

**CITATIONS:**

**Bluebook 22nd ed.**

Rachel J. Greenberg, Taking a Byte out of International Tax Evasion: Combating Base Erosion and Profit Shifting, 19 CHAP. L. REV. 307 (2016).

**ALWD 7th ed.**

Rachel J. Greenberg, Taking a Byte out of International Tax Evasion: Combating Base Erosion and Profit Shifting, 19 Chap. L. Rev. 307 (2016).

**APA 7th ed.**

Greenberg, R. J. (2016). Taking byte out of international tax evasion: combating base erosion and profit shifting. *Chapman Law Review*, 19(1), 307-332.

**Chicago 18th ed.**

Greenberg, Rachel J. "Taking a Byte out of International Tax Evasion: Combating Base Erosion and Profit Shifting." *Chapman Law Review* 19, no. 1 (2016): 307-332. HeinOnline.

**McGill Guide 10th ed.**

Rachel J. Greenberg, "Taking a Byte out of International Tax Evasion: Combating Base Erosion and Profit Shifting" (2016) 19:1 Chap L Rev 307.

**AGLC 4th ed.**

Rachel J. Greenberg, 'Taking a Byte out of International Tax Evasion: Combating Base Erosion and Profit Shifting' (2016) 19(1) *Chapman Law Review* 307

**MLA 9th ed.**

Greenberg, Rachel J. "Taking a Byte out of International Tax Evasion: Combating Base Erosion and Profit Shifting." *Chapman Law Review*, vol. 19, no. 1, Winter 2016, pp. 307-332. HeinOnline.

**OSCOLA 4th ed.**

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# Taking a Byte out of International Tax Evasion: Combating Base Erosion and Profit Shifting

Rachel J. Greenberg\*

## INTRODUCTION

Benjamin Franklin said that nothing is certain except death and taxes. However, this popular slogan must not ring true; in today's economy, some of the world's largest multinational companies have found loopholes in the tax system and manage to evade paying billions of dollars worth of taxes in various jurisdictions.<sup>1</sup> Obviously, to the common folk, the ability of companies to evade this surety of life is troublesome.

International efforts, led by the Organisation for Economic Co-operation and Development (OECD), have been undertaken in an attempt to combat the issue of base erosion and profit shifting (BEPS). Erosion of the tax base occurs when multinational companies shift profits from high-tax jurisdictions to low-tax jurisdictions, so companies pay significantly lower taxes than they otherwise would.<sup>2</sup> The OECD enacted its Action Plan in 2013,<sup>3</sup> and a number of countries have been working to implement facets of the plan since that time. While the Action Plan is an important attempt to create social justice by allowing governments to regain corporate taxes generated by multinational entities, this will require ameliorating actions by

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\* J.D., Chapman University Dale E. Fowler School of Law, May 2016; B.A., University of California, Los Angeles, June 2011. I wish to express my gratitude to Professor Stephanie Lascelles for her assistance and feedback, as well as the entirety of *Chapman Law Review* for their comments and advice throughout the editing process. I would like to dedicate this Comment to my family, and thank them for their unwavering love and support in all endeavors I pursue.

<sup>1</sup> Jim Edwards, *Here's How Much Money Apple Avoids Paying in Taxes by Pretending It's Based in Ireland*, BUSINESS INSIDER (June 11, 2014, 12:59 PM), <http://www.businessinsider.com/how-much-money-apple-avoids-paying-in-taxes-2014-6> [perma.cc/P7T9-EKUJ] (stating that between 2011 and 2012, Apple was able to avoid paying \$12.5 billion in U.S. taxes).

<sup>2</sup> *About Base Erosion and Profit Shifting*, OECD, <http://www.oecd.org/ctp/beps-about.htm> [perma.cc/B3SZ-UMYQ].

<sup>3</sup> OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING (2013), <http://www.oecd-ilibrary.org/docserver/download/2313331e.pdf?expires=1447316590&id=id&accname=guest&checksum=024E863CD25458C99B042F1F03A46A16> [hereinafter ACTION PLAN].

all involved parties and cooperative rather than competitive behavior. However, until the goals of the Action Plan align with those of the individual countries affected by BEPS, it is unlikely that the Action Plan will accomplish its stated objectives.

This Comment will provide a background of the problem of BEPS, from the time of its inception through the present day. It will then explore the economic problems of selected countries that represent the spectrum of the parties involved in addressing this problem and certain unilateral solutions they are undertaking. Specifically, it will examine the United States as a high-tax jurisdiction, which is the home of most of the offending companies, the United Kingdom as a relatively high-tax jurisdiction, which is a European Union member, India as a developing source country, and Bermuda as a tax haven. The United States and the United Kingdom are OECD members, India is a non-member observer country, and Bermuda has no OECD affiliation.<sup>4</sup> Finally, this Comment will focus on several recommendations which could be implemented multilaterally to accomplish the goals of the OECD's Action Plan.

## I. BACKGROUND

In order to have a comprehensive understanding of the issue of BEPS and make suggestions which could reasonably be integrated into the international tax regime, it is necessary to consider the evolution of the dilemma and the actions that have already been attempted. This Part will cover the formation of the OECD, a focused history of the issue of BEPS, and a factual overview of the OECD's recently published Action Plan.

### A. Formation of the OECD

In the early 1900s, most businesses were located within the borders of a single country.<sup>5</sup> Although firms occasionally operated across national borders, company wealth and property were generally bundled within a single country where the firm was subject to taxation.<sup>6</sup> Each country created its own domestic laws regarding taxation of corporations.<sup>7</sup> As industrialization continued, companies began to do business in multiple countries, and, eventually, multinational corporations developed. Questions arose as to how to allocate profits to different countries so each

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<sup>4</sup> *About the OECD: Members and Partners*, OECD, <http://www.oecd.org/about/membersandpartners/> [http://perma.cc/KNT6-HFRW].

<sup>5</sup> Steven A. Bank, *The Globalization of Corporate Tax Reform*, 40 PEPP. L. REV. 1307, 1307 (2013).

<sup>6</sup> *Id.*

<sup>7</sup> ACTION PLAN, *supra* note 3, at 7, 9.

country could share in taxing the company. However, sometimes the independent rules for different countries conflicted, causing friction, and potential double taxation, defined as taxation of the same income in both countries in which the company does business.<sup>8</sup> In the 1920s, the League of Nations recognized that double taxation would slow economic growth and recovery, and international tax laws were designed to limit this friction and to support global economic growth.<sup>9</sup> “International co-operation has resulted in shared principles and a network of thousands of bilateral tax treaties that are based on common standards and that therefore generally result in the prevention of double taxation on profits from cross-border activities.”<sup>10</sup> Bilateral treaties have been formulated to encourage foreign companies to engage in businesses, which will generate income in the home country, and domestic companies to earn revenue in foreign countries, by creating tax laws which are favorable to all entities.

Conflicts frequently occur between residence and source countries regarding taxable income. The residence country is where the company is formed or managed and controlled (frequently the United States or another highly developed country), and the source country is one in which the company does business, in terms of having factories, research and development, or sales.<sup>11</sup> Through the application of bilateral tax treaties and local source country tax law, residence countries have maintained principal taxing jurisdictions for income earned in source countries.<sup>12</sup> As a result, source countries have retained minimal (or no) tax jurisdiction, which creates friction between the source and residence countries, because the source countries believe they are entitled to a portion of the taxes.<sup>13</sup> This enables multinational entities (MNEs) to operate in other countries but pay tax in those countries to the extent they operate through a separate entity located in the source country or through a permanent establishment (PE) in the source country.<sup>14</sup> “This

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<sup>8</sup> *Id.* at 9.

<sup>9</sup> *Id.* at 7.

<sup>10</sup> *Id.* at 9–10.

<sup>11</sup> *Source and Residence Taxation*, TAX JUST. NETWORK, [http://www.taxjustice.net/cms/upload/pdf/Source\\_and\\_residence\\_taxation\\_-\\_SEP-2005.pdf](http://www.taxjustice.net/cms/upload/pdf/Source_and_residence_taxation_-_SEP-2005.pdf) [perma.cc/7QNW-7645].

<sup>12</sup> See Lee A. Sheppard, *Twilight of the International Consensus: How Multinationals Squandered Their Tax Privileges*, 44 WASH. U. J.L. & POL'Y 61, 62 (2014).

