest growth amongst the G7 economies in the year to the fourth quarter of 2013; there are over one and a half million new private sector jobs since 2010. We have taken the difficult decisions needed to secure a recovery that benefits all, and to equip the UK to succeed in the global economic race.

When it came to our approach to businesses, I was clear that we would cut their taxes to help them grow, but in exchange we would expect them all to play by the rules. That meant a strategy of reforming the corporate tax system to create the most competitive tax environment in the G20. We have done this by reducing the main rate from 28% in 2010 to 20% in April 2015, and increasing the incentives for investment such as the R&D Tax Credit and introducing a Patent Box, as well as cutting Business Rates and introducing a £2,000 Employer's Allowance to reduce the costs of creating jobs. But alongside it we set out to aggressively tackle tax evasion and avoidance.

Our approach is simple - we are doing everything we can to help companies compete in the world but expect them all to pay the tax they owe. We have already passed 34 separate measures since 2010 to clamp down on tax avoidance and we know it is working. In total, HMRC recovered £23 billion in additional compliance revenues from large businesses between April 2010 and March 2013. We are putting almost £80 million more funding into HMRC, so that they delve deeper into the tax arrangements of multinationals. HMRCs new strategic approach to managing the tax affairs of the largest 2000 businesses in the UK in a single large business directorate will enable us to do this even more effectively.

But, while we are determined to take every possible action against abuse of the UK tax rules, the truth is that in a global economy where goods and services flow freely between countries, measures taken in Britain alone will not deal with the problem; we need global tax rules too. That is why we have been pushing, through the G8 and the G20, the European Union and the OECD, for global solutions. At the G8 we led efforts to force companies to declare who owns them and to adhere to new standards of transparency so that we can see where multinationals are paying their tax and making their profits.

International cooperation is the only way to tackle the challenge of tax avoidance in the global economy. The widespread adoption of new and more powerful information technologies and the growth of the digitised economy have expanded the opportunities for UK companies to trade and grow and revolutionised how companies operate. The UK has a sophisticated digital marketplace with the highest global average online spend per capita by e-consumers. But with these opportunities we have seen new problems too when it comes to making sure companies are paying their fair share of tax. Aggressive tax planning by some digital businesses has given them an unfair advantage over their competitors. The ability of some companies to deliver products and services into a market, without the need to physically locate there, means that under current rules they can pay little or no tax on profits made in the UK. That is unfair and wrong.

The growth of highly mobile intangible assets, primarily intellectual property such as software or brands, has allowed some companies to manipulate internal transactions to ensure a high proportion of their profits accrue in low tax jurisdictions. This separation of profits from the economic activities which generates them denies the UK its fair share of tax for products and services purchased in the UK.

In 2012, the Governments of the G20 decided to take a stand, and to work together to curtail aggressive tax planning by businesses. We are already working with our international partners to legislate where we can. From next January VAT will be charged in the country where goods and services are consumed rather than where the supplier is based. This was leading to some companies deliberately locating in countries with a much lower tax rate. We expect VAT receipts to increase by £300 million a year as a result. The UK has led the way in this international action, driving the international tax, transparency and trade agenda forward under the UK's G8 presidency in 2013, and fully backs the OECD's Base Erosion and Profit Shifting project. We have also provided €550,000 to support this work and ensure that it is delivered on time. In July 2013, the OECD published a 15 point Action Plan, which I, and other G20 Finance Ministers, have endorsed and committed to deliver to the agreed timetable, with the first actions to be completed in September 2014. Whilst the project will not be completed until the end of 2015, if we can achieve our goals, we will succeed in fundamentally changing the international tax landscape, and shift the balance of the rules in favour of tax authorities, enabling us to clamp down on those who refuse to play by the rules.

In addition, the UK has already acted against tax avoidance by multinationals using certain cross-border business structures or finance transactions that exploit differences between two countries' tax rules. As part of the BEPS project, the UK supports the introduction of new rules which will deal with this issue on a global basis. Our aim is that the banking sector should not be unfairly advantaged or disadvantaged by the introduction of these rules; we do not think that banks should be privileged over other groups and we will aim to prevent this. We are also acting at this Budget to block tax avoidance arrangements that involve disguising the nature of payments between companies in a group to avoid tax in the UK. We will disregard these for tax purposes, and companies will have to pay the tax they owe on profits generated in the UK.

I am convinced that this is the right approach for Britain. To act unilaterally would not only be ineffective, it would be counterproductive too. It would simply shift more multinational tax revenues abroad, while punishing British companies who play by the rules. Because of the importance we attach to this issue, for the first time we are publishing a document to set out the 15 areas where the global tax community has committed to act, and what the UK's position on each of these issues is.

I strongly believe that our approach is the only way to deal with this problem effectively, working at a global level to secure the changes Britain wants to see - an international tax system fit for a global economy.

George Osborne
Chancellor of the Exchequer

Executive summary

Globalisation has had an important impact on the way multinational enterprises (MNEs) are structured and managed. The increasing mobility of capital and people and the rapid adoption of communication and other technologies has resulted in restructuring of MNE business models and operations. These are often based on centralised functions at a regional or global level, rather than operations being managed within individual countries. Within MNEs, individual companies undertake their activities within a framework of group policies and strategies. The separate legal entities forming the group operate together as an integrated enterprise following an overall business strategy. Moreover, digital technologies have made it possible for businesses to supply goods and services from geographic locations that are distant from the physical location of their customers. This has made it easier to shift profits, which can be done in a variety of ways. These include:

- using corporate structures or financial instruments to exploit asymmetries in the tax rules of different countries to create a hybrid mismatch. The result is that transactions are treated as taxable in one country but not in another, or give rise to a deduction in both countries. As a result the MNE can end up paying no tax in either country, or gain a tax deduction in one country but no matching taxable receipt in the other;

- manipulating transfer pricing. Transfer pricing is used to determine how profits should be allocated to companies in different jurisdictions within a MNE, and is based on the "arms length principle" (which states that these transactions should be priced as if they were transactions between unrelated parties). MNEs can seek to manipulate transfer pricing to artificially separate their assets, capital and risk, so that profit can be declared in a low tax jurisdiction;

- using structures or new technologies to minimise the need for a physical presence within a tax jurisdiction, or to deliver certain functions from another geographical location. This enables a business to ensure that the level of its activities does not create a permanent establishment and therefore a taxable presence in a jurisdiction where it is not resident;

- using contrived transactions that exploit countries' double taxation agreements, a MNE is able to "treaty shop" and attempt to reap the benefits of a lower tax rate. For instance, a resident of a low tax jurisdiction that does not have a tax treaty with the UK may attempt to limit the tax that the UK levies at source on interest, by setting up a subsidiary in a country that has a treaty with the UK and routing the transaction through that subsidiary; and

- creating Special Purpose Entities (SPEs). A SPE is defined as a legal entity that has little or no employment, operations, or physical presence, located in a separate jurisdiction to its parent company. Within the EU there are countries that act as conduits for investments, with significant in and outflows travelling through SPEs.

Tax avoidance and aggressive tax planning by MNEs is an international issue that will require a comprehensive and coordinated approach to come up with effective international solutions. For this reason, the Government helped to initiate and continues to fully support the G20/OECD BEPS project. We believe that these changes can modernise the international tax rules to tackle base erosion and profit shifting, through preventing MNEs from manipulating internal transactions, ensuring that a significant economic presence in a country gives rise to taxation in that country, preventing the establishment of shell companies to exploit tax treaties between countries, and ensuring that companies disclose more information to tax authorities and that tax authorities share that information with each other where relevant. We also believe that this will ensure a fairer and more consistent set of international rules, as well as protecting the UK tax base. Whilst changes to the international tax rules as a result of BEPS actions will not always increase UK revenues or taxing rights, they will ensure that the UK is able to apply tax rules in a fair and consistent way, and ensure that profits generated in the UK are taxed more effectively.

1 Introduction

1.1 Since the 19th century there have been successive waves of globalisation[1]. The factors behind this include: an ongoing decline in transport and communications costs; the stable and progressive removal of trade barriers, as a result of the creation of a system of international trade rules now overseen by the World Trade Organisation (WTO) and a series of multilateral trade negotiations; productivity improvements driven by technology that have improved productive capacity and made exports of products and services competitive in overseas markets; the emergence of the digital economy; and rapid economic growth, meaning that a greater number of countries and companies are engaged in significant levels of trade across borders. Between 2003-2011, the value of world goods exports rose from US $7,377 billion to US $17,816 billion[2].

1.2 This process of globalisation has put pressure on the international tax rules to adapt to these changes. These rules, which govern the taxation of cross-border transactions, are a combination of countries' domestic rules and the obligations they have taken on by entering into bilateral double taxation agreements, which are based on models developed by the Organisation for Economic Co-operation and Development (OECD) and United Nations (UN). These models originated with principles developed by the League of Nations in the 1920s. These were designed when levels of trade and cross-border investment were much lower, involved a more limited range of products and services, and relatively few companies engaged in such trade and investment. In addition, those companies that traded internationally tended to do so through similar structures and operations.

1.3 Globalisation has also created a challenge as to how to ensure that the international tax rules, and the network of tax treaties between countries built upon them, can keep pace with developments. If they are to remain fit for purpose, they will need to continue to achieve a balance of taxing rights between countries, to ensure that companies are taxed on a consistent basis across countries to facilitate trade and growth, as well as enabling tax authorities to manage compliance by MNEs effectively. Economic and technological developments have made it harder to identify where value is created within businesses and in ensuring that the rules are consistently applied to companies. Based on available data, the OECD has concluded that companies are increasingly exploiting gaps in tax rules, new technologies and business models to divorce profits from the business activities that generate revenue, in order to shift these to low tax jurisdictions where they are reported. This is apparent from analysing Foreign Direct Investment (FDI) flows. For example, in 2010 Barbados, Bermuda and the British Virgin Islands received 5.11% of global FDI[3], more than Germany or Japan. Combined, they were responsible for 4.54% of global investment. In comparison, Germany accounted for 4.28% of global investment. The British Virgin Islands were the second largest investor into China, with 14% of China's total investments, relative to the USA's 4% contribution.

[1] Chase-Dunn et al
[2] Figures for goods exports: WTO International Trade Statistics 2012.
[3] Source: OECD, Addressing Base Erosion and Profit Shifting (2013)

1.4 For these reasons, the UK played a key role in persuading the G20 group of countries to launch the work on Base Erosion and Profit Shifting (BEPS) that is being undertaken within the Organisation for Economic Co-operation and Development (OECD). This project represents the most comprehensive attempt to reform the international tax rules undertaken since they were first drafted; it will modernise the rules for the 21st century, and significantly improve the ability of the UK and other countries to prevent unfair tax avoidance by multinationals.

