Washington University Journal of Law & Policy

Volume 44 *Conceptualizing a New Institutional Framework for International Taxation*

2014

Twilight of the International Consensus: How Multinationals Squandered Their Tax Privileges

Lee A. Sheppard

Twilight of the International Consensus: How Multinationals Squandered Their Tax Privileges*

Lee A. Sheppard

In September 2013, Exxon Mobil Corp. announced it would recognize gay marriage for its employees.[1] This was front-page news, right up there with a New Jersey Supreme Court judge telling the state it had to do the same.[2] Why? Because Exxon is a politically conservative oil company that makes most of its political donations to Republicans? No, because Exxon is such a huge non-state actor that anything it does is tantamount to a government action.

In *The Power Elite*, C. Wright Mills cogently explained how giant multinational corporations had escaped the writ of national governments.[3] Exxon is one of the world's ten largest multinational corporate groups measured by market value.[4] At the time of this writing, nine companies on that list were American, along with around half of the fifty.[5] Some of the world's largest companies pay very little tax anywhere in the world. But to their home governments, they are often national champions.

Some other countries' multinationals are unfairly skipping-out on their corporate tax obligations to Organization for Economic

---

* A version of this Essay was previously published as Lee A. Sheppard, *News Analysis: The Twilight of the International Consensus*, 72 TAX NOTES INT'L 7 (Oct. 7, 2013).

1. Jonathan Fahey, *Exxon to Offer Benefits to Same-Sex Couples in US*, ASSOCIATED PRESS, Sept. 27, 2013, *available at* http://bigstory.ap.org/article/exxon-offer-benefits-same-sex-couples-us.

2. Kate Zernick, *Judge Orders New Jersey to Allow Gay Marriage*, N.Y. TIMES, Sept. 27, 2013, at A1, *available at* http://www.nytimes.com/2013/09/28/nyregion/new-jersey-judge-rules-state-must-allow-gay-marriage.html.

3. *See generally* CHARLES WRIGHT MILLS, THE POWER ELITE (1956).

4. *The World's Biggest Firms: Back on Top*, ECONOMIST, Sept. 21, 2013, *available at* http://www.economist.com/news/briefing/21586558-american-private-enterprise-dominates-corporate-premier-league-again-thanks-waning.

5. *Id.*

Cooperation and Development (OECD) member and observer countries.[6] That was the genesis of the OECD Base Erosion and Profit Shifting project (BEPS),[7] which has produced an action plan designed to repair and preserve the fragile international consensus in the short run, but may end up upsetting it in the long run.[8] In the long run, the international consensus is dead, and everyone knows it; but BEPS has to be tried and allowed to fail first.

What is the international consensus? It is a century-old, mostly European gentlemen's agreement to give residence countries tax jurisdiction over income earned by their residents in source countries.[9] Legally, the source country has the superior right to tax income earned within its borders, so the consensus requires countries to agree to be deprived of tax jurisdiction.[10]

This consensus was intended to permit multinationals to do business in treaty countries while paying tax only on income earned locally through separate entities and permanent establishments.[11] This limitation of tax jurisdiction is key to the OECD model treaty.[12]

Of course, multinationals are vertically integrated and don't transact with their affiliates at market prices. So an economic philosophy—which appears nowhere in the OECD model treaty—that multinationals should transact with their affiliates at hypothetical arm's-length market prices was grafted-on later.[13]

It has been an open secret for some time that multinationals—led by the Americans and their huge tax departments—have abused these

---

6. *See Members and Partners*, ORG. ECON. COOP. DEV., http://www.oecd.org/about/membersandpartners/ (last visited Mar. 3, 2014).

7. *See About BEPS*, ORG. ECON. COOP. DEV., *available at* http://www.oecd.org/tax/beps-about.htm (last visited Jan. 29, 2014).