<sup>13</sup> See *id.*

<sup>14</sup> See *id.* In the United States, a “PE generally is defined as a fixed place of business.” PRICEWATERHOUSECOOPERS, WORLDWIDE TAX SUMMARIES: CORPORATE TAXES 2014/15, at 2117 (2014), <http://www.pwc.com/gx/en/tax/corporate-tax/worldwide-tax-summaries/assets/pwc-worldwide-tax-summaries-corporate-2014-15.pdf> [http://perma.cc/8TVB-MRSR] [hereinafter TAX SUMMARIES]. The definition of a PE may vary in other countries. For example, in the United Kingdom, the definition of a PE is partially based

limitation of tax jurisdiction is key to the OECD model treaty,”<sup>15</sup> because it prevents double taxation and encourages commerce between treaty countries.

After World War II, the Organisation for European Economic Co-operation (OEEC) was established to implement the Marshall Plan, financed by the United States, with the goal of boosting the economy.<sup>16</sup> It was at this juncture that the collective governments acknowledged the “interdependence of their economies, [which] paved the way for a new era of cooperation that was to change the face of Europe.”<sup>17</sup> The OECD was created on September 30, 1961,<sup>18</sup> representing over thirty countries, whose members include the United States and many European countries,<sup>19</sup> as well as observers like India and China.<sup>20</sup> With globalization, a shift has occurred from country-specific models to global operating models, and, with the advent of a greater service component and digital products, it is “much easier for businesses to locate many productive activities in geographic locations that are distant from the physical location of their customers.”<sup>21</sup> However, multinational corporations are currently manipulating tax rules set forth in the OECD model treaty, allowing them to pay taxes in low-tax jurisdictions while making large profits in other countries.<sup>22</sup> This is harmful for a number of reasons. Governments receive lower corporate tax payments than they should, individual taxpayers have a greater tax burden to make up the difference, and domestic companies are placed at a competitive disadvantage.<sup>23</sup> Also, public awareness of low tax payments can damage a company’s reputation.<sup>24</sup>

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on the OECD model, and a non-resident company can have a PE if it “has a fixed place of business in the United Kingdom through which the business of the company is wholly or partly carried on, or an agent acting on behalf of the company has and habitually exercises authority to do business on behalf of the company in the United Kingdom.” *Id.* at 2093.

<sup>15</sup> Sheppard, *supra* note 12.

<sup>16</sup> *About the OECD: History*, OECD, <http://www.oecd.org/about/history/> [<http://perma.cc/45QP-GVL7>].

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> See Tracy A. Kaye, *The Offshore Shell Game: U.S. Corporate Tax Avoidance Through Profit Shifting*, 18 CHAP. L. REV. 185, 187–88 n.19 (2014).

<sup>20</sup> Sheppard, *supra* note 12, at 64.

<sup>21</sup> ACTION PLAN, *supra* note 3, at 7.

<sup>22</sup> See Sheppard, *supra* note 12, at 61–63.

<sup>23</sup> Foreign companies can lower their profits based on local taxes and international treaties, which reduce withholding tax on royalties and/or interest payments, while domestic companies cannot decrease their tax burden in this way. See *id.*

<sup>24</sup> See ACTION PLAN, *supra* note 3, at 8.

## B. History of BEPS

The main cause of base erosion, or erosion of the tax base which determines tax liability, is profit shifting. “Profit shifting allows U.S. multinationals to maintain their actual investments in high-tax countries that have the appropriate infrastructure and labor forces necessary for actual business operations but report profits in tax havens or low-tax jurisdictions.”<sup>25</sup> Various studies estimate that the United States loses between \$10 billion and \$90 billion annually from profit shifting, which has brought the enormity of the issue to public scrutiny.<sup>26</sup> International tax rules allow loopholes which, while exempting companies from double taxation, enable them to avoid taxation completely and enjoy “double non-taxation.”<sup>27</sup>

Profit shifting is particularly easy for intellectual property (IP) income, because there is no production location and consumers can be anywhere.<sup>28</sup> A number of multinational technology companies have moved assets like IP “to Ireland, whose low 12.5% corporate income tax rate allowed it to attract major corporations and become a center of high technology jobs in Europe.”<sup>29</sup> To avoid incurring higher taxes, some companies employ the “Double Irish” tax structure.<sup>30</sup> For example, an American company forms two subsidiary companies in Ireland, but one of them has its management center in Bermuda or a similar tax haven. The company based in Bermuda pays the parent company a fee to allow it to sublicense its IP to the other Irish subsidiary, which can then sell the products internationally.<sup>31</sup> “The Bermuda-based company is an Irish company for U.S. purposes, which presumably aids in the approval of the transfer pricing arrangement because of the presence of a U.S.-Ireland tax treaty, but is a Bermuda company for Irish purposes, which allows it to avoid Irish taxes.”<sup>32</sup> Therefore, the American company has low taxable U.S. income, and the Bermuda-based company has no income subject to Irish

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<sup>25</sup> Kaye, *supra* note 19, at 185–86.

<sup>26</sup> *Id.* at 187; *see also* Yariv Brauner, *What the BEPS?*, 16 FLA. TAX REV. 55, 57–58 (2014).

<sup>27</sup> *See* Kaye, *supra* note 19, at 187.

<sup>28</sup> *See id.*; *see also* Bank, *supra* note 5, at 1310.

<sup>29</sup> Bank, *supra* note 5, at 1310.

<sup>30</sup> *Id.* at 1310–11.

<sup>31</sup> *Id.* The licensing fee paid to the parent company will be based on the fair market value of the license (using an arm’s length standard). However, this fee may be a relatively small amount compared to what the parent company would otherwise pay in taxes. *See id.* at 1311.

<sup>32</sup> *Id.* The Bermuda-based company is an Irish non-resident company under Irish law. Ireland only requires “resident” companies to pay standard corporate taxes. TAX SUMMARIES, *supra* note 14, at 886–87.

tax, because Irish law uses the location where the company is controlled and managed (i.e. Bermuda) to determine tax residency.<sup>33</sup> So, most of the income is attributed to Bermuda, with no corporate tax.<sup>34</sup>

Three popular mechanisms for accomplishing profit shifting are hybrid mismatches, special purpose entities (SPE), and transfer pricing.<sup>35</sup> Hybrid mismatches create double non-taxation or long-term tax deferral when different countries have tax rules that are domestically logical but incompatible with the other country's rules.<sup>36</sup> This can occur when the MNE deducts twice for the same borrowing, claims deductions without matching income, or uses differences between countries' rules related to foreign tax credits or exemptions.<sup>37</sup> SPEs are defined as companies with minimal physical presence in a host country and a small number of employees.<sup>38</sup> Their core business involves holding activities or group financing, and their assets and liabilities are investments in or from other countries.<sup>39</sup> Transfer pricing allows intangibles to be taxed in a lower-tax jurisdiction than the United States.<sup>40</sup> According to the IRS rules for transfer pricing, MNEs must utilize an arm's length standard when determining the pricing of transactions among members of the group, based on the risks and functions of each entity.<sup>41</sup> This is designed to protect the tax base by preventing the shifting of income that otherwise would be taxed in the United States to another country.<sup>42</sup> The arm's length standard for transfer pricing is regulated in the United States under Section 482 of the Internal Revenue Code, and in the 2010 OECD transfer-pricing guidelines, so "the prices charged in transactions between commonly controlled parties must be consistent with the consideration in, or results of, similar transactions between uncontrolled taxpayers."<sup>43</sup> Transfer prices divide the profits of a MNE among countries based on risks and functions to determine

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<sup>33</sup> Bank, *supra* note 5, at 1311 n.30.

<sup>34</sup> *Id.* at 1311.

<sup>35</sup> Patrick Love, *What is BEPS and How Can You Stop It?*, OECD INSIGHTS (July 19, 2013), <http://oecdinsights.org/2013/07/19/what-is-beps-how-can-you-stop-it/> [<http://perma.cc/9Q27-URPA>].

<sup>36</sup> See Brauner, *supra* note 26, at 79.

<sup>37</sup> ACTION PLAN, *supra* note 3, at 15.

<sup>38</sup> Patrick Love, *BEPS: Why You're Taxed More than a Multinational*, OECD INSIGHTS (Feb. 13, 2013), <http://oecdinsights.org/2013/02/13/beps-why-youre-taxed-more-than-a-multinational/> [<http://perma.cc/U98A-EWCA>].

<sup>39</sup> *Id.*

<sup>40</sup> Brauner, *supra* note 26, at 96.

<sup>41</sup> Kaye, *supra* note 19, at 186.

