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Base Erosion and Profit Shifting: Options, Opportunities and Alternatives

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Abstract

Base erosion and profit shifting is generally defined as tax strategies that serve to exploit gaps or inconsistencies in global tax systems that allow an enterprise to shift profits to lower tax jurisdictions. This can be accomplished by either shifting income to lower tax jurisdiction or shifting deductible expenses to higher tax jurisdictions. Historically, these shifting strategies have been handled on a country by country basis with no centralized framework. In 2015 the Organization of Economic Cooperation and Development proposed modifications through its Base Erosion and Profit Shifting project that if adopted by the member countries, would reverse the adverse impact to the global tax system caused by shifting profits and assets among members of controlled groups. By reviewing the major tax shifting strategies as well as the Organization of Economic Cooperation and Development proposals to curb any perceived abuses, this research will serve to fill a gap in the literature surrounding Base Erosion and Profit Shifting strategies. The conclusions and recommendations reached in the paper are generalizable and appropriate for use in developing best practice solutions.

Keywords: Transfer Pricing, Interest stripping, Supportive expenses & OECD

1. Introduction

Base erosion typically occurs when multinational organizations engage in cross-border transactions that will shift income, expenses or assets from one tax jurisdiction to another.

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The tax strategies employed to reduce an organizations overall tax burden give rise to a zero-sum game at the jurisdictional or county level, where one country will lose tax revenues and another will gain revenues. The overall tax shifting strategy is referred to as Base Erosion and Profit Shifting (BEPS). Mohs, Goldberg, Butler and Heath (2016) noted that international tax strategies have been around since the inception of the United States Tax Code due in part to a distinctive feature relating to the taxation of worldwide income.

There are many different tax strategies that are employed by multi-national organizations to reduce their overall tax burden. The three predominate strategies which are addressed in this study center around transfer pricing, interest stripping and supportive expenses. In an effort to curb any limit base erosion and prevent abuses, as discussed below, we look to the section of the Internal Revenue Code which addresses BEPS issues.

2. Background

The primary provision of U.S. income taxation law that addresses BEPS issues is Internal Revenue Code (“Code”) sec. 482, titled, “Allocation of income and deductions among taxpayers,” a section that is only two sentences long. The first of these states:

“In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, theSecretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary inorder to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.”

This language does not explicitly target transactions between businesses in two different countries. However, the potential for abuse is high where there are two business entities that are commonly owned or controlled, one in a country where the net income of a business entity will be taxed at a relatively high rate, and another in a country where the net income of a business entity will be taxed at a relatively low rate. Although the abuse targeted by this language can appear in many different variations and forms, we advance the following example as an illustration;

Consider, there are two entities that are commonly controlled, one in a high-tax jurisdiction and one in a low-tax jurisdiction. As a result of a business arrangement between them. The transaction could be a loan, a lease, a sale, a license, or the performance of services. In this transaction, there is money owed from the entity in the high-tax jurisdiction to the entity in the low-tax jurisdiction. Increasing the amount of this payment decreases the taxable income of the entity in the high-tax jurisdiction, at the cost of only a commensurate increase in the taxable income of the entity in the low-tax jurisdiction. Since the entities are commonly controlled, they may be motivated more by a desire to minimize overall taxes than to create an arrangement that is fair for either of the two entities. Thus, the payments could be artificially inflated to reach the desired combined tax result. If the entity receiving the payments were in the high-tax jurisdiction, the payments could be artificially low this would have the effect of keeping the taxable income in the high-tax jurisdiction as low as possible.The goal of Code sec. 482 is to keep this from happening. The reallocation authorized by that section would have the effect of making sure, that for tax purposes, the entities will be treated as having made a fair payment in terms of specific types of transactions enumerated below:

Transfer Pricing

As noted in Rainish, Mensz and Mohs (2015) transfer prices are broadly defined as the amounts charged for goods and services exchanged between divisions or units of the same company. Additionally, Transfer pricing provides the vehicle for multinational firms to shift profits from high tax jurisdictions to lower tax jurisdictions. This effectively reduces the tax burden which in effect increases value by increasing overall profitability and value (Adams and Dirtina, 2010). The universally accepted approach for setting a transfer price is referred to as the arms-length standard. The arms-length pricing standard reflects the price at which two unrelated parties agree to execute a transaction in an open market transaction. The arms-length standard is based on the notion of comparables. Section 482 of the Internal Revenue Code and the regulations promulgated there under provide in part for the computation of comparables. The notion of comparables is that related party pricing should equal to open market pricing.