1.5 Along with most major economies in the world, the Government taxes individuals and businesses on both consumption and income. The UK has a territorial tax system that levies corporation tax on profits derived from economic activity carried out here – corporation tax is not levied on either sales or turnover[4].

1.6 The Government believes that the fundamental principles that underpin the international tax rules remain valid and should be retained. These include preventing double taxation and ensuring that MNEs are subject to a single set of international rules across jurisdictions to minimise disputes. However, these must be balanced by better alignment of taxing rights over profits with the economic activities that generate these, the principle that there should be no double non-taxation, and that groups should be prevented from gaining an unfair competitive advantage through aggressive tax planning. In addition, reform of the tax rules needs to take account of developments in the global economy, including the widespread adoption and use of digital technologies. Reform also needs to support economic growth and trade and investment as activities that will increase prosperity, and avoid becoming an obstacle to future growth.

1.7 The Government is committed to two objectives: ensuring that the UK remains an open, competitive economy, to achieve our aim of investment and export–led economic growth; and working with our international partners to prevent unfair tax avoidance and aggressive tax planning by MNEs. These are not incompatible objectives, but delivering them will require us to balance a number of factors, make decisions on the basis of a range of information and consult with stakeholders. This document sets out how we will achieve this, and play our part in delivering a modernised and effective set of international tax rules that are fit for purpose in the global economy.

Ensuring effective compliance

1.8 HMRC will continue its intensive management of multinationals' tax compliance and will challenge their tax planning arrangements where those amount to avoidance or otherwise push the boundaries of acceptable legal interpretations.

1.9 To support this work, HMRC will maintain and further develop its relationship with other tax authorities. HMRC will work with member countries in JITSIC and the OECD's Forum of Tax Administration to apply the model of enhanced exchange of information developed under JITSIC to a wider group of countries and explore new avenues of collaboration to identify and challenge cross-border avoidance and tax planning. One of these new initiatives involves HMRC working with a number of other tax authorities to tackle the risks posed by the cross-border operations of a number of multi-nationals in the digital sector, with administrations producing and sharing profiles of these businesses.

1.10 In his 2012 Autumn Statement, the Chancellor announced further investment of £77m to expand HMRC's avoidance and evasion work, including £29m to strengthen HMRC's work to identify and challenge multinationals' transfer pricing arrangements and its risk assessment

[4] Turnover is the monetary flow into the company based on its sales, and profit is the company's sales revenue less its costs.

capability across large business. This is expected to bring in an additional £2 billion over the five years to 2018 in tax that would have otherwise gone unpaid.

1.11 The BEPS project will to lead to changes to international guidelines, double taxation treaties and domestic tax law that will provide new sources of information to identify international tax avoidance and new rules and guidelines to challenge such avoidance. HMRC will assess the implications of these changes and ensure that they are effectively implemented and enforced by having professional staff with the right commercial and technical skills and the right arrangements for working collaboratively with other tax authorities.

Free Trade and Fair Competition

1.12 Free and fair trade requires a system of international rules, supplemented by laws in individual countries, that prevent protectionist measures from being introduced and ensures that domestic and foreign based companies are treated equally. As an advanced, internationalised economy, the UK benefits from free trade and the system of international trade rules, overseen by the WTO. British companies rely on access to global markets, investment flows, technology and expertise to improve their productivity and generate growth and employment. In 2012, UK exports reached the record level of £299.5 billion, whilst UK holdings of external assets reached £10,223 billion[5].

1.13 Globalisation has also increased competition between countries for mobile business investment, with countries seeking to use their tax systems to attract this. In the global economy, where countries compete to attract business investment, tax competition is inevitable. The UK supports fair tax competition between countries and both the EU and OECD acknowledge that this can be beneficial in driving economic growth and public sector reform, through encouraging countries to develop a balanced tax base that minimises economic distortions.

1.14 The Government has sought to balance taking steps to improve the UK's competitiveness, and to enable the UK to attract business investment, with acting to prevent unfair tax avoidance and aggressive tax planning by businesses. Reforms to the rate of corporation tax (which will be reduced to 20% by 2015), increases to generosity of reliefs for business investment in R&D and other activities, introduction of the Patent Box and reform of outdated rules (such as reform to UK Controlled Foreign Companies rules) have improved our competitiveness. Reducing the corporation tax rate will support investment and export led economic growth, through increasing the resources for business to invest. Through the changes that it has introduced, the Government has created a more competitive and sustainable corporate tax base which will continue to account for around 9% of tax receipts. This is consistent with the aim of supporting robust economic growth in the UK. To counter aggressive tax avoidance, the Government has passed 34 separate measures since 2010. In addition, targeted enforcement and compliance activity by HMRC has raised £23 billion in additional revenues from large businesses.

1.15 Whilst the Government supports tax competition, it is important that this takes place in a fair and transparent way, which is consistent with the international tax rules. Fair tax competition is where countries use their tax systems to incentivise genuine business activity or investment, without offering preferential treatment to foreign capital (known as ring-fencing.) These can include reducing their tax rates or providing incentives for certain types of investment (e.g. R&D and innovation), where such measures are targeted to create economic activity and there are safeguards to prevent abuse.

[5] *UK Balance of Payments Pink Book*, Office of National Statistics

1.16 Harmful tax practices are those which allow the shifting of profits that are divorced from the economic activity linked to those profits or which discriminate between companies operating in a jurisdiction, particularly where these are used to attract foreign investment. These include rules that facilitate tax avoidance through exploiting loopholes in treaties or domestic law. One of the objectives of the BEPS process will be to reform the tax rules to make it easier to identify and combat such unfair tax practices, which will benefit the majority of businesses that do not seek to exploit the rules. This approach will not encourage protectionism, but will encourage competitive markets that force companies to compete through innovation, quality and price, to the benefit of consumers.

UK and International Law

1.17 The UK must ensure that any reform of the international tax rules that it supports through the BEPS process is consistent with UK and international law. EU law is also an important consideration, because its provisions influence how some international tax rules operate within the EU, which affects the 21 EU Member States that are members of the OECD. The EU Treaties also oblige all Member States to respect customary international law. With regard to tax, international laws and administrative practices are based on OECD rules and guidelines, and so by extension these are the basis of relations between Member States on tax issues.

1.18 When the United Kingdom joined the European Economic Community (EEC) in 1973, it became a signatory to the European Treaties. These have subsequently been developed through negotiations between Member States, which led to the creation of the European Union in 1993.The relevant Treaties now in force and which govern the application and function of the Single Market are the Treaty of the European Union (TEU) and the Treaty on the Functioning of the European Union (TFEU) as set out in the Treaty of Lisbon[6]. These Treaties, along with the Charter of Fundamental Rights[7] and general legal principles, represent the primary legislation of the EU. Secondary EU legislation, which includes Regulations, Directives and Decisions, is subordinate to primary legislation and is only valid if it is consistent with legislation which precedes it.

1.19 The Court of Justice of the European Union (CJEU) is the judicial authority of the Union and the body charged with interpreting EU law. As primary legislation, Treaty rights can be directly invoked by individuals and businesses to challenge the validity of domestic legislation. Regulations are also directly applicable, are binding and must be complied with fully by those to whom they apply, to ensure the uniform application of Union law in all the Member States. Directives are binding as to the result to be achieved, but leave to the national authorities the choice of form and methods.

1.20 These Treaties have created Fundamental Freedoms for individuals and businesses within the EU to support the internal market as an area without internal frontiers: the free movement of goods, persons, services and capital. These enable business activity to be carried out across borders, without discrimination between domestic and foreign enterprises. Businesses can choose to locate production, management, supply chains and reach customers anywhere across the world. The application of Fundamental Freedoms to direct taxes aims to decrease the distorting effect of tax factors when businesses choose where to locate within the internal market and has largely been successful in this.

1.21 EU rules on State Aid seek to prevent the distortion of international markets, and ultimately derive from the WTO Agreement on Subsidies and Countervailing Duties. The European

[6] Came into force 1 December 2009.

[7] C364/1, 18 December 2000

Commission may instigate proceedings against a Member State when it considers that a measure is provided through State resources, favours certain undertakings or the production of certain goods or relates to an activity that is tradable between Member States and the measure distorts, or has the power to distort, competition. In terms of tax, State Aid must be taken into account when considering incentives or reliefs.

1.22 Under EU law, direct taxes are a Member State competence, over which they exercise sovereignty. However, this competence must be exercised consistently with EU law and Member States must not implement any domestic law which is contrary to the Treaties (including interpretation of the Treaties by the CJEU). Member States' power to act in relation to taxation, whether direct or indirect, must also be exercised in accordance with State Aid rules (paragraph 23). However, State Aid may be permitted, subject to certain conditions and guidelines, where aid is deemed to be compatible with the Treaties.[8]

1.23 To date there have only been three directives in the area of direct taxation: the Mergers Directive[9], the Parent-Subsidiary Directive[10] and the Interest and Royalties Directive[11]. These put in place a common system of taxation for cross-border reorganisations and cross-border interest and royalty payments between group companies, abolished withholding taxes on dividends paid cross-border within a group and has abolished, wherever possible, withholding tax on cross-border interest and royalty payments. These measures have benefited business and helped to minimise double taxation.

1.24 The CJEU has developed a significant body of case law which illustrates the practical tensions between Member States' autonomy in the area of direct tax policy and their Treaty obligations. For example, the CJEU has been reluctant to accept instances of discrimination and has interpreted circumstances where anti-avoidance can be used by Member States as an effective defence in a narrow way, as exemplified by the decision in *Cadbury Schweppes*[12]. However, in more recent tax decisions, the CJEU has shown a willingness to embrace the concept of a balanced allocation of taxing rights between Member States, as per the decisions in *National Grid Indus*[13] and *Commission v Portugal*[14].

1.25 Apart from EU law, there are a number of other international obligations which also affect the UK's power to tax. These include trade obligations under the WTO's General Agreement on Tariffs and Trade (GATT), which prevents discrimination through taxes on imports. In addition, as a member of the OECD, the UK is subject to non-legislative agreements on taxation such as minimum standards on exchange of information and other standards within the OECD Model Tax Convention.

The BEPS Project

1.26 In 2012, the G20 Finance Ministers called on the OECD to consider how to address base erosion and profit shifting, or the exploitation of the international tax rules by MNEs to move profits to low tax jurisdictions, divorced from the economic activities that generate them. The OECD presented its initial report on *Addressing Base Erosion and Profit Shifting*[15] to the G20

[8] For instance, UK film tax credits are deemed to be a State Aid because they support a specific sector; however, they are considered to be compatible with State Aid rules in that they address market failure and support common European goals for culture in a proportionate way.
[9] Council Directive 90/434/EEC of 23 July 1990, as amended
[10] Council Directive 90/435/EEC of 23 July 1990, as amended
[11] Council Directive 2003/49/EC of 3 June 2003, as amended
[12] C-196/04) [2006] ECR I-7995.
[13] November 2011 – C- 37/1/10
[14] Case C-38/10
[15] The original Addressing BEPS report and subsequent action plan are both available on-line http://www.oecd.org/ctp/beps-reports.htm

meeting of Finance Ministers in Moscow in February 2013. This presented the studies and data available regarding the existence and extent of BEPS, as well as analysing the international tax rules and the BEPS opportunities these rules may create.