<sup>42</sup> *Id.*

<sup>43</sup> ROBERT T. COLE & WILLIAM H. BYRNES, PRACTICAL GUIDE TO U.S. TRANSFER PRICING § 1.02 (3d ed. 2014). Most countries have enacted similar transfer pricing rules. *Id.*

how much income is taxed in each country. Over the past twenty years, transfer-pricing rules have become stricter in the United States and in foreign countries, but some observers believe that “MNEs are still using transfer pricing to improperly shift income from the jurisdictions where they function (developed countries and developing countries) to low-tax jurisdictions, significantly eroding the tax base.”<sup>44</sup> However, due to transfer pricing and profit shifting, in 2008, American multinational companies claimed to earn 43% of overseas profits in Ireland, Bermuda, the Netherlands, Luxembourg, and Switzerland (all considered tax havens), while only 7% of their international investments and 4% of foreign employees were located there.<sup>45</sup>

It has been calculated that “[a]round 60% of world trade actually takes place within multinational enterprises.”<sup>46</sup> This large percentage accounts for the billions of dollars lost each year to the governments of various jurisdictions where these companies avoid the payment of taxes, “undermin[ing] voluntary compliance by all taxpayers” and threatening the foundation of modern tax administration.<sup>47</sup> The OECD itself admits that there must be cooperative, international efforts implemented, because unilateral efforts made by individual countries will likely lead to the troubling alternative of double-taxation, which treaties years ago were created to avoid.<sup>48</sup> A number of issues need to be resolved, including how to divide taxes between source and residence countries, how to tax IP, and how to deal with havens and enablers, who may have no incentive to change.

### C. Current Status of the Plan

A number of countries have expressed concern regarding the way tax rights are allocated between countries.<sup>49</sup> “The G20 finance ministers called on the OECD to develop an action plan to address BEPS issues in a co-ordinated and comprehensive manner.”<sup>50</sup> In February 2013, the OECD released its Action Plan, designed to aid countries struggling to increase tax revenues and suffering from companies evading tax payments in high-tax

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<sup>44</sup> *Id.*

<sup>45</sup> Kaye, *supra* note 19, at 186.

<sup>46</sup> Love, *supra* note 38.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.* The chairman of the Business and Industry Advisory Committee to the OECD feels that “if the project does not come up with multilateral agreed solutions which match the needs of many countries, then many countries are going to act unilaterally, and that is going to be worse for business than any multilateral solution that you can envisage.” Katy O’Donnell, *OECD Seeks to Curb Corporate Tax Avoidance*, CQ ROLL CALL, Sept. 17, 2014, 2014 WL 4628469.

<sup>49</sup> ACTION PLAN, *supra* note 3, at 11.

<sup>50</sup> *Id.*

jurisdictions.<sup>51</sup> “The OECD BEPS Action Plan seeks to realign taxation with the relevant economic substance and ensure that taxable profits cannot be artificially shifted.”<sup>52</sup> Simply put, everyone should pay their fair share of taxes. The goal of the plan is to create equity by making corporate taxation more coherent, transparent, cooperative, and beneficial on an international scale.<sup>53</sup>

With a timeline for completion in 2015, the plan includes five general categories and fifteen action items.<sup>54</sup> The broad categories can be divided into: 1) identifying the tax challenges of the digital economy, 2) creating international coherence of taxation, 3) restoring the effects and advantages of international standards, 4) increasing transparency, and 5) implementing the actions in a timely manner.<sup>55</sup>

The first category includes only the first action item, Action 1, which advocates forming a task force to identify options relating to tax concerns associated with e-commerce and the digital economy.<sup>56</sup> The second category includes Actions 2–5, relating to neutralizing the effects of hybrid mismatch, strengthening controlled foreign corporation (CFC)<sup>57</sup> rules, limiting base erosion via interest deductions and other financial payments, and countering harmful tax practices more effectively, taking into account transparency and substance.<sup>58</sup> The third category involves Actions 6–10, setting international standards for tax systems through updates in defining PE status and making sure that transfer-pricing outcomes are consistent with value creation,

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<sup>51</sup> See *OECD Urges Stronger International Co-operation on Corporate Tax*, OECD (Dec. 2, 2013), <http://www.oecd.org/tax/oecd-urges-stronger-international-co-operation-on-corporate-tax.htm> [<http://perma.cc/N5SN-T526>].

<sup>52</sup> Kaye, *supra* note 19, at 188.

<sup>53</sup> Sean Rosenthal, Note, *The OECD's International Tax Proposal: The Action Plan*, 33 REV. BANKING & FIN. L. 20, 23 (2013).

<sup>54</sup> *Base Erosion and Profit-Shifting (BEPS): OECD and Ways & Means Start Taking Action*, PRICEWATERHOUSECOOPERS: U.S. OUTBOUND NEWSALERT (Aug. 2, 2013), [http://www.pwc.com/en\\_US/us/tax-services-multinationals/newsletters/us-outbound-tax/assets/pwc-beps-oecd-wm-start-taking-action.pdf](http://www.pwc.com/en_US/us/tax-services-multinationals/newsletters/us-outbound-tax/assets/pwc-beps-oecd-wm-start-taking-action.pdf) [<http://perma.cc/Q79N-34GQ>] [hereinafter *Ways & Means*].

<sup>55</sup> *Id.* at 2.

<sup>56</sup> ACTION PLAN, *supra* note 3, at 14–15. There are no specific suggestions regarding this action item; it is merely an acknowledgement of the fact that the current rules are unable to encompass the challenges intangibles present. See *id.*

<sup>57</sup> CFCs are foreign subsidiaries in which U.S. shareholders own at least 50%, by value or vote. TAX SUMMARIES, *supra* note 14, at 2120.

<sup>58</sup> ACTION PLAN, *supra* note 3, at 15–18. Recommendations to limit hybrid mismatch include disallowing the exemption of deductible payments, double deductions, or deductions without corresponding income. *Ways & Means*, *supra* note 54, at 3. The plan suggests limiting the deduction of interest expenses when the related interest income is not being fully taxed. ACTION PLAN, *supra* note 3, at 17; *Ways & Means*, *supra* note 54, at 3. Action 5 involves reviewing domestic tax regimes of member and non-member countries, and evaluating harmful tax practices. ACTION PLAN, *supra* note 3, at 18.

especially relating to intangibles.<sup>59</sup> The fourth category deals with transparency in Actions 11–14, with the collection and analysis of data, requirement to disclose aggressive tax planning arrangements, documentation of transfer pricing, and improvement in dispute resolution.<sup>60</sup> The fifth category is limited to Action 15,<sup>61</sup> which suggests forming a multilateral instrument to facilitate these changes because the OECD has no legal standing to enforce its recommendations, and any adopted changes must be enacted by all involved parties.<sup>62</sup> Various aspects of several of these actions will be discussed, but they tend to overlap, so it is difficult to evaluate them individually.

The quick implementation time for the OECD Action Plan implies that a number of the actions are underway and have been set for completion. The OECD released a discussion draft identifying issues raised by the digital economy and possible actions to address them in March 2014, and the deadline for completion of Action 1 was set for September 2014.<sup>63</sup> The OECD intended that the Model Tax Convention would be updated with changes, and by September 2014, “recommendations regarding the design of domestic rules” would be finalized.<sup>64</sup> Comparatively,

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<sup>59</sup> ACTION PLAN, *supra* note 3, at 19–20. The goal is to “ensure that entities and locations earning income have sufficient substance to justify that income.” *Ways & Means*, *supra* note 54, at 4–5.

<sup>60</sup> ACTION PLAN, *supra* note 3, at 21–23.

<sup>61</sup> *Id.* at 24.

<sup>62</sup> *Ways & Means*, *supra* note 54, at 6.

<sup>63</sup> See ACTION PLAN, *supra* note 3, at 29. The committee met again in April 2014. See generally BEPS Action 1: Address the Tax Challenges of the Digital Economy, 24 March 2014–14 April 2014, OECD, <http://www.oecd.org/ctp/tax-challenges-digital-economy-discussion-draft-march-2014.pdf> [perma.cc/P2CR-BES3]. The OECD issued a 2015 Final Report on Action Plan 1 with the recommendations and conclusions of the Task Force on the Digital Economy (TFDE). This included recommendations to modify the definition of and list of exceptions to PEs, transfer-pricing guidelines, the definition of CFC income, and collection of VAT/GST (value added tax/goods and services tax) in cross-border transactions. OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT (Oct. 5, 2015), <http://dx.doi.org/10.1787/9789264241046-en> [perma.cc/3Y9C-HKKH]. It may be several years before the full effects of any changes made can be seen, as such policies take time to implement. The OECD plans to re-evaluate the tax challenges regarding the digital economy, and the progress made through the Action Plan, by 2020. See *id.* at 149.

