

**Testimony of Pascal Saint-Amans**

**Director, Centre for Tax Policy and Administration,**

**Organisation for Economic Co-operation and Development (OECD)**

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**Hearing on Tax Reform: Tax Havens, Base Erosion and Profit Shifting**

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Chairman Camp, Ranking Member Levin, and Members of the Committee, thank you for inviting me to testify today regarding the work of the Organisation for Economic Co-operation and Development (OECD) on base erosion and profit shifting (BEPS).

The OECD is an international organization with 34 member countries and six key partners (Brazil, China, India, Indonesia, Russia, and South Africa). The mission of the OECD is to promote policies that will improve the economic and social well-being of people around the world. The OECD provides a forum in which governments can work together to share experiences and seek solutions to common problems. We work with governments to understand what drives economic, social and environmental change. We measure productivity and global flows of trade and investment. We analyse and compare data to predict future trends. We establish international consensus-based standards on topics ranging from tax to the safety of chemicals.

We work with business, through the Business and Industry Advisory Committee to the OECD, and with labour, through the Trade Union Advisory Committee. We have active contacts as well with other civil society organisations. The common thread of our work is a shared commitment to market economies backed by democratic institutions and focused on the wellbeing of all citizens.

### **OECD's Work on Base Erosion and Profit Shifting**

In the area of tax, the core work of the OECD has been to develop, on the basis of international consensus, common standards to eliminate double taxation for cross border investments, specifically the Model Tax Convention (which serves as the basis for over 3,000 bilateral tax treaties) and the Transfer Pricing Guidelines (which provide common standards for allocating income among members of a group of affiliated companies). These instruments have been critical in promoting economic growth by removing barriers to cross-border investment, most importantly by preventing double taxation and by providing the certainty and stability necessary for international investment.

### **The OECD BEPS Project**

While the core of the OECD work in the tax area remains the prevention of double taxation, there is growing concern in OECD member countries and in G20 countries about the issue of double non-taxation due to BEPS. Stated simply, BEPS arises because under the existing rules multinational enterprises (MNEs) are often able to artificially separate their taxable income from the jurisdictions in which their income-producing activities occur. This can result in income going untaxed anywhere, and significantly reduces the corporate income tax paid by MNEs in the jurisdictions where they operate. BEPS thus impacts countries around the globe, and it has become a significant political issue in OECD and non-OECD countries alike.

While there clearly is a tax compliance aspect, as shown by a number of high profile cases, there is a more fundamental policy issue: the common international tax standards may not have kept pace with the changing business environment. Domestic rules for international taxation and internationally agreed standards are still grounded in an economic environment characterised by a lower degree of economic integration across borders, rather than today's environment of global taxpayers, characterised by the increasing importance of intellectual property as a value-driver and by constant developments of information and communication technologies.

The ability of some taxpayers to reduce their taxes by separating their income from the jurisdictions in which they operate creates an unlevel playing field, which undermines competition and economic efficiency. This is because some businesses, such as those which operate cross-border and have access to sophisticated tax expertise, may profit from BEPS opportunities and therefore receive unintended competitive advantages compared with enterprises that operate mostly at the domestic level. This, in turn, leads to an inefficient allocation of resources by distorting investment decisions towards activities that have lower pre-tax rates of return, but higher after-tax rates of return. Moreover, such a result affects the perceived fairness of the tax system as a whole, which can undermine voluntary compliance by all taxpayers.

## **The BEPS Report**

The debate over BEPS, which was initiated at the OECD last year, has become an issue on the agenda of many OECD and non-OECD countries. The G20 leaders meeting in Mexico on June 18-19, 2012, explicitly referred to “the need to prevent base erosion and profit shifting” in their final Declaration. This message was reiterated at the G20 finance ministers meeting of November 5-6, 2012, the final communiqué of which states: “We also welcome the work that the OECD is undertaking into the problem of base erosion and profit shifting and look forward to a report about progress of the work at our next meeting,” in February 2013.

Following the call of the G20, the OECD published its report, *Addressing Base Erosion and Profit Shifting*, in February 2013, a copy of which is annexed to this testimony. The report provides results of an in-depth analysis of BEPS to identify, based on the available data and information, the problems and the different factors that cause them.

As noted in the report, every jurisdiction is free to set up its corporate tax system as it chooses. States have the sovereignty to implement tax measures that raise revenues to pay for the expenditures they deem necessary. An important challenge relates to the need to ensure that tax does not produce unintended and distortive effects on cross-border trade and investment nor that it distorts competition and investment within each country by disadvantaging domestic players. In a globalised world where economies are increasingly integrated, domestic tax systems designed in isolation are often not aligned with each other, thus creating room for mismatches. These mismatches may result in double taxation and may also result in double non-taxation. In other words, these mismatches may in effect make income disappear for tax purposes. This leads to a reduction of the overall tax paid by all parties involved as a whole. Although it is often difficult to determine which of the countries involved has lost tax revenue, it is clear that collectively the countries concerned lose tax revenue.

Considering how tax systems interact with each other is therefore relevant not only to eliminate obstacles to cross-border trade and investment, but also to limit the scope for unintended non-taxation. Further, double tax treaties, which are bilateral tools that countries use to co-ordinate the exercise of their respective taxing rights, may also create opportunities for taxpayers to obtain tax advantages in the form of lower or no taxation at source and/or lower or no taxation in the state of residence of the taxpayer.