1.27 G20 Finance Ministers welcomed the report, and requested that the OECD work with countries to produce an Action Plan for reform of the international tax rules. This was endorsed by the G20 Leaders in September 2013. The Action Plan is wide-ranging in scope and covers a number of issues. To demonstrate commitment to this project, the Government, together with Germany and France, contributed €550,000 to the OECD to ensure progress could be made on the Action Plan. The 15 actions contained in the Action Plan will be delivered between September 2014 and December 2015 by the various OECD Working Parties responsible. This paper sets out the key legal and other factors that the UK Government will take into account when developing its policy towards the BEPS negotiations, sets out what the Actions are and the UK Government position on these on the basis of the timetable to which they will be delivered.

BEPS Principles

1.28 The Government believes that in order to be effective, any solutions developed through the BEPS process will need to embody certain core principles, and be consistent with key policy objectives. They should be consistent with the Ottawa Principles of neutrality and equity between different businesses, provide as clear and simple a framework of rules as possible, be effective and efficient for tax authorities and taxpayers, be flexible and adaptable to commercial and technological developments, and capable of being applied in all jurisdictions. In addition, the Government believes that proposed solutions should be consistent with the following objectives:

Domestically

- contribute to improving the stability and sustainability of tax revenues;
- be proportionate, consistent, provide certainty, and aim to achieve a level playing field with similar rules applying to similar circumstances between firms;
- be consistent with the Government's wish to promote UK growth and competitiveness; and
- be operationally efficient and take account of the compliance and administration burden for the Government and business.

Internationally

- advance international cooperation while respecting the tax sovereignty of individual countries;
- facilitate trade by eliminating double taxation, and prevent companies from gaining an unfair commercial advantage through double non-taxation;
- favour fair tax competition on a global level between jurisdictions and work against harmful tax practices and against protectionism; and
- encourage fairness, both between developed and developing countries, between domestic and international businesses, and between UK-based and foreign-based international businesses.

The BEPS project will inevitably lead to consideration of a range of possible policy options. In considering whether to support options, the Government will undertake a careful assessment of these against these principles, to determine the most effective options to resolve specific tax challenges. This will inevitably involve the need to weight consideration of these factors according to circumstances, including where special rules may be needed in special circumstances. We will also need to ensure that solutions are consistent with relevant national and international law.

2 2014 Actions

Tax and the Digital Economy (Action 1)

2.1 There are very real concerns over how certain digital businesses engage in aggressive tax planning and the impact that this has on competitors - particularly small, domestic businesses, which do not have the opportunity to arrange their tax affairs in this way. Because of this, the UK is fully supportive of the work of the OECD's Task Force on the Digital Economy.

2.2 The rise of the internet and the effect of its integration into every business sector has been compared to the Industrial Revolution in the 19th century. In an increasingly globalised and digitised economy, technology has transformed growth potential through the collection, storage, analysis and communication of information, enabling small and large businesses alike to reach and service more customers, across a wider geographic spread, than ever before.

2.3 With the highest take-up and coverage of superfast broadband among leading European economies[1] and one of the highest levels of broadband penetration globally[2], some studies have found that the UK is a net exporter of digital products and services[3] and that the UK has the highest global average online spend per capita by e-consumers[4]. In addition, UK-based businesses are utilising digital technology to underpin growth strategies. Digitisation of the economy has changed the way many types of traditional businesses are conducted. For example, sectors as diverse as logistics, financial services and education have been able to use key features of the digital economy to significantly influence how they generate both value and income.

2.4 This means that it is not feasible to ring-fence the digital economy from the rest of the economy in order to apply entirely separate rules to it. Attempting to do so by creating artificial boundaries would cause unintended consequences, is unlikely to provide a long-term solution as the digital economy continues to evolve and could hamper prospects for growth in the UK. Instead, we think it is important for the OECD to analyse precisely how value is created in modern businesses which rely on digital technologies and complex systems, or where computing-related intangibles are central to revenue models, and consider how the existing rules can be updated to take this into account. Therefore, our view is that the key objective is to achieve consistent tax treatment of primarily digital companies and those where digital technologies are incorporated into their business models by focusing on comparable activities and seeking to ensure these receive consistent tax treatment within a jurisdiction.

2.5 So far, the Task Force on the Digital Economy has found that tax planning structures and arrangements which result in BEPS are generic and can be utilised by multinational groups in all sectors. However, some characteristics of digitised business models exacerbate existing challenges in applying the international tax rules consistently to companies. These include, for instance, the ability of businesses to deliver products and services into a market without the

[1] Ofcom, European Broadband Scorecard (2014)
[2] Ofcom, European Broadband Scorecard (2011)
[3] The Connected Kingdom, BCG (2010), The Internet Economy in the United Kingdom, AT Kearney (2012)
[4] http://www.emarketer.com/Article/UK-Ecommerce-Sales-per-Person-Lead-All-Markets-Worldwide/1009650

need to physically locate there and thereby create a permanent establishment[5]; the ability to fragment activities within a group to ensure that the threshold for creating a permanent establishment in relation to any particular group company operating in that country is not breached; the growth in proportional value of mobile intangible assets and increased reliance in a value chain on computing power and infrastructure which can more easily be located in low or no tax jurisdictions; and the ability of some market-leading businesses to quickly establish a significant market share through multi-sided business models[6] and the impact of network effects[7].

2.6 We consider that many of these challenges can be addressed through work that is already within the scope of the BEPS Project. Working Party 1 is currently considering the definition of permanent establishment and options, amongst other things, to address fragmentation. There is a need to seriously consider revising this concept in order to take account of technological advances, including advances in functionality. Any changes to the definition of permanent establishment should apply to all businesses and would likely need amendments to the rules on profit attribution, which would be done in conjunction with Working Party 6.

2.7 Working Party 6's work on the transfer pricing of intangibles[8] is focussing on 'important functions', to ensure that under revised transfer pricing rules, less profit should be allocated to the mere holding of IP and provision of capital, which can typically be done from low/no tax jurisdictions.[9] The OECD must also undertake detailed economic analysis of digital economy issues on an ongoing basis. This is needed to enable a full understanding of the role and valuation of intangible assets within digital business models, including how brands and markets develop and expand in the digital economy, where value is created within the supply chains of digital businesses, and the capability and adoption of new technologies and systems. This understanding is crucial to ensuring that activities requiring a physical presence, such as advertising and brand management, are fully identified and rewarded and should feed into the ongoing work of WP6 to update transfer pricing guidelines.

2.8 Many of the tax challenges in the digital economy are the result of digital technologies exacerbating problems that exist as a result of development in the global economy outpacing the development of the tax rules. These problems are likely to be most effectively addressed through expanding the work of other OECD Working Parties to take account of issues in the digital economy. However, there may still be outstanding digital issues apart from the work carried out by WPs 1 and 6, and as part of the BEPS Project we will propose supplementary rules in those areas if progress on updating the existing international framework fails to materialise. For example, one issue we will explore is how to ensure that income from online advertising is properly taxed, as this is how a number of 'digital firms' with lower physical requirements generate significant income. In general terms, however, digital technology should be seen as an opportunity to foster growth and we would not want to see this impeded by ill-considered actions emerging from the BEPS project.

2.9 The UK has been at the forefront of moves to modernise the EU VAT indirect tax rules so that services are taxed by the Member State where these are used or consumed (the destination principle). EU Ministers unanimously agreed to a series of changes to achieve that, with the final

[5] A permanent establishment is the minimum threshold at which a company doing business in another country becomes liable to tax there. See AP7 on Permanent Establishment.

[6] For example, a business may provide free or subsidised services that attract a large number of users. This enables the business to generate revenue from advertisers who want to sell products and services to those users.

[7] Network effects in the digital economy are created when a particular service or platform attracts such a high level of use that it offers significant advantages in terms of connectivity to suppliers and users. This then becomes self-reinforcing, as users perceive a need to use the service or platform, which increases the market share of the company in attracting business or revenue from related activities such as advertising.

[8] See Actions 8-10 on transfer pricing.

[9] See paragraphs 108-112 (Separation of reward from value creation)

step being changes to be introduced across the EU on 1 January 2015. This is a key step as the changes will ensure broadcasting, telecoms and e-services are taxed by the UK, when they are supplied to UK consumers from suppliers located elsewhere in the EU. This will bring the VAT treatment in line with the rules that already apply to suppliers located outside the EU.

2.10 This will end the distortions caused by the current treatment, whereby such supplies from suppliers located elsewhere in the EU are taxed where the supplier belongs. Under the current treatment it is only if the supplier belongs in the UK that VAT is charged and accounted for in the UK. If the supplier is located elsewhere in the EU, then VAT is charged at the rate of the country in which that supplier is located, even if the supplier is supplying services to UK consumers. This has led some businesses to locate in countries where the tax rate is most advantageous to them. The changes will level the playing field for UK businesses and consumers and ensure the UK receives its fair share of VAT revenues. Overall, the changes will protect up to £5 billion in UK VAT revenues that could be lost if UK businesses supplying these services to UK consumers were to re-locate to low VAT rate Member States. UK VAT receipts are expected to increase by approximately £300 million a year as a result of the changes.

2.11 The OECD is currently developing International VAT/GST Guidelines. The aim is to put in place a global framework for the application of VAT/GST and to build the widest possible international consensus on the Guidelines as the future international standard for applying VAT to cross-border trade. This work takes as its starting point the destination principle on which the EU rules are based. The EU experience, including work leading up to the 2015 VAT changes, is feeding into the International VAT/GST Guidelines project. This in turn is feeding directly into the work of the OECD's Task Force on the Digital Economy.

2.12 Whilst securing an effective consumption tax is important, and part of ensuring that the UK is able to maintain the right tax mix from a policy perspective, it cannot be the only answer to the challenges that digital technology raises with respect to international taxation. Corporation tax continues to be an essential part of the UK's tax base and we emphasise the importance of designing both corporate income and consumption tax systems that promote growth and investment and establish a level playing field among businesses.

AP1: Tax and the Digital Economy

Digitisation of the economy is challenging the way that international tax rules are applied. We believe that work to update the threshold at which a company becomes taxable in a foreign country and transfer pricing guidelines to take into account technological advances will address many of these challenges, but we will propose supplementary rules to tackle specific issues raised by digitisation if progress on updating the existing international framework fails to materialise.