<sup>64</sup> ACTION PLAN, *supra* note 3, at 30 (noting also that Action 2’s effort to neutralize the effects of hybrid mismatch arrangements should be completed by September 2014). The OECD released a preliminary report in September 2014. In addition, the recently completed 2015 Final Report recommends changes to domestic law and the OECD Model Tax Convention, which “will neutralise hybrid mismatches, by putting an end to multiple deductions for a single expense, deductions without corresponding taxation or the generation of multiple foreign tax credits for one amount of foreign tax paid. [This] . . . will prevent these arrangements from being used as a tool for BEPS without adversely impacting cross-border trade and investment.” OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT, at 11 (Oct. 5, 2015), <http://dx.doi.org/10.1787/>

the strengthening of the CFC Rules and the related recommendations were not to be completed until September 2015.<sup>65</sup> However, aspects of the BEPS plan have been initiated, and one observer notes that “the first part of the OECD’s ambitious package has been delivered on time and intact. The scale and scope of change surpasses what many people had anticipated at the outset.”<sup>66</sup>

## II. EVALUATION OF REPRESENTATIVE COUNTRIES

Every country seeks to maximize its income—through taxation or providing tax incentives for foreign companies—but what helps one country may hurt another. A “game theory approach” illustrates that the maximum payoff occurs when both countries exchange information and cooperate.<sup>67</sup> Any country can be a source country or residence country at different times, so its interests are best protected by exchanging information. If a country acts unilaterally to protect its tax base at the expense of another country, one will always lose, and the total payoff for the countries combined will be lower than if they exchange information and work cooperatively.<sup>68</sup> In this Comment, four countries will be presented as examples of the range of concerns and viewpoints involved in BEPS. The tax systems and problems faced by the United States as a high-tax jurisdiction, the United Kingdom as a relatively high-tax jurisdiction and European Union (EU) member, India as a source country, and Bermuda as a tax haven will be discussed, along with some innovations which may further the BEPS plan.

### A. The United States

The United States can be seen as the principal perpetrator and victim of BEPS. Many of the world’s largest companies, which are central in the BEPS debate, including Google, Amazon, Apple, Facebook, and Microsoft, were founded and incorporated in the United States. For decades, the defining characteristics that associated a company with a specific country were the

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9789264241138-en [perma.cc/6TSW-9HA9].

<sup>65</sup> ACTION PLAN, *supra* note 3, at 30.

<sup>66</sup> Richard Collier, *OECD and BEPS: The Most Significant Change in Modern Times*, PRICEWATERHOUSECOOPERS: TAX BLOG (Sept. 16, 2014), <http://pwc.blogs.com/tax/2014/09/oecd-and-beps-the-most-significant-change-in-modern-times.html> [https://perma.cc/T333-XJWT]. In October 2015, the OECD released final reports on each of the fifteen actions. *BEPS 2015 Final Reports*, OECD, <http://www.oecd.org/ctp/beps-2015-final-reports.htm> (last visited Jan. 9, 2016).

<sup>67</sup> See Carlo Garbarino, *The Use of Cross-Border Corporate Profits and Losses and “Global Corporate Tax Information”: A Game Theory Approach*, 5 COLUM. J. TAX L. 133, 153 (2014).

<sup>68</sup> *Id.*

location of incorporation and its principal place of business.<sup>69</sup> However, a Harvard Business School professor explains that the modern business corporation is experiencing a globalization process which he describes as “decentering”; “[n]ational identities [are] mutat[ing] with remarkable ease and firms are unbundling critical headquarters functions and reallocating them worldwide.”<sup>70</sup> This “decentering” has contributed to a significant decline in U.S. corporate tax revenue, which is lower than a number of other OECD countries.<sup>71</sup> The United States has a corporate tax rate of 35% for high-earning corporations,<sup>72</sup> one of the highest in the world, yet in the United States today, “[c]orporate tax receipts as a share of profits are at their lowest level in at least 40 years.”<sup>73</sup> With such a high tax rate imposed on the worldwide income of resident corporations,<sup>74</sup> even with a number of deductions available, it is not surprising that these companies have sought to shift their profits to jurisdictions with lower tax rates in an effort to maximize their profits.<sup>75</sup>

The Obama Administration recognizes that U.S. taxation laws of MNEs must change, and the IRS has reported a gap of up to \$345 billion between what taxpayers actually pay and what they should pay.<sup>76</sup> Senator Max Baucus, the former Senate Finance Committee Chair, acknowledged, “In the past two decades, the number of U.S.-based companies on the Fortune Global 500 list has declined by 20 percent. . . . When it comes to international tax rules, [the United States has] the worst of all worlds.”<sup>77</sup> Congress is also in support of working to find reasonable solutions that can be implemented in accordance with the OECD Action Plan. Congress has considered options such as

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69 Mihir A. Desai, *The Decentering of the Global Firm*, 32 *WORLD ECON.* 1271, 1272 (2009).

70 *Id.*

71 Bank, *supra* note 5, at 1308–09; see also Mihir A. Desai, *A Better Way to Tax U.S. Businesses*, *HARV. BUS. REV.*, July–Aug. 2012, at 135, 137–38.

72 *TAX SUMMARIES*, *supra* note 14, at 2116.

73 Damian Paletta, *With Tax Break, Corporate Rate Is Lowest in Decades*, *WALL ST. J.* (Feb. 3, 2012, 1:02 PM), <http://online.wsj.com/article/SB10001424052970204662204577199492233215330.html>. However, the recent recession may have contributed to the lowering of taxable income, by enabling companies to offset profits with previous losses. *Id.*

74 *TAX SUMMARIES*, *supra* note 14 (defining a domestic corporation as a company organized under the laws of the United States (or any state within the United States) and stating that a domestic corporation qualifies as a resident corporation even if the company does not conduct any business or own any property within the United States).

75 See generally *TAX SUMMARIES*, *supra* note 14, at 2120–25 (discussing various deductions that companies may use to maximize their profits).

76 CYM H. LOWELL & MARK R. MARTIN, *TRANSFER PRICING STRATEGIES* ¶ 2.04 (2013).

77 Senator Max Baucus, Chairman, Senate Fin. Comm., Keynote Address at the Bipartisan Policy Center: A Tax Code for the 21st Century (June 11, 2012), <http://www.finance.senate.gov/newsroom/chairman/release/?id=7f75cb4c-d83f-405b-8063-b1d7c1d2ea88> [<http://perma.cc/P9NU-6M7K>].

a structural reformation to a “purer” worldwide system of taxation, or options as drastic as converting to a territorial system (only taxing income earned domestically).<sup>78</sup> However, a number of economists believe that changing to a territorial system will only enhance the problems.<sup>79</sup> These economists acknowledge that IP is one of the primary assets and sources of income of the global technology companies, and this income-producing asset can easily be “shifted” to a low-tax jurisdiction. This is a prime example of where companies take advantage of the “Double Irish” structure,<sup>80</sup> in which a large multinational company incorporates a subsidiary in Ireland, with management and control in a country such as Bermuda. That subsidiary can incorporate a sales principal in Ireland that is licensed by the first Irish company. Although the parent company remains in the United States, it is difficult for the United States to collect taxes on the profit made by the subsidiaries.

President Obama has also proposed a “one-off 14% tax on U.S. profits stashed overseas, as well as a 19% tax on any future profits,” but it is still unclear as to whether Congress will approve the proposal.<sup>81</sup> Under U.S. corporate law, companies are not required to pay taxes on profits which are earned by a foreign subsidiary, so long as they are not brought back to the United States through dividends, leading many of these companies to leave earnings abroad rather than reinvest them in the U.S. economy.<sup>82</sup> As a result, the United States may not be able to tax the profits of these foreign subsidiaries, which may facilitate further base erosion.<sup>83</sup>

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78 CONG. BUDGET OFFICE, OPTIONS FOR TAXING U.S. MULTINATIONAL CORPORATIONS 1 (2013), [http://www.cbo.gov/sites/default/files/43764\\_MultinationalTaxes\\_rev02-28-2013..pdf](http://www.cbo.gov/sites/default/files/43764_MultinationalTaxes_rev02-28-2013..pdf) [<http://perma.cc/YEC5-388W>]; see also Bank, *supra* note 5, at 1309.

79 See Lee A. Sheppard, *News Analysis: Why Do We Need Treaties?*, 137 TAX NOTES 825, 825–26 (2012).

80 See *supra* notes 27–34 and accompanying text; see also J. Bryan Lowder, *The Double Irish and the Dutch Sandwich: The Explainer's Field Guide to Exotic Tax Dodges*, SLATE (Apr. 14, 2011, 6:00 PM), [http://www.slate.com/articles/news\\_and\\_politics/explainer/2011/04/the\\_double\\_irish\\_and\\_the\\_dutch\\_sandwich.html](http://www.slate.com/articles/news_and_politics/explainer/2011/04/the_double_irish_and_the_dutch_sandwich.html) [<http://perma.cc/MJM6-53Y6>].