The report notes that, while the specific goals vary among MNEs, broadly speaking BEPS focuses on moving profits to where they are taxed at lower rates and expenses to where they are relieved at higher rates. The report identifies key pressure areas giving rise to opportunities for BEPS:

- International mismatches in entity and instrument characterisation including, hybrid mismatch arrangements and arbitrage;
- Application of treaty concepts to profits derived from the delivery of digital goods and services;
- The tax treatment of related party debt-financing, captive insurance and other intra-group financial transactions;
- Transfer pricing, in particular in relation to the shifting of risks and intangibles, the artificial splitting of ownership of assets between legal entities within a group, and transactions between such entities that would rarely take place between independents;
- The effectiveness of anti-avoidance measures, in particular general anti-avoidance rules (GAARs), CFC regimes, thin capitalisation rules and rules to prevent tax treaty abuse; and
- The availability of harmful preferential regimes.

The report was discussed at the February 2013 Moscow G20 meeting of finance ministers, who expressed strong support for the work done and urged the development of a comprehensive action plan to be presented at the G20 meeting in July. The action plan will provide comprehensive, coordinated strategies for countries concerned with BEPS, while at the same time ensuring a certain and predictable environment for business.

### **Development of the Action Plan**

The action plan will provide a sense of direction on actions that will be taken to address BEPS. Specifically, the action plan will call for the development of tools that countries can use to address BEPS. Because BEPS strategies often rely on the interaction of countries' different systems, these tools will have to address the gaps and frictions that arise from the interface of these different systems.

For example, the report calls for the development of tools to address hybrid mismatch arrangements – structures or transactions that take advantage of the different treatment of entities or instruments by different countries to achieve a deduction with no corresponding inclusion, or multiple deductions for the same economic expense. Work in this area is expected to examine the existing rules that countries have developed to address these issues, and provide recommendations regarding the design of such rules.

Similarly, a key concern of many countries is the use of excess interest expense to erode the tax base. While many countries have enacted limitations on the deductibility of interest expense, the different approaches taken can create the opportunity for countries to arbitrage the different rules, and in some cases may result in economic double taxation to the extent that real economic costs are denied deduction in all jurisdictions. The report calls for the action plan to develop rules in this area, and the work is expected to examine the existing approaches countries have taken and to develop best practices.

A second key element is to better align taxation and the substance of taxpayers' value creating activities. The international standards, including the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines, are generally based on the assumption of a

bilateral relationship between two jurisdictions with relatively comparable tax systems. Today's environment, by contrast, is characterized by globally integrated business models, with investments often channelled through third countries.

The international standards must be updated to reflect this new reality, and the report thus calls for updates to treaty provisions in this regard. Similarly, the report calls for improvements to the transfer pricing rules to address, in particular, the use of intangibles and the shifting of risk to separate taxable income from value creation.

Finally, in order for changes to the rules and international standards to be effective, greater transparency will be needed. This includes the provision of better information by taxpayers to tax administrations and more effective cooperation among tax administrations. For example, many countries, including the United States, have rules that require disclosure of certain types of aggressive transactions, and work is expected to develop recommendations regarding the design of such rules. In addition, the documentation that companies currently provide regarding their transfer pricing strategies can be very extensive and burdensome, both on taxpayers and on tax administrations, and in many cases may not be very useful to provide an overall picture of the relevant transfer pricing risks. Work is expected to develop more effective (and preferably, simplified) forms of transfer pricing documentation.

The action plan will also consider the best way to implement in a timely fashion the measures governments can agree upon. If treaty changes are required, solutions for a quick implementation of these changes should be examined and proposed as well. At the same time that the OECD steps up its efforts to address double non-taxation it must also continue its work to eliminate double taxation. In this respect, the report suggests that a comprehensive approach should also consider possible improvements to eliminate double taxation, such as increased efficiency of mutual agreement procedures and arbitration provisions.

It is important to note that the work of the OECD is done entirely by consensus. That is, measures cannot be adopted without the consensus of all member countries. Moreover, the results of the work on BEPS generally will be tools that countries can use to address BEPS. Each country ultimately must make its own tax policy choices. Countries have recognized, however, that opportunities for BEPS fundamentally arise from the interaction of gaps in the interaction of different countries' systems, and that no one country can by itself completely address BEPS. In addition, countries have recognized that uncoordinated, unilateral action to exert taxing rights over cross-border activity likely will result in double or multiple taxation of cross-border investment, leading to increased disputes among governments and harming economic growth at a time when the world can least afford it. The OECD work thus represents a critical forum for countries to collaborate to establish consensus-based international standards to address this common issue while also providing business the certainty and predictability needed for international investment and growth.

## **Next Steps**

The development of the BEPS action plan is being driven by OECD member countries, in consultation with key non-OECD countries and other stakeholders, including the business community and civil society. Businesses generally recognize the serious risks that would come from uncoordinated action, and have expressed their support for work on BEPS to be done multilaterally, and by the OECD in particular, given the OECD's existing expertise and consensus-driven process.

After the action plan has been approved, it is expected that work on the actions will generally be complete within two years, though some actions may be developed more quickly, and some may take additional time. We believe this work will provide countries with the tools they need to address this pressing issue.

While the work on BEPS is a key issue in many countries, it should also be viewed in the context of the broader tax policy choices that each country makes. In this context, the OECD has long recommended that countries reduce the distortive impacts of their tax regimes, and thus improve economic growth, by broadening the tax base (of which measures to address BEPS can be an important part) and lowering the rate. We hope that our work, including the work on BEPS, can be helpful in the ongoing tax policy reform discussions in the United States.

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