Neutralise the effects of hybrid mismatch arrangements (Action 2)

2.13 Hybrid mismatches occur when an MNE makes use of a hybrid financial instrument or a hybrid entity to reduce the corporation tax that would otherwise be payable when looked at on a group-wide basis. A hybrid financial instrument is one that is treated as producing a payment that is tax deductible in the country in which it is paid, but which is not treated as a taxable receipt in the recipient's country (or which is not very highly taxed). A typical example is an instrument treated as debt in one country but as equity in the other.

2.14 A MNE can set up a hybrid entity that is treated as taxable (or opaque) under the law of one country, for example the country of residence but which is not recognised (is transparent) under the law of another, for example the country in which its parent is resident. Hybrid entity mismatches can arise because of differences between countries' tax treatments of a particular entity, or because a country has rules which permit businesses to choose whether an entity is opaque or transparent. Depending on the circumstances, a payment by a hybrid entity can give rise either to a deduction in two countries (a double deduction) or a deduction in one country with no taxable receipt in another. In other circumstances, payments made to a hybrid entity can produce the same mismatches.

2.15 For a cross-border transaction it is not always possible to establish which country's tax base is being eroded and so rules which rely on being able to show that there is a main purpose of eroding a specific country's base, such as the UK's anti-arbitrage rules, can only operate from that country's perspective. But designing rules which can be adopted by a number of countries and applied consistently by each can provide a solution which addresses the international problem comprehensively. For hybrid financial instruments, important considerations are the way in which the hybrid mismatch is neutralised, and the scope of the rules in terms of the type of instrument and the relevance of any relationship between the payer and payee.

2.16 To solve this problem, it has been proposed that a rule should be introduced to apply only where there is a mismatch. This would either deny the payer a tax deduction for the payment, or force the recipient to include the amount as a taxable receipt, neutralising the mismatch. To prevent rules designed for multilateral adoption from producing double taxation, there must be an agreed order for their application. For example the rules could deny a deduction first, and force inclusion second. Applying the rules in this order provides the most direct response to the asymmetric deduction produced by a hybrid financial instrument. If the instrument was between two countries which had adopted the anti-mismatch rules then only the primary rule (deny deduction) would be needed. But if the payer's country did not operate these rules and a deduction was not denied, then the secondary rule would apply to force inclusion for the recipient.

2.17 For the scope of the rule, two approaches are being considered. The first is to set out specifically what falls within the scope of the rule. The second is to say specifically what falls outside its scope. An example of the first approach might be to include only hybrid financial instruments held by related parties (including parties acting together) and hybrids held as part of structured arrangements. An example of the second approach might be for the rules to apply to all hybrid financial instruments other than those which are widely held or traded. If the second approach were adopted, it would be necessary to ensure that instruments held by related parties or as part of structured arrangements were included, even if those instruments were widely held or traded.

2.18 In assessing which of the two approaches is preferable, an important factor is the relative practicality of the two approaches. It is important to have workable rules which address the areas of greatest risk while seeking to minimise the additional compliance costs imposed on both business and the tax authorities. The first approach may well be easier to operate, given that it would require less information exchange between potentially affected parties.

2.19 In considering the scope, thought will also need to be given to the treatment of hybrid regulatory capital held by the financial sector, where the hybrid nature of the instrument is essentially imposed by the regulator rather than being chosen by the business. The concern would be the extent to which anti-mismatch rules might disincentivise regulated financial institutions from raising capital in more loss absorbing forms, an outcome which would be counter to regulatory objectives. The case for any specific rules designed to reduce the impact of the hybrid mismatch proposals on banks' holding of regulatory capital would need to be considered in the light of evidence about the wider commercial constraints arising from the regulatory environment. The effect of any such rules would be limited to addressing any demonstrable disadvantaging of the financial sector compared to other business sectors when raising capital.

2.20 Similar practical issues arise between parties using a hybrid entity to produce a mismatch. Where the mismatch arises from a country's rules which permit an entity to choose whether it is opaque or transparent, then their scope could determine the scope of the anti-mismatch rules. Where the mismatch arises from the difference in tax treatment by two countries of a particular legal entity, then the scope needs to be considered separately, but again by reference to the need to balance the workability and practicality of the rules with the aim of providing a general solution to the use of hybrid entities to erode the global tax base. For example in dealing with hybrid entities it would seem reasonable for the primary response to be to deny a deduction for the payment giving rise to the mismatch, with forced inclusion as the defensive rule. All these issues are being considered by Working Party 11, who are developing draft recommendations on anti-hybrid rules which will be published by the OECD Secretariat for consultation in April.

AP2: Neutralise the effects of hybrid mismatch arrangements

Hybrid mismatches occur when the tax treatment of a financial instrument (or entity) differs between countries, allowing for exploitation by multinational groups seeking to artificially lower their effective tax rate. The UK supports the current work around Action 2 to develop new international tax rules to prevent companies avoiding tax through the use of certain business structures or finance transactions, ensuring that these do not create an unfair advantage. However, the exercise needs to consider whether there could be special rules for intra-group hybrid regulatory capital instruments that are a direct consequence of regulatory requirements.

Prevent treaty abuse (Action 6)

2.21 The UK has around 120 bilateral Double Taxation Agreements with other countries and territories. Their intention is to secure that, as far as possible, residents of each country may trade or invest in the other country without the deterrent of unrelieved double taxation. At the same time, it is important to ensure that taxpayers do not exploit the terms of the agreements and differing tax systems in each country for tax avoidance purposes. For this reason, the purpose of tax treaties explicitly includes the prevention of "fiscal evasion", a phrase that has been interpreted broadly by the OECD and the UK courts as encompassing the avoidance of taxation.

2.22 Tax treaties generally prevent double taxation by dividing taxing rights between the country in which income arises and the country in which the owner of the income resides. Some categories of income are either exempt from tax in the country in which they arise, or may only be taxed in that country under certain conditions or up to a particular rate of tax. Where income, profits or gains are taxable in both countries, double taxation is prevented by the country of residence either exempting them from tax, or giving credit for the tax charged in the other country. Provisions limiting the rights of a country to tax income have obvious potential to be exploited in an attempt to obtain the benefits of a tax treaty in situations that were not envisaged by the signatories.

2.23 A common example of this abuse of tax treaties is "treaty shopping" where a resident of a country, that is not a party to a treaty, attempts to access the benefits it provides by the use of artificial or contrived transactions. For example, a resident of a low tax jurisdiction that does not have a tax treaty with the UK may attempt to limit the tax that the UK levies at source on interest by setting up a subsidiary in a country with which the UK does have a tax treaty and routing the loan through that subsidiary.

2.24 The avoidance of withholding taxes and the obtaining of treaty benefits are key elements of some of the structures employed by some MNEs to shift profits out of countries in which economic activity takes place to low or no tax jurisdictions. For example, the advantage of reducing taxable profits in one country through the payment of tax deductible interest or royalty payments would be negated if those payments were subject to a withholding tax in the country in which they arose.

2.25 The UK fully supports the objective of preventing treaty abuse and has, for some time now, included in its tax treaties provisions aimed at denying benefits where persons have a main purpose of taking advantage of a treaty's provisions (see for example the UK's tax treaties with Canada, France, Germany, Italy, Japan and Russia). Other countries also already take measures in their treaties to prevent them being abused; some taking a similar approach to the UK while others prefer a "limitation on benefits (LoB)" approach. The UK has LoB provisions in its tax treaties with Japan and the USA.

2.26 The focus group on Action 6 is examining the effectiveness of these two basic approaches, both from the perspective of preventing treaty benefits where necessary and, equally importantly, ensuring that benefits are not denied inappropriately. The LoB approach ensures that treaty benefits are granted only to defined categories of residents ("qualifying persons") and can deny benefits where structures are employed in order to access treaty benefits inappropriately. A purpose based approach, on the other hand, looks at transactions and provides a more flexible approach to treaty abuse than the LoB. This is because a purpose-based approach is able to deny benefits where qualifying persons are engaged in abusive transactions but will not deny benefits where non-qualifying persons are engaged in wholly commercial transactions. Draft recommendations on anti-abuse measures to be included in tax treaties have now been published by the OECD.

2.27 As well as recommendations on the design of treaty provisions to prevent abuse, the work on Action 6 also includes measures to state explicitly for the first time that the purpose of tax treaties is not to facilitate non-taxation and recommendations on the tax policy considerations that countries should take into account before deciding whether to enter into a tax treaty.

AP6: Prevent treaty abuse

Tax treaties are intended to prevent double taxation by dividing taxing rights between countries, but these can sometimes be exploited by the use of artificial or contrived transactions. The UK fully supports the objective of preventing treaty abuse and includes provisions in its treaties to deny benefits to persons whose main purpose is to access tax benefits through those treaties. The OECD is examining the most effective way of preventing treaty abuse and has published draft recommendations.

Country-by-country reporting template and transfer pricing documentation (Action 13)

2.28 One of the key obstacles for tax authorities is a lack of useful information that allows for an effective assessment of risks to tax systems arising from aggressive tax planning. A clear overall picture of the global position on profit and tax of the multinational groups operating in their jurisdiction will enable tax authorities to make a more informed assessment of where risks lie and thus where their efforts to counter such activity should be focused.

2.29 Through its Presidency of the G8 last year, the UK played a leading role in initiating the proposal for a country-by-country reporting template. The work is now being taken forward through the BEPS project to meet the deadline of September 2014. We believe that this important initiative will enhance transparency between business and tax authorities, including those of developing countries, by providing tax authorities with high-level information to help them efficiently identify and assess risks.

2.30 For example, information on the level of profit being reported in the countries in which a multinational operates might reveal that a large portion of a multinational's overall profits are being reported in a low tax jurisdiction – but without an indication of what value-added activity is taking place there. This scenario would likely be flagged as high risk and merit further investigation by the authorities concerned. In other circumstances, where the profits are split between normal rate tax countries, it is more likely that this reflects low risk as the likelihood of profits being moved artificially is small.

2.31 Improved transparency between business and tax authorities would be useful to developing countries in dealing with compliance, as often they lack the capacity to collect this information themselves. Reporting high level information using a standardised format across all jurisdictions would ensure consistency, enable tax authorities to readily compare data and minimise the additional administration burden on business.

2.32 In taking forward these proposals we need to balance the compliance burdens on businesses with the objective of providing high level, useful information to tax authorities for risk assessment. We do not require businesses to produce huge amounts of new information – that would not be constructive for government or business. Instead we are looking for companies to provide the data they prepare in the normal course of business to the tax authorities in the jurisdictions in which they operate in order to maintain confidentiality.

Transfer pricing documentation

2.33 The wider proposals contained in the redraft of Chapter V of the Transfer Pricing Guidelines to reform transfer pricing documentation set out a model comprising a master file and country files. The aim is to deliver an appropriate level of documentation to tax administrations to explain the business operations of a group and how its transfer prices have been arrived at. We recognise the cost to business of providing information. Therefore, the guidelines should also reduce the compliance burden to business by standardising documentation and providing a common master file which could be made available to all jurisdictions in which an MNE operates.