81 *Obama Plans Tax on US Firms Overseas to Fix Roads at Home*, BBC NEWS (Feb. 2, 2015), <http://m.bbc.com/news/business-31085912> [<http://perma.cc/25RM-N3VE>].

82 *Id.* The United States is alone in taxing worldwide income; many other countries will only tax money earned inside the residence country, in an effort to encourage the company to bring the money back to the host country and reinvest it in the economy. Mihir A. Desai, *Tax Only Corporate Income Earned in the United States*, N.Y. TIMES (May 30, 2013), <http://www.nytimes.com/roomfordebate/2013/05/30/how-multinationals-can-best-be-taxed/tax-only-corporate-income-earned-in-the-united-states> [<http://perma.cc/NTL3-NLKC>].

83 The U.S.-Ireland tax treaty and the use of the “Double Irish” technique facilitate lower tax payments by the U.S. parent company. The subsidiary in Ireland claims it has little profit which can be taxed in Ireland, and most of the profit earned is attributed to

A number of economists believe that it might be in the best interest of the United States to lower its corporate tax rates, finding that the current rates are hurting smaller companies, individuals, and the overall economy of the United States.<sup>84</sup> While campaigning in 2012, both Obama and Romney proposed lowering the corporate tax rate to 28% and 25% respectively.<sup>85</sup> The corporate tax rate is a sliding scale based on income; there is also an alternative minimum tax (AMT) of 20% over \$40,000, with fewer deductions.<sup>86</sup> Lowering the corporate tax rate would presumably encourage companies to do business in the United States and pay taxes.

While many U.S. corporations use foreign tax havens, some observers note that the United States can also be a haven for foreign corporations.<sup>87</sup> Although the United States can act as a source or a residence (parent) country, many of the U.S. government approaches to base erosion (e.g. a minimum tax) address the residence-country problem, while most other countries are focusing on the source-country problems.<sup>88</sup> CFC rules in the United States have been weakened because of the check-the-box rules, “which permit elective inconsistent treatment or even non-recognition of entities for tax purposes.”<sup>89</sup> This means the taxpayer can choose whether it wants to be a corporation, a partnership, or a “disregarded entity” for tax purposes.<sup>90</sup> While this is helpful for the taxpayer (to reduce taxable income), it makes it more difficult for the government to collect any taxes.<sup>91</sup> Strengthening the CFC rules along with

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the non-resident Irish subsidiary in Bermuda, which pays no taxes in Bermuda and owes no taxes to Ireland. There will be no taxation unless these funds are repatriated into the United States. Bank, *supra* note 5, 1311–12; see also Kyle Pomerleau, *How Much Do U.S. Multinational Corporations Pay in Foreign Income Taxes?*, TAX FOUND. (May 19, 2014), <http://taxfoundation.org/article/how-much-do-us-multinational-corporations-pay-foreign-income-taxes> [<http://perma.cc/CT6W-7MMM>].

<sup>84</sup> See Desai, *supra* note 82 (“In a world of highly mobile capital and products, economic theory and empirical evidence indicate that the least mobile factor – labor – will bear the corporate tax. In short, lower investment leads to less productive workers and lower wages.”).

<sup>85</sup> Bank, *supra* note 5, at 1324.

<sup>86</sup> TAX SUMMARIES, *supra* note 14, at 2116.

<sup>87</sup> Colloquium, *Conceptualizing a New Institutional Framework for International Taxation*, 44 WASH. U. J.L. & POL’Y 7, 28 (2014) [hereinafter *Conceptualizing*].

<sup>88</sup> *Id.* at 32–33.

<sup>89</sup> Sheppard, *supra* note 12, at 71–72. Inconsistent entity treatment between the United States and a foreign country does not reduce foreign taxation; it is more likely the result of a hybrid instrument, which lowers the tax in one country without a compensatory increase in another country.

<sup>90</sup> *Conceptualizing*, *supra* note 87, at 22.

<sup>91</sup> *Id.*; see also Sheppard, *supra* note 12, at 72 (“These [check-the-box] rules have been called the single stupidest administrative gesture in the history of the income tax.”). However, Congress has made the check-the-box rules less relevant, as it has extended a rule that exempts from Subpart F treatment certain dividends, interest, and royalties

lowering corporate taxes could help limit BEPS. In March 2014, the Obama Administration released some proposals for fiscal year 2015, such as:

the current taxation of excess returns associated with transfers of intangibles offshore, the creation of a new category of Subpart F income for transactions involving digital goods or services, as well as deferral of the interest expense deduction related to the deferred income of the foreign subsidiaries of U.S. multinational corporations.<sup>92</sup>

Another unilateral undertaking by the United States is the Foreign Account Tax Compliance Act (FATCA) of 2010.<sup>93</sup> This is designed to eliminate offshore tax evasion by providing the IRS information about U.S. taxpayer bank accounts outside the United States, but does not require the United States to supply any information to other governments.<sup>94</sup> Numerous treaties exist between the United States and other countries to decrease the percentage of withholding and avoid double taxation. However, “FATCA mandates that multinational businesses evaluate entity payees differently, engage in withholding on certain gross proceeds transactions[,] . . . [and] report different information to the IRS.”<sup>95</sup> Beginning in July 2014, this required new intergovernmental agreements between the U.S. Treasury and foreign governments to provide this information.<sup>96</sup> While FATCA has been called a “hammer,” other countries have agreed that they also need information, so “the inevitable result of FATCA [will be] a multilateral system.”<sup>97</sup> This has the same effect as the transparency requirements of the BEPS plan, to provide reciprocal information exchange to all governments involved. While there are a number of issues relating to BEPS that the United States is unilaterally considering in terms of CFC rules, lowering corporate taxes, transparency, structural changes in the tax laws, and rules governing intangibles, there are few suggestions being implemented at this time specifically relating to the Action Plan. The only current action that the United

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from one foreign subsidiary to another foreign subsidiary. *See generally* Kenan Mullis, *Check-the-Box and Hybrids: A Second Look at Elective U.S. Tax Classification for Foreign Entities*, TAX ANALYSTS (Nov. 4, 2011), <http://www.taxanalysts.com/www/features.nsf/Articles/58D8A3375C8ECCD18525793E0055EB9B?OpenDocument> [perma.cc/Z6Q8-NMYD].

<sup>92</sup> Kaye, *supra* note 19, at 190. Subpart F income refers to a type of undistributed foreign income from CFCs; it can be “easily transferred to a low-tax jurisdiction.” TAX SUMMARIES, *supra* note 14, at 2120.

<sup>93</sup> TAX SUMMARIES, *supra* note 14, at 2134.

<sup>94</sup> *Conceptualizing*, *supra* note 87, at 14.

<sup>95</sup> TAX SUMMARIES, *supra* note 14, at 2135.

<sup>96</sup> *Id.*

<sup>97</sup> *Conceptualizing*, *supra* note 87, at 27–29 (reporting that the United States already has intergovernmental agreements with Canada, Germany, the United Kingdom, France, Spain, and Italy).

States has considered is moving to adopt country-by-country reporting under BEPS.<sup>98</sup> While the end results of the U.S. and OECD plans may be similar, the goals are really not in line, as the United States is trying to capture more income domestically, and the OECD is trying to create social justice and equity.

## B. The United Kingdom

Similar to the United States, the United Kingdom has attempted to cut its corporate tax rate over the past decade to maintain business competitiveness; the United Kingdom had the sixteenth lowest OECD tax rate in 2006.<sup>99</sup> The tax rate has continued to decrease, with the main rate of corporate taxation set at 21% in April 2014,<sup>100</sup> and 20% in April 2015.<sup>101</sup> Recently, a plan to move to 19% in 2017 was announced.<sup>102</sup> The effective corporate rate is lower than most households and small businesses are paying.<sup>103</sup> Unlike the United States, the United Kingdom falls under the jurisdiction of the EU and must follow tax guidelines set out by the EU. The EU is attempting to pressure its member states to stay within certain boundaries and work harmoniously to avoid major disparities.<sup>104</sup> However, the United Kingdom is trying to position itself as a favorable tax jurisdiction, with revised CFC rules and rules concerning cross-border transactions, understanding that this will significantly decrease the amount of corporate tax it collects. Since the United Kingdom does not want its companies moving operations to Ireland, with its very low tax rate, or to other offshore havens, it has increased individual tax rates to offset the loss of corporate tax income.<sup>105</sup>

While the United Kingdom has been actively involved with the BEPS project, the government decided to unilaterally initiate a new Diverted Profits Tax (DPT), which was enacted in April

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<sup>98</sup> There has been a lack of support from the CEOs of various U.S. multinational companies regarding the idea that their companies should have to disclose tax and financial information. See *U.S. CEOs Resist Country-by-Country Tax Reporting -Survey*, REUTERS (May 1, 2014, 2:26 PM), <http://www.reuters.com/article/2014/05/01/usa-tax-survey-idUSL2N0NN0PG20140501> [<http://perma.cc/SF5M-Y5BR>].