Mutti and Grubert (2004) argued that despite the fact that countries worldwide use the arms-length standard to set transfer prices, they often enact rules that can lead to different interpretations of what the price or the standard would be. Therefore, it can be concluded that meeting the rules of one country does not guarantee that the other countries requirements will be met. In an effort to counter the inconsistencies the Organization for Economic Co-operation and Development (OECD) member countries embarked on numerous studies relating to the various aspects of base erosion (see OECD A-J, 2015). Included in the transfer pricing would be rent and sale of tangible and intangible property between members of a controlled group as reviewed below.

Rent of Tangible Property, Sale of Tangible Property, and Payment for Services

One type of issue that may be the cause of a BEPS problem would be the charging of rent by one business for the use of property by a commonly-controlled entity. Undercharging rent would overstate the income of the lessee, overcharging rent would understate the income of the lessee. So, if a business in a high-tax jurisdiction overpaid rent to a commonly-controlled entity in a low-tax jurisdiction, this would artificially reduce the overall taxes paid by the two businesses.

This problem is specifically addressed by the regulations. Treas. Reg. sec. 1.482-2(c)(1) requires that there be an “arm’s length rental charge” in order to avoid a reallocation under IRC sec. 482. Treas. Reg. sec. 1.482-2(c)(2) defines that as;“…the amount of rent which was charged, or would have been charged for the use of the same or similar property, during the time it was in use, in independent transactions with or between unrelated parties. Under similar circumstances considering the period and location of the use, the owner's investment in the property or rent paid for the property, expenses ofmaintaining the property, the type of property involved, its condition, and all other relevant facts.”

A similar rule will apply to the sale of tangible property. Underlying all these principles is an assumption that the property will in fact have an ascertainable arm’s length rental value. In order to avoid any problems, there is a procedure available by which a corporation can enter into an agreement with the Internal Revenue Service, called the Advance Pricing and Mutual Agreement (APMA) program. A revised procedure, in part reflecting some of the considerations of OECD’s BEPS project, was issued on August 12, 2015 in Rev. Proc. 2015-40.

Intangible Property

The discussion of Code sec. 482 so far has been of the first sentence, and the regulations relative to that sentence. The second sentence of Code sec. 482 addresses a very specific issue, stating:

"In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."

Although the words "intangible property" can have a much broader meaning, in this case the words are as defined in Code sec. 936(h)(3)(B), which states:

"The term "intangible property" means any—

i. Patent, invention, formula, process, design, pattern, or know-how
ii. Copyright, literary, musical, or artistic composition
iii. Trademark, trade name, or brand name
iv. Franchise, license, or contract;
v. Method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or
vi. Any similar item, which has substantial value independent of the services of any individual."

For these purposes the term, "intangible property" has a definition more closely related to what one would think of as intellectual property. A great deal of abuse in the BEPS area arises from intellectual property. Perhaps even more so than executive services, intellectual property is unique. It is more difficult to establish both a fair market value for an intangible asset as well as an arm's-length licensing fee, and that uncertainty makes it susceptible to BEPS abuse. Thus, one entity can transfer the property to another claiming a low value, and then license the property back for a disproportionately large amount. As with services, the regulations provide multiple ways of calculating the amount to be charged for the sale or licensing of intangible property.

These are based on the profit generated by the intangible property, which in all events will be more susceptible of calculation than the profits generated by services. So, the rules applicable to intangible property will be more predictable and reliable than those related to services, at least with regard to executive and specialized services. The regulations applicable to intangible property can be found at Treas. Reg. 1.482-4.