8. ORG. ECON. COOP. DEV., ACTION PLAN ON BASE EROSION & PROFIT SHIFTING (2013), http://www.oecd.org/ctp/BEPSActionPlan.pdf [hereinafter OECD ACTION PLAN].

9. *See* Lee A. Sheppard, *News Analysis: OECD Tries to Fix Income Shifting*, 138 TAX NOTES 782 (Feb. 18, 2013) [hereinafter Sheppard, *Income Shifting*].

10. *See id.*

11. Permanent establishment is a deliberate limitation on tax jurisdiction.

12. *See* OECD COMM. ON FISCAL AFFAIRS, MODEL TAX CONVENTION ON INCOME & ON CAPITAL (2010), *available at* http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-2010_9789264175181-en#page1 [hereinafter OECD MODEL TAX CONVENTION].

13. Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 TAX NOTES 625 (1986).

privileges. The affected countries are no longer limited to corrupt, badly governed, resource-exporting countries. They now include European states with sophisticated tax administrations and the home governments of multinationals. Every country is just another country to be exploited. And the multinational actors are larger and more powerful than some of the affected governments. So the BEPS project can be seen in some ways as a way for governments to regain control of their corporate tax bases and of multinationals in general. Corporate income taxes account for a tiny proportion of total revenues in the United States and Europe.[14]

At the Washington University School of Law symposium, some speakers worried about the lack of consensus and the chaotic results that could flow from it. The title of the symposium, "Conceptualizing a New Institutional Framework for International Taxation," reflected this concern. But a new consensus cannot be built until the old one dies, weakened by impossibility of administration.

In the short run, U.S. multinationals will pay some more tax to some foreign governments, but not the U.S. government. In the long run, we already know what the outcome will be—apportionment of multinationals' profits based on sales.

But we are years away from a new worldwide consensus on any kind of apportionment—which would be a practical, not philosophical, solution. The United States and Europe still think they run the world, and residence country prerogative will not be surrendered easily. Europe has a formulary apportionment project, the common consolidated corporate tax base, waiting in the wings.[15]

The old order has to fail completely first. It is not failing quickly enough for some tastes. The international consensus was always fragile, and always required agreement of the players. OECD member countries, in true European fashion, often pushed subjects of disagreement under the rug. The OECD Centre for Tax Policy and Administration, as guardian of the OECD model treaty, has been

14. *See, e.g.*, TAX. TRENDS IN THE EUR. UNION 189, 190 (2013), *available at* http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_structures/2013/report.pdf.

15. *See generally Commission Proposal for a Directive of the Council on a Common Consolidated Corporate Tax Base*, at 21, COM (2011), *available at* http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/com_2011_121_en.pdf.

identified as the enabler of multinational tax avoidance.[16] So the BEPS project sees the OECD trying to reclaim relevance.

The United States and its overbanked crony, the United Kingdom, used the OECD as a vehicle to push their agendas.[17] European countries that genuinely believed in multilateral solutions began the BEPS project—but they have European institutions like the European Commission as an alternative.[18] Taken together, both sets of countries need the OECD to remain relevant for different reasons.

The OECD needs India and China—which, despite being observers, are equal partners in the BEPS process—because their economies are too big and too important to the functioning of Western multinationals to ignore. The BEPS project is an attempt to get these countries back on the reservation.[19] If these countries are not happy with the results, they will continue to take creative license with the OECD model treaties they signed.[20] The likelihood is that they will be dissatisfied, they will continue to audit aggressively, and they will continue to undermine international consensus from within.

The OECD is at work drafting the BEPS action plan recommendations, which are narrowly targeted to a few specific behaviors of mostly American multinationals.[21] The main objects of concern are companies that have intellectual property at the center of operations and have managed to shift the excess profits from the intellectual property to havens. Apple—the world's largest company by market value—is an example of that behavior.[22] Most of these behaviors are legal or tolerated under U.S. law and, in the view of their proponents, should go unchallenged by the affected countries.[23]

---

16. OECD admitted as much. ORG. ECON. COOP. DEV., ADDRESSING BASE EROSION & PROFIT SHIFTING (2013), http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/addressing-base-erosion-and-profit-shifting_9789264192744-en [hereinafter OECD ADDRESSING BASE EROSION].