Example of how the high level information in the country-by-country reporting template could be of use to tax authorities (see pictorial diagram overleaf)

2.34 Consider a multinational group operating in a normal rate Country A that has global publicly reported profits of 1000 but only a small portion (100) of this is reported in that country. Currently, Country A does not know where the remaining profit is reported so does not know if there is anything untoward taking place, typically until well into an audit. Under the new proposal, the tax authority of country A can access the high level information on the global allocation of profits between the different countries in which the multinational operates to find out where the remaining profits are reported. The outcomes would be:

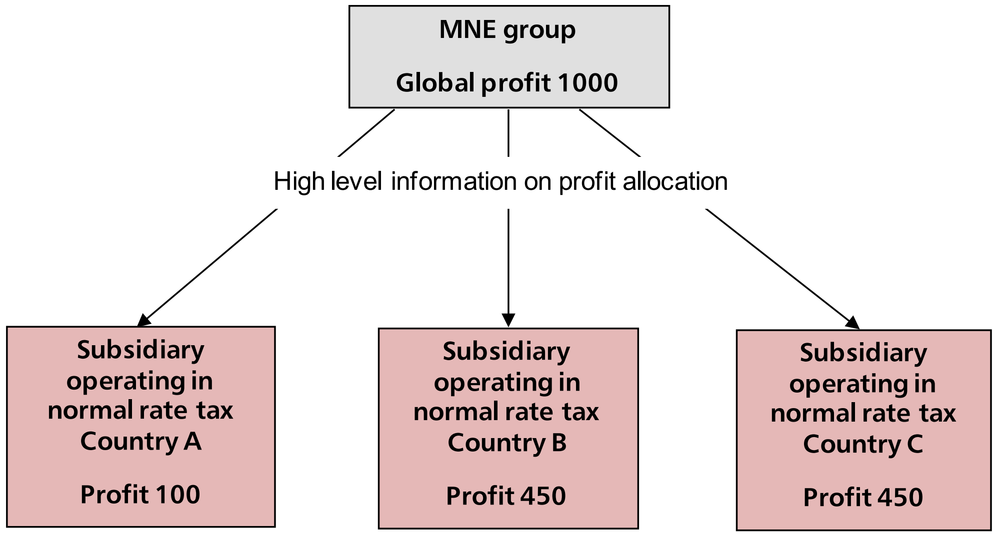
- *Scenario 1 (low risk)* – If the remaining 900 of profit is found to be reported across other normal rate tax Countries B and C then there would, quite probably, be little cause for concern.

- *Scenario 2 (high risk)* – However, if the remaining 900 of profit were to show up in a subsidiary in a low tax jurisdiction this may highlight a need for the tax authority of Country A to further investigate the appropriateness of the profit allocations, by carrying out an audit.

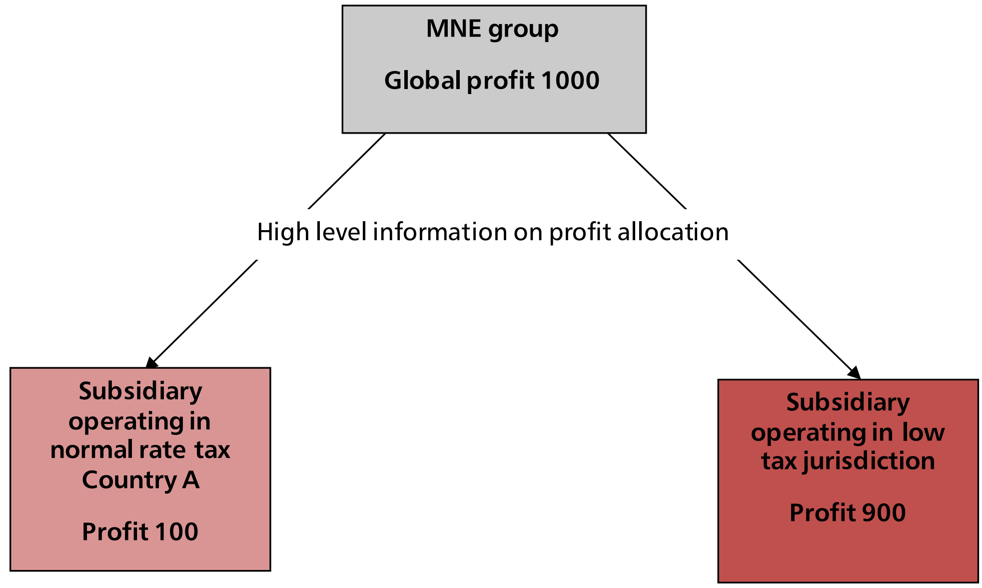
AP13: Country-by-country reporting template and transfer pricing documentation

One of the key obstacles for tax authorities is a lack of useful information that allows for an effective assessment of risks to tax systems arising from aggressive tax planning. Through its Presidency of the G8 last year, the UK played a leading role in initiating the proposal for a country-by-country reporting template, which will give tax authorities worldwide a clear picture of multinational's profit and tax. We believe that this important initiative will enhance transparency between business and tax authorities, including those of developing countries, by providing tax authorities with high-level information to help them efficiently identify and assess risks.

Scenario 1 (low risk)



Scenario 2 (high risk)



3 2015 Actions

Strengthen CFC rules (Action 3)

3.1 The purpose of the UK's Control Foreign Company (CFC) rules is to protect the UK tax base from tax avoidance and aggressive tax planning. They do so by preventing the artificial diversion of taxable profits to low-tax subsidiaries, if those profits result from UK economic activity and associated intellectual property, or from UK capital. The rules take a practical approach to quantifying the profits which have been diverted from the UK to foreign companies that are controlled by UK residents, and which pay significantly less tax on those profits than a UK company would. These profits are then taxed at the UK rate, with relief given for any foreign tax paid. The rules aim to minimise the compliance burden for businesses.

3.2 The UK first introduced CFC rules in 1984. By the 21st century, these rules were not aligned with the rapid changes to the global economy. Businesses were increasingly of the view that the rules sometimes caught profits that they saw as having no real connection with the UK. One consequence was that UK-headed MNEs chose to establish new ultimate holding companies outside the UK, thus escaping the UK's CFC rules entirely. A further consideration in designing workable CFC rules is that in an open economy like the UK's, it is important to have as level a playing field as possible between home-based and foreign-based groups.

3.3 CFC reform had been an area of discussion between business and government since 2007 and this Government concluded that, as part of wider reforms to improve the competitiveness of the UK's corporate tax system, new CFC rules should be introduced. This involved further design work and consultation. The new rules were introduced in 2012 and took effect from January 2013 onwards. The new rules take account of the way businesses operate in the global economy, while still protecting the UK tax base.

3.4 Importantly, the new CFC rules reflect the UK's move to a more territorial corporate tax system, an approach adopted by most developed countries, which is well adapted to a more open economy and to globalisation. Given the high level of foreign investment in UK-based MNEs, attempting to tax foreign shareholders on profits relating to genuine overseas activity simply because a business is headquartered in the UK cannot be justified, and would likely result in foreign shareholders investing directly in the third (foreign) country or via a MNE which is based outside the UK. As a consequence, the rules do not tax businesses on profits arising from genuine activity outside the UK and they do not tax businesses which have invested profits earned in one overseas territory in another. This benefits UK businesses seeking to expand into other countries, ensuring they can compete with other businesses operating there. Keeping the rules closely focused on artificially diverted profits also helps ensure that CFC rules comply with EU law.

3.5 The BEPS project should encourage more countries to adopt and enforce workable CFC rules. This will make it more difficult for MNEs based outside the UK to divert profits to low-tax countries, helping to level the playing field between MNEs and UK domestic businesses. Countries will adopt CFC rules that suit their own circumstances. For example, very restrictive CFC rules may lead to adverse consequences for investment in an open economy where large business has a global shareholder base. The UK is contributing actively to the BEPS discussions on the design and operation of CFC rules, based on the experience gathered during the reform process. In particular the rules can help to prevent overcapitalisation of low-tax companies and the separation of risk (and hence reward) from the related economic activity for those MNEs to which they apply. Having just completed its own major reform, it is not anticipated that the UK's rules will require further substantive changes.

3.6 It is important to recognise that some countries have very different tax systems from the UK, and do not tax corporate profits. The reasons for such a country to adopt CFC rules are not obvious. Even where a country has corporation tax, current experience shows that some countries see a competitive advantage in not having CFC rules. The consequences of increased but not universal introduction of CFC rules might have the unintended effect of increasing this perceived advantage.

3.7 The BEPS Action Plan offers opportunities to consider both primary rules such as transfer pricing and rules such as the CFC rules which provide an essential backstop against profit shifting. One advantage that transfer pricing has over CFC rules is transparency of application. The proper application of transfer pricing rules is easier for other countries to establish during resolution of disputes than the effective operation of a country's domestic CFC rules. Taken together with the other issues discussed, including the need for CFC rules to be applied within the European Union to meet EU law requirements, it is therefore important to give greater focus and priority to primary rules such as transfer pricing rules and to some of the other BEPS Actions.

AP3: Strengthen CFC rules

CFC rules can provide an essential backstop against profit shifting. The UK has recently reformed its Control Foreign Company (CFC) rules to protect the UK tax base from tax avoidance and aggressive tax planning. Importantly, the new CFC rules reflect the UK's move to a more territorial corporate tax system, an approach adopted by most developed countries which is well adapted to a more open economy and to globalisation. The BEPS project should encourage more countries to adopt and enforce workable CFC rules. This will make it more difficult for MNEs based outside the UK to divert profits to low-tax countries, helping to level the playing field between MNEs and UK domestic businesses.

Limit base erosion via interest deductions (Action 4)

3.8 Giving tax relief for interest as a business expense in earning profits accords with international accounting treatment and is the approach adopted by most OECD countries, including the UK. However, the integrated global financial system means that debt finance can be relatively easily raised and moved across a range of tax jurisdictions by a group, to facilitate the shifting of profits to low or no tax jurisdictions.

3.9 In order to address this risk, many countries have introduced anti abuse rules or arm's length tests that restrict interest deductions on particular loans or debt instruments, where respectively there is an abusive purpose, or the interest deduction claimed does not reflect an arm's length amount. The UK corporate tax code includes both types of rules: an unallowable purpose rule where a company is party to a loan or debt instrument with a main purpose of tax avoidance; and a thin capitalisation rule that applies where a company has more debt than it either could or would borrow if it was acting at arm's length from the lender or guarantor of the debt.