<sup>99</sup> Bank, *supra* note 5, at 1321.

<sup>100</sup> TAX SUMMARIES, *supra* note 14, at 2090.

<sup>101</sup> *Corporation Tax: Main Rate*, GOV.UK (July 8, 2015), <https://www.gov.uk/government/publications/corporation-tax-main-rate> [[perma.cc/C8TQ-RDJF](http://perma.cc/C8TQ-RDJF)].

<sup>102</sup> *Id.*

<sup>103</sup> Bank, *supra* note 5, at 1322.

<sup>104</sup> *Id.* at 1310, 1318 (noting that the EU has pressured Ireland to raise its tax rate of 12.5%, especially in light of the need for the EU bailout of the Irish government in 2010). Several EU members, including Ireland, the Netherlands, and Luxembourg are considered tax havens. Sheppard, *supra* note 12, at 75–76.

<sup>105</sup> *Conceptualizing*, *supra* note 87, at 34–35 (commenting that raising the personal income tax rate while lowering corporate taxation will maintain equivalent total tax income for the government).

2015.<sup>106</sup> The U.K. government is concerned that “current rules allow foreign businesses contracting with domestic customers to pay less tax on the profits generated by those sales.”<sup>107</sup> Since its e-commerce spending is the highest among the surveyed major nations, and it has the “highest proportion of online spending,” this particularly concerns the United Kingdom.<sup>108</sup> This tax is an interim fix that will become irrelevant when BEPS is eliminated, but is consistent with the Action Plan and may be more in line with the OECD’s goals than other legislation.<sup>109</sup> “The tax rate of the DPT at 25% is 5% higher than [the] normal corporation tax and this is indicative of it being a move intended to change behaviour; ie to get businesses to change the way they operate to anticipate the new world.”<sup>110</sup> As a unilateral tax, it may backfire if other countries enact similar laws, taxing profits now allocated to the United Kingdom. However, it is an attempt to tax income locally, where the customer is located, targeting foreign companies which otherwise might not incur tax on these profits.

The United Kingdom already has anti-hybrid arbitrage rules to prevent hybrid instrument mismatches, such as double deductions, or a deduction in one territory without taxing it in another territory. The BEPS plan recommends more stringent rules, however, with several key differences. First, the U.K. rules have a “business purpose get-out” so they only apply if the main purpose of the scheme is a U.K. tax advantage.<sup>111</sup> There is no business purpose test or get-out in OECD rules.<sup>112</sup> Second, in the United Kingdom, the anti-hybrid rules are only enacted if Her Majesty’s Revenue and Customs (HMRC) department issues a notice, while the OECD rules apply to any hybrid entity or instrument.<sup>113</sup> This is one example of a change that the United Kingdom is committed to make, but these few differences can make a big difference in what types of hybrid instruments will still be allowed.

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<sup>106</sup> John Stevani, *UK Brings in Digital Tax as Ofcom Report Identifies UK Shoppers as the Most Prolific Online*, PRICEWATERHOUSECOOPERS: TAX BLOG (Dec. 16, 2014), <http://pwc.blogs.com/tax/2014/12/uk-brings-in-digital-tax-as-ofcom-report-identifies-uk-shoppers-as-the-most-prolific-online.html> [<http://perma.cc/CD65-82JD>].

<sup>107</sup> *Id.*

<sup>108</sup> *Id.*

<sup>109</sup> It is not clear whether the DPT was actually enacted with the same social justice goals as the Action Plan or, simply, as a mechanism to increase the tax profits earned by the United Kingdom. It can likely be argued that both goals influenced the U.K.’s decision to act preemptively.

<sup>110</sup> As of April 2015, the normal corporate tax rate is 20%. Stevani, *supra* note 106.

<sup>111</sup> *BEPS: Financing and Hybrid Mismatches*, PRICEWATERHOUSECOOPERS: U.K. (2014), <http://www.pwc.co.uk/tax/issues/beps-financing-and-hybrid-mismatches.html> [<http://perma.cc/8LCH-8U2J>].

<sup>112</sup> *Id.*

<sup>113</sup> *Id.*

### C. India

India is not a member of the OECD, but is one of the enhanced engagement countries (observers);<sup>114</sup> these developing countries are known by the acronym BRICS.<sup>115</sup> In March 2012, the Indian government criticized the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, claiming that the guidelines treat developing source countries unfairly.<sup>116</sup> In January 2013, the Heads of Revenue of the BRICS countries issued a statement that "they confirmed their agreement to develop a cooperative approach on issues relating to international taxation, transfer pricing, exchange of information, and tax evasion and avoidance."<sup>117</sup>

In India, non-resident (foreign) companies are taxed on income received in India at a rate of 40%, plus various surcharges; there is also a minimum alternative tax of about 20%.<sup>118</sup> Indian companies are taxed at 30% plus surcharges,<sup>119</sup> but this will be lowered over the next four years to 25%.<sup>120</sup> India states that tax residency "include[s] the concept of place of effective management."<sup>121</sup> India's economy is driven by transfer pricing, which aims to create economically fair transactions. It uses the arm's length price, which is consistent with OECD guidelines, and it has recently enacted safe harbour provisions to decrease litigation in transfer-pricing disputes.<sup>122</sup> Although India has claimed that the arm's length standard has negatively impacted developing countries, the United Nations has continued to accept it.<sup>123</sup> The Indian government is also utilizing advance pricing agreement (APA) rules to cooperatively resolve transfer-pricing disputes, making transfer pricing less of an issue.<sup>124</sup>

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<sup>114</sup> The other enhanced engagement non-member countries are Brazil, China, Indonesia, and South Africa, and Russia is an accession candidate. *About the OECD: Members and Partners*, *supra* note 4.

<sup>115</sup> BRICS refers to Brazil, Russia, India, China, and South Africa. David Spencer, *BRICS, BEPS, and the U.N. Transfer Pricing Manual (Part 1)*, *J. INT'L TAX'N*, May 2013, at 29, 29.

<sup>116</sup> *Id.* at 30–31.

<sup>117</sup> *Id.* at 30.

<sup>118</sup> TAX SUMMARIES, *supra* note 14, at 836–37 (noting that 2013–2014 surcharge is 2% for smaller and 10% for larger companies, plus an additional educational charge of 3%).

<sup>119</sup> *Id.* at 836.

<sup>120</sup> PRICEWATERHOUSECOOPERS, *LOOKING AT A NEW HORIZON: BUDGET ANALYSIS 2015*, at 1 (2015), [http://www.pwc.in/en\\_IN/in/assets/pdfs/budget/2015/pwc-budget-flash-2015.pdf](http://www.pwc.in/en_IN/in/assets/pdfs/budget/2015/pwc-budget-flash-2015.pdf) [<http://perma.cc/KUJ8-TQ4Z>].

<sup>121</sup> *Id.* at 4.

<sup>122</sup> TAX SUMMARIES, *supra* note 14, at 836, 849–50.

<sup>123</sup> COLE & BYRNES, *supra* note 43.

<sup>124</sup> TAX SUMMARIES, *supra* note 14, at 836 (commenting that multilateral APAs will better prevent double taxation).

Economists observe that India<sup>125</sup> is unhappy that the U.S. multinationals do not pay what India considers to be appropriate taxes to the source countries, believing that the source countries should have the first claim on the tax money.<sup>126</sup> Emerging economies like India's have pushed the OECD to increasingly allow source taxation, leveraging their increased power base.<sup>127</sup> The OECD needs India to cooperate with the BEPS plan because its economy is too large and "important to the functioning of Western multinationals to ignore."<sup>128</sup> Though it is not a full member, India is an equal partner in the OECD's plan, and "[t]he BEPS project is an attempt to get these countries back on the reservation."<sup>129</sup> The consequence of India's dissatisfaction with the results of the plan will be that it will "take creative license with the OECD model treaties" and "continue to undermine international consensus from within."<sup>130</sup> India is concerned with the value added by its market and the correct way to attribute the worth of research and development when allocating profits.<sup>131</sup> The Indians "believe IP value is created where the IP is developed,"<sup>132</sup> and they are not collecting the appropriate taxes. While India is portraying its discontent with the status quo as a social issue (powerful entities taking advantage of developing countries), transfer pricing is primarily an economic issue. Driven by objective, economic analysis, transfer pricing has no social justice element, and India's current system of revenue generation (based on transfer pricing) does not lend itself to a BEPS fix. Although the OECD and India both wish to promote social justice, the OECD's goal is to prevent companies from evading taxation in countries in which they generate a lot of income. This is not the case in India, where the income is based on cross-border support and R&D.