17. *See* Lee A. Sheppard, *News Analysis: Is Transfer Pricing Worth Salvaging?*, 136 TAX NOTES 467 (July 30, 2012) [hereinafter Sheppard, *Transfer Pricing*].

18. *See id.*

19. These countries are participating in the base erosion project as full members, even though they have only observer status at the OECD.

20. *See* Sheppard, *Transfer Pricing*, *supra* note 17.

21. *See id.*

22. *See* Lee A. Sheppard, *Apple's Tax Magic*, 138 TAX NOTES 967 (2013).

23. *See* Lee A. Sheppard, *News Analysis: How Can Vulnerable Countries Cope with Tax Avoidance?*, 138 TAX NOTES 409 (Jan. 28, 2013).

The other main objection is specific tax planning to shift income out of European market countries through intragroup payments for interest, commissions, and the like, which goes under the euphemism supply chain restructuring.[24] All multinationals employ these tricks—many of which should never have been tolerated in the first place. This problem requires adjustments to domestic law, and the Europeans are looking to the OECD for guidance about best practices, despite the idiosyncrasies of their own laws.

Exxon would hardly be touched, except by the action plan's call for country-by-country reporting of income—a concept that originated in attempts to keep resource extraction companies honest and is already in place for those companies under the Dodd-Frank Wall Street Reform and Consumer Protection Act.[25]

Banks would not be touched, despite their size, worldwide connections, and continuing propensity to lead the world economy over the cliff. But it was the bank-engineered financial meltdown that prompted strapped European governments to start looking for more tax revenue. Only the U.S. government, which has its own currency, the petrodollar, has failed to ramp up tax enforcement in the wake of the meltdown.[26] In the good times, no one cares whether rich people and big companies don't pay tax. Budget numbers—not some grand philosophy about fairness—motivated the G-20 to endorse the BEPS project.

SPECIFIC IDENTIFIED PROBLEMS

At the Washington University symposium, much of the discussion concerned multinational tax avoidance tactics. The trouble is, most of these tactics are enabled by separate company accounting, which is enshrined in European agreements made in the wake of World War I.[27]

24. *Id.*
25. 15 U.S.C. § 78m(q) (2013).
26. United States tax enforcement does not adjust to revenue needs.
27. *See, e.g.*, Vienna Convention on the Law of Treaties, May 23, 1969, 1155 U.N.T.S. 331. By treating each legal entity in a multinational corporate group as formally distinct, the tax law must attempt to recreate arm's-length prices for transactions between them, notwithstanding that the entities are related and all part of a single economic unit.

Separate company accounting has not been identified as a problem by the OECD. Eventually, the artificial separateness of legal entities will have to be ignored, as will many of their transactions with affiliates. Until then, the symptoms of the problem will be addressed piecemeal. The BEPS action plan can be read as a series of patches on separate company accounting and transfer pricing.[28]

The abuses to which the BEPS project is addressed typically take the form of intangibles holding companies[29] in havens and supply chain restructuring in which a buy-sell distributor's sales income is reduced to a commission.[30] When a multinational can move its intellectual property, these tactics are used in combination. So the normal income from selling patent-protected goods wholesale is broken up into several streams of income, large chunks of which are hived off to havens.[31]

How could valuable intangibles be so easily moved to havens without some sort of toll charge along the way? American multinationals moved a lot when U.S. cost-sharing rules had no restrictions.[32] Now that the rules have been amended to require participation by the tax haven recipient of the transfer, companies transfer inchoate ideas that ripen into hugely valuable intangibles under haven ownership.[33]

The OECD had previously blessed restructuring as business-motivated.[34] But the OECD changed tack when it described some

28. *See* Sheppard, *Transfer Princing*, *supra* note 17. *See also* Lee Sheppard, *Transfer Pricing* as *Tax Avoidance*, FORBES, June 26, 2010, *available at* http://www.forbes.com/2010/06/24/tax-finance-multinational-economics-opinions-columnists-lee-sheppard.html.