3.10 In the past decade, many countries have also introduced 'structural' interest restriction rules that apply to all borrowings on a company or group basis, rather than by reference to particular debt transactions, aiming, at least in part, at countering the tax-driven creation of intra-group debt. The two most common models are:

- earnings-stripping rules that place restrictions on the level of debt held by a company or group relative to its income. The majority of these rules are targeted at curtailing a wider use of excessive debt finance, not just related-party debt; and
- models based on allocating or attributing interest across a group. These approaches normally recognise interest paid to external lenders as a legitimate business expense, but seek to prevent groups from loading too much of the debt to group members in a particular jurisdiction. They also seek to prevent groups from using the creation of intra-group debt to shift profits to low or no tax jurisdictions through the payment of interest from a debtor in a normal tax jurisdiction to a creditor in a tax haven. Such rules may restrict net interest relief where a country's share of the group's overall interest expenses exceeds that country's share of the group's worldwide business, measured by a proxy for economic activity on a per company basis. Identification of a suitable proxy measure is one of the key challenges for this approach.

3.11 The UK corporate tax code includes a limited version of the second model called the Worldwide Debt Cap. This rule ensures that the interest relief claimed in the UK does not exceed the amount attributable to the group's total worldwide external debt. Action 4 is exploring both of the models described in paragraph 75 and will make recommendations on best practices around the design of domestic rules on interest restrictions that countries could introduce to limit base erosion from interest payments. The timetable for report on this Action is September 2015. The UK looks forward to the output from the BEPS work on limiting the use of interest deductibility as a means for shifting profits, especially the identification of best practice.

3.12 There are advantages to businesses and governments in a more standardised approach to interest restriction that reduces the opportunities for tax arbitrage, but also reduces the complexity of applying and abiding by different sets of rules where businesses operate across a number of jurisdictions. However, restricting the deductibility of interest is likely to have a significant impact on many businesses. The design of such rules therefore needs to recognise the heterogeneity of business models across sectors, particularly those that have legitimately high leverage ratios. The design of such rules would also need to take account of the constraints of EU law.

3.13 There are two sectors in particular that would need careful consideration with regard to the design and application of any structural interest restriction rules. Any amendments to the rules would also have to take into account the specific circumstances of sectors that would be significantly affected by the application of structural interest restriction rules, such as the infrastructure and the financial services sectors.

Infrastructure

3.14 Most major infrastructure projects are financed and delivered through special purpose companies, which have a very high level of debt relative to equity with most projects financed by around 80-90% senior debt. This is standard international commercial practice. Debt finance is used to fund infrastructure because this minimises the financial risk for investors, who are also willing to lend against the secure, predictable cash flows into the special purpose company. The characteristics of infrastructure projects are such that their financing may be sensitive to changes in the tax treatment of financing costs, in part because of the very long term nature of the projects.

Financial Sector

3.15 Banks make trading profits from, among other things, the margin between interest paid on money borrowed and interest earned on money lent. Debt is thus part of the circulating capital of the business and the associated interest cost of servicing that debt is a core trading expense. For insurers interest is earned on investments to provide a return for customers and customer premiums are invested to ensure funds are available to pay out on policies. Therefore insurers will normally be net interest recipients with respect to certain lines of business in their trading operations. Both banks and insurers meet part of their regulatory capital requirements through debt financing (which is different from their circulating or day to day capital). Banking and insurance groups are subject to both group capital requirements and local capital requirements in respect of those parts of their groups operating in different local markets.

3.16 Therefore any structural interest restriction or allocation method is likely to either create asymmetries or place a disproportionate burden onto the financial sector and would, in many cases, wholly undermine their business models. We do not therefore believe that it is appropriate to apply a structural interest restriction model to the financial sector, and certainly not in relation to their day to day trading activities.

AP4: limit base erosion via interest deductions

Giving tax relief for interest as a business expense in earning profits accords with international accounting treatment and is the approach adopted by most OECD countries, including the UK. However, the integrated global financial system means that debt can be raised and moved around a group relatively easily to facilitate the shifting of profits to low or no tax jurisdictions. The UK already has a number of defences against excessive interest deductions, and looks forward to the output from the BEPS work on limiting the use of interest deductibility as a means for shifting profits, especially the identification of best practice.

Counter harmful tax practices more effectively taking into account transparency and substance (Action 5)

3.17 The Forum on Harmful on Tax Practices (FHTP) was created as a result of an OECD report in 1998, to underpin efforts to ensure that competition between countries is based upon transparent and internationally accepted standards. It provides OECD member countries with the opportunity to scrutinise tax measures introduced by their peers and to challenge those that may be harmful when assessed against agreed criteria. Its work has led to the amendment or abolition of a number of preferential tax regimes.

3.18 The work of the FHTP applies to all tax measures on geographically mobile activities including those at sub-national level. The ultimate aim of the work is to create an environment in which all countries can compete freely and fairly, supporting economic growth and increased prosperity. Similar work is carried out in the EU by the Code of Conduct Group, the criteria of which are similar although not exactly the same as those of the OECD.

3.19 The FHTP assessment criteria include: (i) no or low taxation on the relevant income; (ii) lack of transparency; (iii) lack of effective exchange of information; and (iv) whether the regime is ring-fenced from the domestic economy. The introduction of a measure which applies a low or zero tax rate acts as a trigger for further consideration of the other assessment criteria - the measure itself is never sufficient to identify a preferential tax regime as harmful. Decisions on the appropriate rates of tax for individuals and companies are for sovereign countries to make;

jurisdictions have the right to design and use genuine incentives for economic growth and job creation, for example to support R&D and the commercialisation of innovation.

3.20 Action 5 of the BEPS Action Plan involves reviewing the current rules on harmful tax practices to consider whether these remain relevant, and on prioritising work on transparency around rulings on preferential tax regimes. It will also consider how to more clearly define the requirement for 'substantial activity' to occur in a jurisdiction in order for companies to quality for the benefits of the relevant preferential tax regime. Finally, this work will consider how to engage with non-OECD countries to assess harmful effects of preferential regimes; and then whether the Forum criteria need to be modified or updated, by the end of 2015.

3.21 The first stage of the BEPS Action Plan requests the FHTP to complete the existing review of regimes by September 2014. Central to this work has been discussion on how to clarify what is meant under the existing criteria by the term "substantial activity". Three approaches are being considered:

- a transfer pricing approach that focuses on important functions;
- a nexus approach that requires tax benefits to be connected directly to R&D expenditures; and
- a value creation approach which would require significant development activities.

3.22 The UK fully supports the need for clear rules that help to determine what constitutes a harmful tax measure. The consideration of whether a regime has substance has to consider whether it 'encourages purely tax-driven operations or arrangements', with a concern that 'many harmful preferential tax regimes are designed in a way that allows taxpayers to derive benefits from the regime while engaging in operations that are purely tax-driven and involve no substantial activities."

3.23 However, any approach to this issue has to take account of existing international law. When the EU exercises its competence in the area of taxation, it must act in accordance with the general principles of EU law and fundamental rights as set out in the Treaties. This is important as a majority of members of the OECD are EU countries.

3.24 A better understanding of what constitutes substance is needed so as to effectively address those instances where preferential regimes do present an opportunity to shift profits. This will give certainty to the operation of legitimate tax regimes, such as the UK's Patent Box, which is currently under consideration in the FHTP, and the Government believes that most of the activities currently qualifying for the UK Patent Box would meet any such substance test. However, it is important to be careful in carrying out this exercise that the OECD does not choose an approach which might effectively stop businesses from operating in a fair and legitimate way when there are valid commercial reasons for doing so, for example in making decisions with respect to where they carry out their R&D, but which instead acknowledges the framework of globalised markets and operations. We also need to note that insisting too much on substance alone could risk jobs simply moving to tax havens, some of which may be sizeable countries and not simply small islands.

3.25 The UK strongly supports, in particular, the work of the Forum to look at transparency around informal rulings that give rise to preferential tax regimes.

AP5: Counter harmful tax practices more effectively taking into account transparency and substance

The UK supports the current work around Action 5 to ensure a better understanding of what constitutes economic substance when businesses carry out R&D activities, so as to effectively address those instances where preferential tax regimes might present an opportunity to shift profits. However, the exercise needs to be mindful of compatibility with existing international law and support fair competition, as well as to acknowledge legitimate commercial decisions on R&D within the framework of globalised markets and operations.

Prevent the artificial avoidance of permanent establishment status (Action 7)

3.26 Under longstanding international tax rules, the profits of a company resident in one country can only be taxed in another country if its activities are carried out through a permanent establishment (PE) situated there. To have a PE, the company must either carry out its activities through a "fixed place of business", such as a shop, office or factory, or through a person (a dependent agent) who acts under instruction and is authorised to conclude contracts on the company's behalf. Certain limited activities, such as storage of goods for delivery and purchase of goods, are generally deemed not to constitute a PE.

3.27 Because these rules apply on a company by company basis, multinational groups can sometimes get around them by artificially splitting up their operations. For example, one group company outside the UK may own valuable assets used in the business, another may enter into sales contracts with customers in the UK and a third company may provide lower-value services in the UK for the benefit of other companies in the group. Where, viewed in isolation (that is, company by company), some of these activities fall short of creating a PE in the UK, it is possible that only the lower-value services are taxable here, rather than the activities as a whole. And where the other activities are carried out by companies resident in countries with no or very low rates of tax, the group may be able to avoid large amounts of tax on its profits.

3.28 The current rules were set up to serve what remains an important purpose. By setting a threshold, below which a foreign company's activities in another country are not taxable there, they offer certainty and cost savings to both businesses and governments. The rules mean that UK businesses can export goods, including for example by making sales over the internet, without having to worry about the detailed tax rules and filing requirements in each country. This is particularly valuable for small, exporting businesses. In addition, the majority of businesses, small and large, that comply with the tax rules can be sure that they will not be exposed to new and unexpected tax demands from foreign countries. All of this serves to promote international trade and investment and frees businesses and governments from costly administration and tax disputes. These advantages need to be preserved, whilst ways are found to prevent abuses by those seeking to minimise their tax obligations.

3.29 Whilst the existing rules continue to work well in most circumstances, as they contain an element of flexibility that enables assessments as to whether a PE exists to be made by applying the rules on a case by case basis, there are situations in which they can be difficult to apply as intended. This can be because of the way business models have changed due to the development of information technologies, or because companies can structure their affairs in ways designed to get around them.

3.30 Multinational groups have, for example, sought to shift profits out of countries where goods are sold and into lower tax countries by adopting "commissionaire" arrangements. Under these types of arrangement, the company selling the goods can transfer ownership of its assets, trading stock and customer lists to another group company outside the country in which the goods are sold. The selling company contracts with customers in its own name, but the goods are owned by another group company which pays the selling company a small commission for selling them. It is argued that this justifies a reduction in the share of the group's profit that should be allocated to the selling company under the transfer pricing rules. Because of the legal contractual arrangements, it can be difficult to show that the arrangement creates a dependent agent PE of the company owning the goods and making the entrepreneurial profits. This can result in the profits being stripped out of the country in which the economic activity substantially takes place.