Interest Stripping

The payment of deductible interest is one of the ways that net income can be shifted from one entity to another, and there are two issues at play here. The first issue is that, where there is interest paid on a loan or advance from one member of a group of controlled entities to another, the amount of that interest may be adjusted for tax purposes under IRC sec. 482 if the creditor "…either charges no interest, or charges interest at a rate which is not equal to an arm's length rate of interest…" Treas. Reg. sec. 1.482-2(a)(1)(i).

The second issue is that, whether or not the interest rate is arm's length, the amount charged will only be respected for tax purposes if there is a bona fide indebtedness. A bona fide indebtedness can arise out of "Loans or advances of money or other consideration…" or "Indebtedness arising in the ordinary course of business from sales, leases, or the rendition of services by or between members of the group, or any other similar extension of credit." Treas. Reg. sec. 1.482-2(a)(1)(ii)(A).

However, even an arm's length rate of interest will be not be respected to the extent it is paid on "…an alleged indebtedness which is not in fact a bona fide indebtedness…" Examples of alleged indebtedness which is not bona fide indebtedness are those based on payments which are contributions to the capital or a corporation, distributions from corporations to shareholders, or consideration for an alleged sale between controlled entities which is really a lease. Treas. Reg. sec. 1.482-2(a)(1)(ii)(B).

To the extent that the regulations may treat alleged indebtedness as contributions to the capital of a corporation, they echo Code sec. 385. The general rule of that section is "The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness)." Code sec. 385(a)

It is not at all difficult to imagine a scenario where a payment from a shareholder to a corporation, which the corporation would treat as a loan on which interest payments would be deductible, to be recharacterized as a contribution to the capital of the corporation, resulting in the purported interest payments being treated as non-deductible distributions. This could be the result under either Code sec. 385(a) or Treas. Reg. sec. 1.482-2(a)(1)(ii)(B). The difference is that Code sec. 385 only operates to the extent of regulations, which at the present time are not as broad as the regulations under Code sec. 482.

Even though Code sec. 385 was enacted in 1969, the only regulation promulgated under it were finalized just recently, on October 21, 2016. These regulations were still limited in that they applied only to debt issued by domestic corporations in certain narrow circumstances, such as debt issued as part of the acquisition of a related corporation. As noted in Mohs et al (2106) Code sec. 482 and the regulations promulgated there under, transnational shifting of taxable income was not explicitly the object of the Code sec. 385 regulations, but it clearly was an intended target

But there are also common law principles broader than the current narrow reach of Code sec. 385 regulations. The Tax Court has recharacterized purported debt as equity, in order to disallow deduction of payments characterized by the taxpayer as interest.

In making such a recharacterization the Tax Court cited factors such as "…presence or absence of a fixed maturity date; source of payments; right to enforce payments; participation in management as a result of the advances; status of the advances in relation to regular corporate creditors; intent of the parties; identity of interest between creditor and stockholder; "thinness" of capital structure in relation to debt; ability of corporation to obtain credit from outside sources; use to which advances were put; failure of debtor to repay; and risk involved in making advances." Dixie Dairies Corp. v. Commissioner, (1980).

In short, then, interest payments used for profit shifting can be challenged until multiple fronts under U.S. tax law: Deductibility of interest can be challenged under Code sec. 482 and its regulations, both in terms of the amount that can be deductible and in terms of whether the debt will be challenged as being bona fide.

Code sec. 385 and its regulations also provide a means for recharacterizing debt as equity, where they apply. Finally, there is common law that could be used to recharacterize debt as equity, which would also have the effect of denying a deduction for amounts purported to be interest payments.