29. *See A Brief History and Update of Intangible Holding Companies*, ALVAREZ & MARSAL HOLDINGS, LLC (Sept. 22, 2006), http://www.alvarezandmarsal.com/brief-history-and-update-intangible-holding-companies-1.

30. *See* OECD ADDRESSING BASE EROSION, *supra* note 16.

31. *Id.*

32. Methods to Determine Taxable Income in Connection with a Cost Sharing Arrangement, 26 C.F.R. § 1.482–7.

33. Veritas Software Corp. v. Comm'r, 133 T.C. 297 (2009), *nonacq. action on dec.*, 2010-05 (Nov. 10, 2010).

34. *See* ORG. ECON. COOP. DEV., TRANSFER PRICING GUIDELINES FOR MULTINAT'L ENTERS. & TAX ADMINS. (1995), *available at* www.oecd.org/ctp/transfer-pricing/transfer-pricing-guidelines.htm.

typical restructuring arrangements in its February 2013 report, *Addressing Base Erosion and Profit Shifting*.[35]

Buy-sell distributors located in European market countries are contractually converted to commissionnaires and other stripped-risk distributors, confined to taking orders and negotiating prices.[36] But nothing changes in the former distributor's relationship with the customers—who are often explicitly told that nothing has changed.[37]

The remainder of what would have been the typical selling margin, taxable in the country of sale, could be paid as deductible royalties to an intangibles holding company in a haven and as product purchase to a principal company in another haven. The product may be made by a related contract manufacturer whose compensation is limited to cost plus markup. After the conversion, the principal company owns all of the product (or materials, in the case of contract manufacturing) and indemnifies the commissionnaire against risks.[38]

These structures have been challenged by tax authorities arguing that the former distributor should earn more of the sales income.[39] Multinationals have successfully deflected challenges by pointing to contractual limitations and continental commissionnaire statutes.[40] They won their cases under domestic law, saying that commissionnaires cannot bind their principals.[41] But the taxpayer lost when the courts looked at the totality of the circumstances.[42]

PERMANENT ESTABLISHMENT

How is it possible to knock out the use of commissionnaires and other stripped-risk distributors without opening up the touchy subject of agency permanent establishment (PE)? It might not be possible to

---

35. OECD ADDRESSING BASE EROSION, *supra* note 16.

36. *See* Lee A. Sheppard, *News Analysis: The Brave New World of the Dependent Agent PE*, 140 TAX NOTES 7 (July 1, 2013) [hereinafter Sheppard, *Brave New World*].

37. *See id.*

38. *See id.*

39. *See id.*

40. *See id.*

41. Cour de cassation [cass.] [supreme court for judicial matters] Mar. 31, 2010, D.P. 111, Nos. 304715, 308525 (Fr.) (Société Zimmer Ltd.); Rt. 2011, HR-2-11-2245-a (Nor.) (Dell Products (NUF) v. Tax East).

42. S.T.S., Jan. 12, 2012 (No. 1626/2008) (Spain) (Roche Vitamins Europe Ltd.).

achieve that result in a clean or lasting fashion without addressing PE. The OECD plans to draft a treaty provision to prevent avoidance of agency PE status by commissionnaires and other stripped-risk distributors, and then to work on profit attribution.[43] That could be messy if the criteria for agency PE remain untouched. The BEPS drafters might have to suggest factual inquiries into whether the former distributor behaved according to the new documents. Or they might have to allow tax administrators to ignore the documents in some circumstances. Restructuring plans are often badly implemented because it is inconvenient to require the principal company to separately approve every sale.