3.31 Because business methods have evolved significantly since the current rules were developed, it can also be difficult to see how those rules should be applied to changing business models. The growth of the Internet and the digital economy gives rise to questions about whether it is possible for a global business to have a significant economic presence in a country without having any physical presence there. If this is the case (and changing the rules to address the problem of fragmentation and the difficulty in applying the existing concept of dependent agency does not resolve these questions), it may be necessary to consider designing special new rules.

3.32 Another consideration is whether activities traditionally considered as preparatory or auxiliary, such as warehousing, may form a more substantial part of profit generation in some newer business models; raising questions as to whether the exception that is made for these activities being a PE should continue to be automatically applied. But any changes that result in these areas must not undermine the important benefits identified in paragraph 92 above.

3.33 The Focus Group on Action 7 is looking at these issues and will be recommending changes to the rules to stop companies using artificial arrangements to get around the current PE definition and avoid paying the right amount of tax in the countries in which they operate. As part of this work, OECD countries are also considering how the rules could be adapted to give the intended outcome in relation to business models that raise new considerations.

3.34 A crucial part of the work on Action 7 is to make sure the rules governing the attribution of profits to a PE will operate effectively in relation to the changes to the PE rules the Focus Group will recommend, so that the rules will both correctly identify a taxable PE and allocate the correct level of profits to it. This will ensure that groups pay tax on profits commensurate with their economic activity in a country, not on some distinctly smaller amount. The work on Action 7 will also be co-ordinated with the transfer pricing work (see below) to ensure that the profits attributable to PEs under the international tax rules are fair and consistent with the approach taken under the rules for cross-border transactions between related enterprises.

AP7: Prevent the artificial avoidance of permanent establishment status

The UK fully supports the work to re-examine and update the international rules governing the threshold at which a company becomes taxable in a foreign country, and work to prevent businesses from artificially fragmenting their operations to avoid breaching this threshold. This work needs to take into account technological advances, modern business practices and the particular needs of small businesses.

Ensure that transfer pricing outcomes are in line with value creation (Actions 8-10)

3.35 With the growth of globalisation, modern communications and centralisation of business management, MNEs effectively operate as a single economic unit. Acting as a single unit allows a business to create efficiencies and maximise overall profit margins across a supply chain. Transfer pricing techniques should therefore reflect that economic reality in attributing profit to where value is created.

3.36 The current transfer pricing rules, based on the "arm's length principle", give little cause for concern where they are effectively allocating profit between group companies located in 'normal' tax jurisdictions, and they generally produce an appropriate result when applied to price transactions that are comparable with transactions that are undertaken between independent enterprises. The rules operate on a transaction by transaction and company by company basis; this approach respects the position of each company in a group as a separate legal entity, governed by company law principles.

3.37 However, this allows some MNEs to argue that excessive risk, capital and intangible assets are located in group companies located in particular (very low-tax) jurisdictions and therefore that all residual profit, including profit properly attributable to group efficiencies and synergies, should be attributed there. As a result, MNEs are able to fragment elements of their business in ways seldom seen by independent businesses, and are able to shift profits from normal rate jurisdictions to reduce their corporate taxes.

3.38 Actions 8 to 10 of the OECD Action Plan seek to address these deficiencies in the current transfer pricing rules and where necessary go beyond these rules to address such instances of BEPS. This will enable the OECD's Transfer Pricing Guidelines and the 'Associated Enterprises' Article of the Model Tax Convention to better reflect the business and economic relationships between companies within a group, which act together to achieve a unified economic outcome. It is looking to develop rules that will:

- set out more clearly when tax administrations should be able to re-characterise transactions;
- address transfers of hard-to-value intangibles; and
- address the allocation of excessive capital and risk to companies within a group which provide little contribution to the earning of profit save for the passive holding of capital and assets.

3.39 These Actions are being taken forward through OECD Working Party 6. The Working Party will also consider whether special measures are required to override the arm's length principle in certain circumstances and if so what the rule would look like and the circumstances in which they would apply. The UK fully supports this work to develop approaches and solutions which produce a fair and equitable allocation of taxing rights between countries and prevent aggressive tax avoidance.

3.40 The Working Party will also consider whether special measures are required to override the arm's length principle in certain circumstances and if so what the rule would look like and the circumstances in which they would apply. The UK fully supports this work to develop approaches and solutions which produce a fair and equitable allocation of taxing rights between countries and prevent aggressive tax avoidance.

Background to transfer pricing rules

3.41 UK transfer pricing rules reflect the international standard set out OECD Model Tax Convention. This standard is incorporated into the UK's extensive network of bilateral tax treaties under which taxing rights are determined between the UK and its treaty partners.The arm's length principle is set out in Article 9 of the Model Convention:

> "[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

3.42 The Model Convention (at Article 7) also relies on the arm's length principle to determine the profits that should be attributed to a permanent establishment. This requires an analysis of the functions performed, assets used and risks assumed by the permanent establishment as if it were a separate and independent enterprise.

Separation of reward from value creation

3.43 The funding of business activities involves taking on considerable risk and hence attracts substantial reward. Over-capitalised subsidiaries located in low tax jurisdictions are able to invest that capital with other group members (for example through loans or the acquisition of assets) which may result, when applying the arm's length principle, in them being entitled to a significant share of group profits. Such allocations of capital and risk within a MNE group, whose companies based in different tax jurisdictions transact with each other, do not affect the total capital of the group or its overall risk profile.

3.44 Where such arrangements allow for the relevant transactions to be priced on an arm's length basis in accordance with current transfer pricing rules, these rules may not themselves effectively address the group's internal allocations of capital and risks (and therefore profits), even though these allocations are not aligned with the activities and capabilities of the separate companies within the group in a way that would be seen at arm's length.

3.45 For example, a local distributor of a particular product may be carrying on substantial activities to promote sales of that product within a particular jurisdiction but the various risks (inventory, credit, and exchange risks together with the risks and rewards associated with the promotional activities) normally associated with such activities are assumed by a connected hub distributor located in a low tax jurisdiction because that entity has the financial capacity to meet the relevant costs and hence assume those risks due to its over-capitalisation by the group.

3.46 Similarly, the contractual arrangements within MNEs can give legal ownership of intangible assets to individual subsidiaries with sufficient capital to bear the costs of developing those assets. This legal owner may itself carry out few, if any, of the activities which contribute to that development and which create their value. Nonetheless, the application of the arm's length principle will entitle the owner to some of the profits arising from the use or licensing of those intangibles.

3.47 We therefore see Working Party 6's work to address Action 9 – risks and capital – in full as a key element in strengthening transfer pricing rules to deal effectively with arrangements that seek to separate rewards from value creation. The resulting changes to the Transfer Pricing guidelines, and potentially Article 9 of the Model Tax Convention, will need to be clear in their scope and application and will need to build in safeguards to ensure that genuinely commercial arrangements are not inadvertently caught. This will require extensive testing against a wide range of examples.

Absence of comparable transactions

3.48 Most of the methods currently adopted by both MNEs and tax administrations to determine the appropriate transfer pricing of a transaction between members of an MNE are based on comparison with a comparable transaction between independent enterprises. This can cause obvious difficulties when the transaction is one rarely encountered between independent enterprises. In such cases, it may be necessary to adopt a methodology such as a profit split which relies less directly on comparable transactions but rather on appropriate allocation keys reflecting the functions, assets and risks of the parties to the transaction. Equally, the inappropriate use of methodologies which simply apply a mark-up on costs can result in significant residual profits being allocated to subsidiaries in very low-tax jurisdictions where little economic activity takes place.

APs 8-10: Ensure that transfer pricing outcomes are in line with value creation

Transfer pricing techniques should reflect economic reality in attributing profit to where value is created. The current transfer pricing rules, which are based on the principle of the "arm's length price", allow some MNEs to argue that excessive risk, capital and intangible assets are located in group companies located in particular (very low-tax) jurisdictions and therefore that all residual profit should be attributed there. As a result, MNEs are able to fragment elements of their business in ways seldom seen by independent businesses, and are able to shift profits from normal rate jurisdictions to reduce their corporate taxes. The work around Actions 8, 9 and 10 will consider whether special measures are required to override the arm's length principle in certain circumstances and if so what the rule would look like and the circumstances in which they would apply. The UK fully supports this work to develop approaches and solutions which produce a fair and equitable allocation of taxing rights between countries and prevent aggressive tax planning.

Collect and analyse data on BEPS and counteractions (Action 11)

3.49 OECD countries need to understand the impact of aggressive tax planning so that actions to address it are proportionate and well targeted. In its 2012 report 'Addressing Base Erosion and Profit Shifting' the OECD concluded that given current data and research it is difficult to establish the extent of BEPS. The OECD is therefore developing economic analysis to determine the scale and impact of aggressive tax planning by multinationals, including on the spill-over effects into other countries.

3.50 As part of the analysis, the OECD will develop a set of indicators depicting the likely scale and change of base erosion over time. As well as using a range of existing data sources, the OECD will also identify any new data that should be collected. The work will also aim to identify information that is currently collected that is no longer needed. Methodologies will be developed based on data on both the aggregate level (e.g. FDI and balance of payments) and micro-level (e.g. from financial statements and tax returns), whilst making sure that taxpayer confidentiality is respected.

3.51 Knowing what works and what does not work is essential to the policy making process. Once policies are implemented, OECD countries will need to understand their impact so that they can, if necessary, be fine tuned. The OECD will support member countries in monitoring and evaluating the effectiveness and economic impact of the actions taken as a result of the

BEPS project. In developing the evidence base, OECD countries will need to collect information from businesses. The UK is aware that this will represent a burden on business and will work to ensure that this is minimised.

AP11: Collect and analyse data on BEPS and counteractions

The OECD is developing economic analysis to determine the scale and impact of aggressive tax planning by multinationals, including on the spillover effects into other countries. The UK supports this work and will aim to ensure that information collected from businesses to develop the evidence base will be minimally burdensome.

Require disclosure of aggressive tax planning arrangements (Action 12)

3.52 Action 12 is to develop recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures drawing on the experiences of countries that have disclosure regimes. One area of focus will be how to capture international tax avoidance schemes in such rules.

3.53 The UK's mandatory disclosure regime was introduced in 2004. The Disclosure of Tax Avoidance Schemes (DOTAS) rules form an important detection tool supporting HMRC's anti-avoidance strategy. Its main objective is to find out how new and innovative schemes work so that, where appropriate, they are closed down early by a change in legislation before significant tax is lost.

3.54 DOTAS applies to all the main taxes as well as national insurance contributions, stamp duty land tax and the annual tax on enveloped dwellings. It:

- provides early information about tax avoidance schemes, allowing the Government, where appropriate to introduce legislation to block the scheme. This can happen very rapidly, sometimes within a matter of days. Since 2004, legislation has been introduced to close down over 900 schemes;
- identifies taxpayers who use disclosed schemes so that HMRC can challenge them. Disclosed schemes have been reported by users over 57,000 times; and
- deters the promotion and use of schemes by changing the economics of avoidance.