Supportive Expenses

Supportive or stewardship expenses are generally defined as those expenses that are incurred for activities undertaken by the parent corporation as an investment in a wholly owned subsidiary. IRC section 861 and specifically Treasury Reg. 1-861-8 provides in part for the allocation of those expenses to the class of income that includes dividends from the subsidiary. Apportioning deductions between the parent and subsidiary is often problematic. In a completely domestic relationship, apportioning can be accomplished using a base that reflects, to a reasonable close extent, the factual relationship between deduction and the gross income. Domestic to domestic apportionments can include but are not be limited to gross income, gross receipts, expenses incurred, assets employed or any cost driver approximates a cost factual relationship. International apportionments are much more complex and the existing guidance is nebulous at best. Rodriquez (2001) argued that "the Section 861 regulations state no preference for volume-based drivers over any others, so the distinction is irrelevant."

An additional argument raised was that "there is no careful optimization calculus at the conclusion of 861 studies based on the ABC analysis, only a realignment of income based on more advantageous matching of expenses to income."However, these methods depend on there being extrinsic measures that can be used to value services. Goldberg, Wnek and Pineau (2012)noted that missing from the listed methods is a way to value specialized and extraordinary services, such as executive services, as these are unique and not susceptible to valuation by external criteria. A more troublesome issue arises with regard to services. Payment for services, like interest payments or payments for the purchase or use of property, can be manipulated in order to reach a desired tax result. Regulations promulgated under Code sec. 482 examine payment for services in extensive detail, outlining seven different ways that services can be valued for purposes of avoiding a recalculation under Code sec. 482. Treas. Reg. sec. 1.482-9(a)(1) -(7)

3. Organization Of Economic Cooperation And Development Centrtalized Framework

The continued growth of cross-border transactions and the politicized issue of base erosion and profit shifting has become a major challenge in the area of international taxation. The OECD has attempted to answer the question of how might policies be changed to combat base erosion and profit shifting in its base erosion and project shifting (BEPS) project, but the complexity of the issues addressed and the short time period allocated to this project resulted in a vague and seemingly incomplete result. Additional research and data collection would be necessary to address the main issue. Cooperation between multinational organizations and governments is a major requirement and hurdle to creating a concrete system to handle the complex transactions used to erode an income base and shift profits. The project was divided into fifteen (15) action items and categorized into three categories: Substantive Actions, Coherence Actions, and Transparency Actions.

Substantive Actions

The first area of the BEPS project is the substantive category. The group of actions in the substance category is dedicated to addressing. The aligning of taxing rights with value-adding activity. The action items here are Preventing Treaty Abuse, Artificial Avoidance and Permanent Establishment, and Transfer Pricing.

Coherence Actions

The second area of the BEPS project is the coherence category. The action items in the coherence category are dedicated to addressing the cohesiveness of the international tax system. The areas are hybrid mismatch arrangements, interest deductions and other payments, and controlled foreign company rules.

Transparency Actions

The third category area of the BEPS project is the transparency category. The group of actions in the transparency category is dedicated to addressing the transparency of transactions performed by multinational enterprises.

This area is dedicated to reporting on transfer pricing documentation, measuring and monitoring BEPS, disclosure of aggressive tax planning arrangements and economic digitalization. This section will focus on the areas of Transfer Pricing Documentation and the Digital Economy.

4. Conclusion

Base erosion typically occurs when multinational organizations engage in cross-border transactions that will shift income or expenses from one tax jurisdiction to another. The tax strategies employed to reduce an organizations overall tax burden give rise to a zero-sum game at the jurisdictional or county level, where one country will lose tax revenues and another will gain revenues. International tax strategies have been around since the inception of the United States Tax Code due in part to a distinctive feature relating to the taxation of worldwide income.The continued growth of cross-border transactions and the politicized issue of base erosion and profit shifting has become a major challenge in the area of international taxation. The OECD has attempted to answer the question of how might policies be changed to combat base erosion and profit shifting in its base erosion and project shifting (BEPS) project, but the complexity of the issues addressed and the short time period allocated to this project resulted in a vague and seemingly incomplete result.

Additional research and data collection would be necessary to address the main issue. Cooperation between multinational organizations and governments is a major requirement and hurdle to creating a concrete system to handle the complex transactions used to erode an income base and shift profits.

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