To its proponents, the point of the narrow PE standard is to prevent a foreign corporation from being subject to taxation when it is merely selling in another country.[44] But the badly drafted agency PE provisions of the OECD model treaty have been abused and are sorely in need of a rewrite.[45]

PE is the biggest subject that the BEPS project will take on—reluctantly. The narrow concept of PE is at the heart of the international consensus that protects multinationals from excessive or, in many cases, meaningful taxation. The Americans don't want to take on PE.[46] The Germans don't want to take on PE.[47] The French don't want to take on PE—but they want some American companies to pay tax in France.[48] The Indians have been quietly expanding PE for years and will continue to do so.[49]

The Americans want to protect their national champions, just like the Germans want to protect theirs. All multinationals that sell complicated products, be they digital or physical, run the risk of creating a PE in a purchaser country when they send personnel in to

43. OECD ACTION PLAN, *supra* note 8, at 32, Annex A.

44. Sheppard, *Brave New World*, *supra* note 36.

45. *Id.*

46. The Americans are also highly resistant to the idea that digital economy companies should be separately defined for purposes of taxation.

47. *See* Sheppard, *Brave New World*, *supra* note 36.

48. *See* Lee A. Sheppard, *News Analysis: Offshored Intangibles and the OECD Base Erosion Project*, 139 TAX NOTES 367 (Apr. 22, 2013).

49. India's treaties and audit practices demonstrate an expansive view of tax jurisdiction over nonresident businesses doing business there. *See* Lee A. Sheppard, *News Analysis: Picking Apart the OECD BEPS Action Plan*, 140 TAX NOTES 965 (Sept. 2, 2013).

help with the product, or even when they help the customer from outside the country.[50] So it is important for the Americans and the Germans to prevent the whole PE subject from being opened up.

Google is the object of French ire. The French believe there should be some way to tax value added when Google scoops up local customer information and resells it to advertisers.[51] The argument is that digital commerce should be taxed in the country of residence of the customer, because the product is transformed when the customer uses it.[52] The French are not wrong in this view, but the OECD hasn't philosophically come around to the idea of economic nexus for remote actors.[53]

The French are talking about a byte tax as a way of getting some non-income tax jurisdiction over digital economy companies having no physical presence there.[54] The conundrum for France is that it would like to assert jurisdiction over Google and its digital economy brethren without subjecting French national champions to tax when a Chinese woman buys a handbag.[55] France is home to some large and adventurous multinationals. The byte tax would be the perfect solution.[56]

A conversation about Google is necessarily a conversation about nonphysical PE, which also goes under the moniker service PE.[57] Only the Indians and other countries with service PE in their treaties want to have that conversation. Having that conversation is inevitable. The BEPS project is an exercise in deferring the inevitable on a number of counts.

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

---

50. *See* Nicolas Colin, *Corporate Tax 2.0: Why France and the World Need a New Tax System for the Digital Age*, FORBES, Jan. 28, 2013, *available at* http://www.forbes.com/sites/singularity/2013/01/28/corporate-tax-2-0-why-france-and-the-world-need-a-new-tax-system-for-the-digital-age/.

51. *See* Lee A. Sheppard, *News Analysis: The Digital Economy and Permanent Establishment*, 139 TAX NOTES 364 (Apr. 22, 2013) [hereinafter Sheppard, *Digital Economy*].

52. *Id.*

53. *Id.*

54. Colin, *supra* note 50.

55. *See* Sheppard, *Digital Economy*, *supra* note 51.

56. *Id.*

57. *Id.*

big digital players are American, and few of them pay tax anywhere, including the United States.[58] So the United States successfully deferred discussion of digital economy tax jurisdiction by getting the others to agree to a study.[59] In American practice, a study is a way to bury a problem.