#### D. Bermuda

Bermuda is not affiliated by any means with the OECD.<sup>133</sup> Bermuda has no corporate taxes.<sup>134</sup> "Bermuda [is] a paradigm of

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<sup>125</sup> The following comments about India also apply to China.

<sup>126</sup> *Conceptualizing*, *supra* note 87, at 26–27.

<sup>127</sup> Brauner, *supra* note 26, at 63.

<sup>128</sup> Sheppard, *supra* note 12, at 64.

<sup>129</sup> *Id.*

<sup>130</sup> *Id.*

<sup>131</sup> *Conceptualizing*, *supra* note 87, at 17.

<sup>132</sup> Jason W. Klimek, *A Big Data Approach to Formulary Apportionment*, CORP. TAX'N, May–June 2014, at 3, 6.

<sup>133</sup> See *About the OECD: Members and Partners*, *supra* note 4 (identifying that other tax havens such as Ireland, Luxembourg, and the Netherlands are OECD member countries and subject to adherence to and promulgation of the BEPS Action Plan).

<sup>134</sup> TAX SUMMARIES, *supra* note 14, at 217. See generally Warren Cabral, *Bermuda: A Paradigm for Offshore e-Commerce*, E-COMMERCE L. REP., Nov. 2000, at 1.

what is available for the e-commerce trader to maximize profit and opportunity and to minimize regulatory interference.”<sup>135</sup> There are no capital gains taxes, VAT, sales taxes, excise taxes, transfer taxes, or stamp taxes imposed on exempt companies (those owned by non-Bermudans).<sup>136</sup> Multinational corporations are only considered to be resident companies if they have resident employees who fall under the Bermuda payroll tax.<sup>137</sup> Also, the government has “extended the tax exemption granted to Bermuda companies under the Exempt Undertakings Act of 1976 from 28 March 2016 until 2035.”<sup>138</sup> Existing companies must apply for the extension of tax exemption, which protects them from any new income or capital gains taxes through 2035. Clearly, Bermuda must get something out of having so many multinationals incorporated in their country; the companies pay a yearly fee. Every year, the company files a report with the Registrar of Companies, noting its assessable capital, and pays a sliding scale fee based on its net worth, with a maximum rate of \$31,120.<sup>139</sup> As a country, Bermuda’s income is derived primarily from its function as a maximum tax haven. There is no incentive for it to change, work with OECD, or support the BEPS plan, and it has extended its tax haven status for the next twenty years.

### III. RECOMMENDATIONS

Clearly, BEPS is a huge issue with a plethora of interlocking factors. Not surprisingly, there are an equally large number of recommendations by industry experts analyzing the plan, regarding how to address its problems, some of which are contradictory or mutually exclusive. The largest difficulty is how to convince all of the countries involved to agree on a multilateral plan and enforce its various parts. Evaluating the issues and their potential resolutions in terms of the individual countries discussed is not particularly useful, since only multilateral agreements will solve the problems. Also, until the motivations of the countries involved are aligned with those of the OECD (social justice rather than income generation), the Action Plan is at risk for failure. Some of the most promising measures to combat BEPS include a byte tax, a shift from arm’s length to formulary apportionment, the common consolidated corporate tax base, and

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<sup>135</sup> Cabral, *supra* note 134 (noting that Bermuda is an excellent offshore tax haven that permits a business to avoid the heavy-handed restrictions of a government like the United States).

<sup>136</sup> TAX SUMMARIES, *supra* note 14, at 217–21.

<sup>137</sup> *Id.* at 217–18 (stating that resident employees must work four consecutive weeks in a calendar year).

<sup>138</sup> *Id.* at 217.

<sup>139</sup> *Id.* at 219.

a multilateral entity that would have some actual authority over international taxation.

#### A. Applying a Byte Tax to Intangibles

While this is not directly addressed in the OECD Action Plan (since there are no recommendations specifically about the digital economy), a byte<sup>140</sup> tax appears to be one of the most objectively fair solutions for each country to earn the taxes they feel they are owed. Some countries are evaluating the byte tax as a method to gain “non-income tax jurisdiction over digital economy companies having no physical presence there.”<sup>141</sup> They present the reasonable argument that intangibles should be taxed in the country in which the customer lives, because the product is changed when it is used by the customer.<sup>142</sup> For example, France wants to tax Google for selling information on French customers to its advertisers (looking at where the income-generating information is being created). However, they do not want French companies to pay taxes when foreigners buy French merchandise (looking at where the customer is located).<sup>143</sup>

The United States has expressed no interest in applying a byte tax, but this may not be the best decision. It has addressed the problem in the Internet Tax Freedom Act,<sup>144</sup> and has recently struck down the consideration again in the “Net Neutrality” decisions.<sup>145</sup> The justification appears to be that the United States does not want the MNEs principally based in its jurisdiction to have to pay byte taxes to other countries, even if taxes cannot be collected in the United States either.<sup>146</sup> This reticence in taxing the Internet stems from a resistance to doing so when it was formed; there was a concern that taxation would hinder the presented opportunities for expansion and innovation. Over the past decades, the Internet has exponentially expanded, and every other industry of its size and influence faces taxation.

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<sup>140</sup> “Byte” and “bit” both refer to digital data (a byte is a sequence of bits), and can be used interchangeably regarding the tax. *Byte*, MERRIAM-WEBSTER, <http://www.merriam-webster.com/dictionary/byte> [<http://perma.cc/Y3UB-ZKKU>].

<sup>141</sup> Sheppard, *supra* note 12, at 69 (mentioning that France believes a byte tax would be an ideal solution).

<sup>142</sup> *Id.*

<sup>143</sup> *Id.*

<sup>144</sup> See Internet Tax Freedom Act, 47 U.S.C. § 151 (2012).

<sup>145</sup> *FCC Adopts Strong, Sustainable Rules to Protect the Open Internet: Rules Will Preserve the Internet as a Platform for Innovation, Free Expression and Economic Growth*, FCC (Feb. 26, 2015), [https://apps.fcc.gov/edocs\\_public/attachmatch/DOC-332260A1.pdf](https://apps.fcc.gov/edocs_public/attachmatch/DOC-332260A1.pdf) [<http://perma.cc/C6UF-EJLD>] [hereinafter *FCC Rules*] (“Broadband service will remain exempt from state and local taxation under the Internet Tax Freedom Act. This law, recently renewed by Congress and signed by the President, bans state and local taxation on Internet access regardless of its FCC regulatory classification.”).

<sup>146</sup> Sheppard, *supra* note 12, at 69–70.

“If governments choose to tax consumption in general—and most of them do, through value-added or sales taxes—it’s logical to tax data consumption, too.”<sup>147</sup> It is no longer reasonable to believe that taxation would present a substantial obstacle to the Internet’s expansion or its utilization. However, the United States does not have any federal sales or value-added taxes, so this would be a major change. Also, this could be seen as a regressive tax, which would disproportionately burden consumers, creating a greater tax burden for those lower-income individuals who spend a larger percentage of their income.

It is impractical to tax individuals using the Internet based on the bytes they utilize, because that would be disproportionately cumbersome on individuals and the government. Assessment, collection, enforcement, and payment would all be exceedingly complex.<sup>148</sup> In addition, this tax might actually present a deterrence to Internet use and development, which is not the purpose of a tax.<sup>149</sup> Rather, corporations should incur a tax based on where the bytes originate. If a person on the Internet purchases a product on Amazon in the United States, the United States will recognize the profit, and Amazon will face taxation in the United States. Although this is bad news for the multinational companies that would quickly begin to accumulate varying taxes in each jurisdiction where a byte tax is implemented, it seems to be an equitable method to assess taxes. This increased tax might, however, just be passed on to the consumer via an increased price, but it presents an opportunity for the countries to act in a reasonable, consistent manner that is beneficial to each, rather than taking unilateral actions which will only cause turmoil. The recent “Net Neutrality” decisions promote transparency; this will better allow for a monitoring of individuals purchasing goods online and a determination of where multinational companies should incur taxes.<sup>150</sup> There are quite a number of issues that would need to be addressed before a byte tax could be practically implemented, including the amount of contact a country would need to have with a transaction before it could claim the right to tax the revenue, and how Internet transactions should be taxed.

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<sup>147</sup> A.L., *Hungary’s Internet Tax: A Bit of Protest*, *ECONOMIST* (Oct. 30, 2014, 10:44 AM), <http://www.economist.com/node/21629492> [<http://perma.cc/B6S9-74CY>].