3.55 A range of information powers are available to enable HMRC to investigate a failure to disclose a scheme. The maximum penalty for failing to disclose a scheme is £1 million. HMRC has recently carried out a review of DOTAS and the results show that DOTAS has delivered its policy objectives.

3.56 The UK's approach to mandatory disclosure has provided a model that a number of other countries have followed, particularly Ireland and Portugal, whose disclosure regimes mirror those of the UK's in all significant aspects. It compares favourably with other disclosure regimes in striking the right balance between getting timely information on avoidance on a wide range of taxes and duties to counteract avoidance whilst not imposing excessive compliance burdens on business. It is one of the models being considered by the OECD in developing its recommendations.

3.57 The UK has suggested a number of international avoidance areas that could usefully be subject to mandatory disclosure rules: hybrid mismatches (Action 2); transactions undertaken for treaty abuse purposes (Action 6); and transactions within the ambit of any future transfer pricing anti abuse or special measures rule (Action 10).

AP12: Require disclosure of aggressive tax planning arrangements

The UK introduced a mandatory disclosure scheme in 2004, which provided a model that a number of other countries have since followed. The UK model strikes the right balance between getting timely information on avoidance on a wide range of taxes and duties to counteract avoidance whilst not imposing excessive compliance burdens on business. It is one of the models being considered by the OECD in developing its recommendations.

Make dispute resolution mechanisms more effective (Action 14)

3.58 A key aim of the BEPS project is to develop a more effective international tax framework. Such a framework would generally remove double taxation, which presents an obstacle to the development of economic relations between countries, and ensure that any cross-border disputes over its interpretation are effectively resolved.

3.59 Tax treaties already provide for dispute resolution under a "mutual agreement procedure" (MAP) between the two countries where both assert the right to tax. This may include advance agreements concerning potential future disputes. Other instruments can exist outside bilateral treaties to facilitate elimination of double taxation. Notably, the EU Arbitration Convention provides another route for resolving disputes between EU countries over transfer pricing and the attribution of profits to a permanent establishment. Despite this, double taxation is sometimes not eliminated in practice for a variety of reasons. In particular, most treaties only require the respective countries to endeavour to reach mutual agreement on the interpretation or application of the treaty.

3.60 Some businesses have expressed concern that the potential changes resulting from the wider BEPS work could increase the number of disputes, and requested that disputes are resolved more quickly and double taxation eliminated more often. Transfer pricing disputes can be especially lengthy, can cause considerable uncertainty and in some circumstances lead to double taxation for businesses, as there are a range of acceptable outcomes in this area.

3.61 The Government shares the aspiration to improve the effectiveness of dispute resolution mechanisms. This will lead to greater transparency and certainty – two factors that are critical in bringing about a more effective global tax framework and promoting investment. One way of achieving this improvement would be through greater use of mandatory arbitration provisions in tax treaties guaranteeing, in appropriate cases, elimination of double taxation within a defined time frame.

3.62 Although the current OECD Model Tax Convention already contains an arbitration article, participants to the BEPS project are considering how this article and its commentary can be modified to make it more attractive to countries and ensure that countries who benefit from the changes to international tax rules also commit to mandatory arbitration to effectively resolve disputes. A linked issue is how to ensure that access to MAP, and therefore potentially arbitration, is properly available in all appropriate cases.

3.63 This raises several complex practical and legal issues. One, in particular, is ensuring that countries' anti-avoidance laws remain fully effective while at the same time giving businesses the assurance that double taxation will be transparently and efficiently eliminated. The arbitration method that is widely favoured for transfer pricing and attribution of profit disputes is "final offer" arbitration (sometimes called "baseball" arbitration). Under this method, the two countries each put forward their final position, and the arbitration panel has to choose one of them. This method encourages tax authorities to put forward reasonable proposals; it is also relatively quick and cheap to administer. However, its use in multilateral disputes would be more problematic because, amongst other things, it would not be possible for the arbitration panel to choose between one of two options.

3.64 Greater use of arbitration could also pose challenges in ensuring that all countries end up with an appropriate result. For example where there are a series of transactions between associated enterprises involving a third country (sometimes referred to as triangular cases) mandatory bilateral arbitration could sometimes lead to the result that at least one of the three countries ends up with a result that does not reflect market realities. This may be a factor in putting some countries off agreeing to mandatory arbitration. Although a multilateral solution may be possible under the bilateral treaties development of a multilateral instrument incorporating arbitration could usefully help to prevent this.

3.65 So, although there are challenges as set out above, the UK fully supports binding arbitration, where tax authorities cannot come to agreement or tax disputes have exceeded a certain length of time. This is a major step which should lead to lower compliance burdens for businesses and tax authorities alike.

AP14: Make dispute resolution mechanisms more effective

Effective dispute resolution mechanisms are needed to prevent double taxation and to provide greater transparency and certainty. The UK therefore fully supports binding arbitration where tax authorities cannot come to agreement or tax disputes have exceeded a certain length of time. This is a major step which should lead to lower compliance burdens for businesses and tax authorities alike.

Develop a multilateral instrument (Action 15)

3.66 Action 15 differs from the others in that it delivers the process through which several of the other actions could be implemented. Where a recommendation is for a change in countries' domestic law, we would expect countries to do that through their normal procedures. Changes to the transfer pricing guidelines and the OECD model commentaries will be consulted on, agreed and then published by the OECD for countries to use.

3.67 However, some of the changes will be to bilateral double taxation agreements (DTAs). New rules on countering treaty abuse, changes to the permanent establishment and transfer pricing rules, provisions governing hybrid mismatch arrangements, and revised mutual agreement procedures will need to be dealt with by amending DTAs. The UK has around 120 DTAs as part of a worldwide network of over 3,000 agreements. It would clearly be far too cumbersome and time consuming to renegotiate all these through the usual bilateral process and countries will therefore be looking to use a multilateral approach to make the changes.

3.68 There are two ways that this could be done. First, countries could agree to a multilateral treaty that itself contained the operative provisions. This sort of instrument would sit alongside existing DTAs and apply instead of them where there was a conflict. An example of such an agreement is the OECD and Council of Europe Convention on Mutual Administrative Assistance in Tax Matters, which currently covers 77 jurisdictions.

3.69 Another way of changing treaties would be to design a multilateral instrument that amended individual bilateral agreements. There are considerable legal and technical challenges in drafting either type of instrument, and especially the second type. But the UK is committed to this process and is working with others to devise effective solutions. This work will accelerate over the coming months as the substantive outcomes of the project emerge.

AP15: Develop a multilateral instrument.

Through analysing international tax and public law, a multilateral instrument will be designed which will enable participating jurisdictions to implement BEPS measures and enhance bilateral tax treaties. The UK is committed to this process and is working with others to devise effective solutions that reflect the rapidly evolving nature of the global economy, and the need to adapt quickly to this evolution. This work will accelerate over the coming months as the substantive outcomes of the project emerge.

4 HMRC operational / compliance efforts

4.1 HMRC's role is to collect the tax that is owed under the law, through promoting voluntary compliance by businesses and relentlessly pursuing those who do not play by the rules.

The Approach

4.2 HMRC's strategic approach to managing the compliance of large businesses is to have an open, professional and robust relationship with them, identifying tax risks and resolving issues in real time where possible. HMRC seeks to resolve disputes by agreement but if necessary will take action through the courts to pursue the tax that is owed.

4.3 HMRC deploys Customer Relationship Managers (CRMs) to manage the relationship with over 2,000 of the largest businesses, mostly multinationals. CRMs are experienced tax professionals, trained to the highest levels of tax compliance, who lead teams of highly skilled specialists to man-mark these most complex and potentially high-risk taxpayers. From 1 April 2014 the management of over 2,000 of the largest businesses will be brought together in a single Large Business Directorate. This will enable HMRC to deploy its skilled resources still more effectively to ensure that multi-national businesses comply with the tax rules.

4.4 HMRC's teams examine multinational groups' global business structures and cross-border arrangements to identify risks of UK profit diversion, excessive interest relief, arbitrage leading to double deductions or non-taxation of profits and excessive credit relief, and challenge tax planning that is not in accordance with UK domestic law, double taxation treaty obligations or international guidelines. These complex enquiries involve in-depth examination of documents, visiting business premises, talking to staff, gathering information from customers and liaising with other tax authorities.

4.5 HMRC's collaborative compliance model has increasingly been adopted by other countries and its benefits have been recognised by the Organisation for Economic Co-operation and Development (OECD). HMRC also works closely with tax authorities in other countries to exchange information and investigate the tax arrangements of multi-national enterprises, including through the nine country Joint International Tax Shelter Information Centre (JITSIC).

Results

4.6 This approach is delivering results and has enabled HMRC to recover around £23 billion in additional compliance revenues from large businesses between April 2010 and March 2013. This includes results from challenging arrangements designed to reduce or divert UK profits such as HMRC's enquiries into companies' transfer pricing which, between April 2010 and March 2013, produced some £2 billion in additional revenues. Action taken by HMRC to investigate and recover tax from cross-border avoidance and planning compares well with other countries.

5 Conclusion

5.1 The current international tax rules were first developed in the 1920s and are no longer fit for purpose in today's global economy. However, the UK believes that the fundamental principles that underpin the international framework are still relevant. As explored in this position paper, the challenge we face is how to modernise the rules in a manner consistent with these principles in order to counter aggressive tax avoidance and the erosion of the tax base.

5.2 The Government recognises the importance of a multilateral approach to tackle BEPS, and is committed to considered negotiations to achieve a fair and consistent framework of international rules. In initiating and supporting this international process, and not acting unilaterally, the Government taking a responsible approach that will ensure that the results are in the best interests of both the UK and other countries, through creating a fair and balanced set of international rules for both countries and companies.

5.3 The Government is also committed to the ambitious BEPS project timetable, and to delivering results and implementing changes, as soon as possible. To achieve this, work is well underway at the OECD. The UK is involved in all OECD BEPS Working Parties, and this ongoing collaboration will generate results as soon as September 2014.

5.4 The Government aims to create a fair playing field for all businesses and recognises the impact of the BEPS action plan on its stakeholders. To ensure that all voices are listened to, the UK has led the way in developing a BEPS stakeholder engagement programme which gives an opportunity for civil society, business and tax professionals to learn about the BEPS Action Plan and to contribute their views.

5.5 Overall, the position paper emphasises the focus of the UK in delivering of the BEPS project and a modernised framework of international tax rules that will strengthen the global economic environment and promote free and fair trade.

HM Treasury contacts

This document can be downloaded from www.gov.uk

If you require this information in an alternative format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 5000

E-mail: public.enquiries@hm-treasury.gov.uk