<sup>148</sup> E.g., Annette Nellen, *Internet Usage or Bit Tax?*, *21ST CENTURY TAX’N* (Mar. 18, 2010), [21stcenturytaxation.blogspot.com/2010/03/internet-usage-or-bit-tax.html](http://21stcenturytaxation.blogspot.com/2010/03/internet-usage-or-bit-tax.html) [<http://perma.cc/RF8N-MFKG>].

<sup>149</sup> *Id.*

<sup>150</sup> *FCC Rules*, *supra* note 145.

## B. Replacing Arm's Length with Formulary Apportionment

Another area that has been addressed is the value of replacing the arm's length principle with formulary apportionment, and this appears to be a particularly promising area of reform.<sup>151</sup> Alternatively, a combination of arm's length and formulary apportionment could be most successful for companies with a significant IP component.<sup>152</sup> The Action Plan requires an allocation of profits associated with intangibles to be in accordance with value creation, which is essentially formulary apportionment without calling it that.<sup>153</sup> The OECD's problem with formulary apportionment has been its rejection of a "one-size-fits all" principle, and the traditional factors of property, sales, and payroll are not relevant to the digital economy.<sup>154</sup> However, "a hybrid approach using big data would allow countries to identify relevant factors to a given industry to accurately capture the value generated by that industry."<sup>155</sup> While arm's length works for material goods, intangibles have "an intrinsic value that simply cannot be captured by a comparable uncontrolled price."<sup>156</sup> Many technology companies, such as Apple, Google, and Microsoft, are collecting and analyzing data ("big data") about users, such as location, which could be utilized to determine what profits should be associated with which country. These statistics could easily be modified to determine the relevant factors useful for formulary apportionment, as it entails no extra expense (companies are already collecting it) and is more transparent.<sup>157</sup> "Further, value creation attributable to location based data collection is also attributable to that country's contribution to the firm's collection activities."<sup>158</sup> Combining sales information and data collection, one can obtain a clear picture of the value that can be allocated to each country. Using this type of formulary apportionment would address the transfer-pricing manipulations, which allow IP companies to avoid taxes so well, and a hybrid approach could work for IP or traditional manufacturing companies.<sup>159</sup>

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<sup>151</sup> See generally COLE & BYRNES, *supra* note 43. Lee Sheppard agrees, noting that she does not believe the BEPS plan will be successful. Sheppard, *supra* note 12, at 62–63 ("In the long run, we already know what the outcome will be—apportionment of multinationals' profits based on sales.").

<sup>152</sup> Klimek, *supra* note 132, at 3.

<sup>153</sup> *Id.*

<sup>154</sup> *Id.* at 3–4.

<sup>155</sup> *Id.* at 3.

<sup>156</sup> *Id.* at 4 (defining a comparable uncontrolled price as the best way to determine the arm's length transfer price for material goods).

<sup>157</sup> *Id.* at 4–6.

<sup>158</sup> *Id.* at 5.

<sup>159</sup> See generally *id.*

### C. Utilizing a Common Consolidated Corporate Tax Base

Another type of formulary apportionment with significant potential to combat BEPS, the common consolidated corporate tax base (CCCTB), is being evaluated in Europe.<sup>160</sup> The CCCTB would involve computing and consolidating tax results in the EU based on sharing Global Corporate Tax Information.<sup>161</sup> The “CCCTB model treats the group as a single entity for tax purposes,” and “can be viewed as a multilateral method for the exchange of Global Corporate Tax Information at the EU level.”<sup>162</sup> The EU has already introduced the legal Europe entity, which is not an entity of any particular EU country, but issues still exist concerning the appropriate amount of profit to be allocated to each country. The CCCTB has several tax-neutralizing effects on groups in member countries. Cross-border transfers within the group do not generate taxable capital gains or losses (only relevant outside the group). Intra-group cross-border dividends are exempt to prevent double taxation, and aggressive transfer pricing and profit shifting would be unnecessary, since there would be no high- or low-tax jurisdictions within the group.<sup>163</sup> The larger the group of countries consolidating, the more advantageous to BEPS. While an EU directive would require the consent of all twenty-seven EU states (which is unlikely), approval though enhanced cooperation would only require nine.<sup>164</sup> The United States could voluntarily join the EU members to exchange information and consolidate its tax base, because if the United States acts as a high-tax residence country and does not exchange information, it cannot protect its tax base.<sup>165</sup> Along with information exchange such as FATCA, this level of cooperation could substantially improve BEPS.

### D. Creating a Multilateral Instrument

A multilateral instrument, one with the power to enforce the OECD’s recommendations, would alleviate the greatest difficulties in implementing the Action Plan. Executing the plan will require unprecedented amounts of cooperation by many different countries and multilateral agreements, which will not always benefit those countries. “In the realm of taxation, where tax revenues are used to provide governmental services, in the

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<sup>160</sup> Sheppard, *supra* note 12, at 63.

<sup>161</sup> Garbarino, *supra* note 67, at 137–38, 157.

<sup>162</sup> *Id.* at 158.

<sup>163</sup> *Id.* at 159.

<sup>164</sup> *Id.*

<sup>165</sup> *Id.* at 165.

end, everyone loses if no one cooperates.”<sup>166</sup> By cooperating, the winner wins a little less, but no one loses, and the countries get equal benefit. For the BEPS plan to succeed, a collaborative-based paradigm must replace competition, a holistic and comprehensive approach is needed, and some necessary innovations may be outside the traditional area of tax policies.<sup>167</sup> Companies must cooperate with governments, and countries must cooperate with each other. This is, of course, the ultimate challenge for the OECD, since it is in each company’s best interest to pay as little in taxes as they legally can. Also, there is little incentive for a country, like the United States, to have its corporate taxpayers pay any more to other countries,<sup>168</sup> or for Bermuda to start charging taxes or change its policies. However, to overcome these obstacles, and for the BEPS plan to work, all of the countries involved need to be motivated to cooperate in ways which will allow for equitable taxation of multinational corporations. The OECD countries could require that all profits be subject to some form of taxation, decreasing the value of low-tax jurisdictions, and incentivizing countries like Bermuda to raise their taxes. A multilateral regulatory body would certainly aid this process. Unfortunately, without any power to enforce its regulations, the OECD can only make suggestions and hope for implementation of its Action Plan.

#### CONCLUSION

Multinational corporations have found a means by which to avoid paying taxes, and have mastered the ability to shift their profits to low-tax jurisdictions and erode the tax base of those jurisdictions with higher corporate tax rates. This problem has only been exacerbated in recent years with the ever-increasing presence and influence of the Internet on the economy. The top technological companies have masked billions of dollars worth of taxes by cleverly manipulating the tax laws to elicit double non-taxation.

The OECD’s BEPS Action Plan provides a comprehensive analysis of the current issues faced by governments in their international taxing policies, with measures designed to ameliorate the problems. However, the OECD faces the issue that there is no way for it to effectively implement its plan, as the

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<sup>166</sup> Klimek, *supra* note 132, at 6.

<sup>167</sup> Brauner, *supra* note 26, at 112.

<sup>168</sup> Sheppard, *supra* note 12, at 68–70 (“The trouble is that the Americans don’t appear to want Google to be paying byte taxes or income taxes to other countries. Most of the big digital players are American, and few of them pay tax anywhere, including the United States.”).

organization as a whole has no actual authority. Another obstacle to the OECD plan involves its ultimate motivation for change. The goal of the Action Plan is to promote social justice for all countries. Member countries, such as the United States and the United Kingdom, who are suffering from lost tax revenues, hope that the BEPS plan will aid their tax collections, but are less concerned with equity. While the United States has considered implementing unilateral actions, there has not been a great deal of change to the corporate tax rate in recent years, nor has the government considered adopting a measure other than the arm's length standard. The U.S. Congress is ambivalent about changing tax laws, which will make their big business constituents unhappy. Additionally, a serious hindrance to the plan is a country like Bermuda. Bermuda, a tax haven for those companies burdened with hefty taxes in their residence jurisdiction, entices these multinational businesses and offers the opportunity to pay zero taxes. The presence of these companies helps Bermuda's economy, and they are able to self-regulate, leaving very little incentive for Bermuda to change its ways.

Thus, the countries facing BEPS must find a way to track taxes due from these companies, despite the obstacles of tax havens. Ultimately, this means that a new system of taxation must be implemented, and countries must adopt a cooperative paradigm to work for the betterment of all, rather than the colossal wealth of the few. A byte tax could allocate taxes associated with the digital economy in an equitable fashion. Formulary apportionment could replace the arm's length standard, which has outgrown its usefulness. A CCCTB could combat BEPS by eliminating some of its causal mechanisms (such as variable tax jurisdictions). While everyone agrees that a multilateral instrument is needed to facilitate change, this requires Congress to stand up to corporate lobbyists, governments to agree, and corporations to play by the rules.