Will the United States tax these digital companies if it succeeds in preventing the Europeans from taxing them? No, and the same is true of all U.S.-based multinationals. The current congressional plan appears to be a conversion to a territorial system with a complicated minimum tax to take some of the juice out of income shifting to tax havens.[60] Nothing in that plan would significantly increase corporate tax revenues or correct structural problems in the U.S. system, but it would make some people feel better.

Starbucks doesn't have a complicated business model, but it doesn't pay much tax, either. It uses a Swiss principal company to buy green coffee beans for the group, which sells them at a high markup to another company that roasts them, which in turn sells the roasted beans to retailers. That a coffee brewer that doesn't depend on unique intangibles or complicated industrial processes should so readily be able to beat its tax bill in countries where it has huge markets is an indictment of the OECD model treaty and the international consensus.

DOMESTIC LAW CHANGES

I have often used the tort law concept of attractive nuisance to describe features of European tax law that are ripe for abuse by multinationals.[61] Contributory negligence should also be invoked. Some of these features are so obviously in need of correction that the affected governments could be said to have contributed to the black

58. Every country has its national champions.

59. *See* Lee A. Sheppard, *Hints About the OECD BEPS Action Plan*, 140 TAX NOTES 22 (July 1, 2013).

60. Lee A. Sheppard, *News Analysis: Globalization and International Tax Rules*, 139 TAX NOTES 587 (2013).

61. *See, e.g.*, Lee A. Sheppard, *News Analysis: OECD BEPS Action Plan: Trying to Save the System*, 140 TAX NOTES 283 (July 22, 2013) [hereinafter Sheppard, *Trying to Save the System*].

holes in their budgets. Happily, these problems are easy to correct, with the OECD providing guidance and, more importantly, political cover for lawmakers.

Controlled foreign corporation (CFC) rules essentially ignore the separation of CFCs in certain circumstances to tax their income to their domestic parents.[62] The BEPS project aims to recommend best practices for strengthening them—assuming the participating countries can agree on the purpose of these rules.

No amount of advice, however, will overcome the high bar for artificiality of companies set by the European Court of Justice.[63] Essentially, European companies can shift income around Europe at will, as long as the purported earners have phones and desks and employees. CFC rules operate on the presumption of tax avoidance, and the *Cadbury Schweppes* decision of the European Court of Justice effectively prohibits this presumption.[64]

The Europeans think requiring substance in CFCs will solve the problem. It will not. Requiring substance will mean income shifting is more expensive, and requires more bodies to be thrown at tax avoidance plans; but when billions of dollars are at stake, a few boots on the ground in a pleasant European tax haven becomes a bearable cost. And the result may still be objectionable to the multinational's home country.

The British have effectively repealed their CFC rules, albeit in a complicated way that requires expensive guidance from tax professionals.[65] So they are sensitive to implied demands that every OECD member strengthen these rules.[66]

The U.S. CFC rules have been effectively repealed administratively by the check-the-box rules, which permit elective inconsistent treatment or even non-recognition of entities for tax

62. CFC rules generally tax the parent company of a foreign subsidiary for certain passive income earned by the subsidiary and not distributed to the parent. *See, e.g.*, 26 USC § 951(a).

63. *See* Case C-196/04, Cadbury Schweppes Overseas, Ltd. v. Comm'rs of Inland Revenue, 2006 E.C.R. I-7997.

64. *Id.*

65. *See* Finance Act, 2012, § 180, sch. 20 (Eng.), *available at* www.legislation.gov.uk/ukpga/2012/14/pdfs/ukpga_20120014_en.pdf.

66. Lee A. Sheppard, *News Analysis: Rosbif Rules: What Should the OECD Do About Base Erosion?*, 140 TAX NOTES 1055 (2013).

purposes.[67] These rules have been called the single stupidest administrative gesture in the history of the income tax.[68] It remains to be seen whether Congress will see fit to strengthen the CFC rules as it contemplates lowering corporate rates.[69]

The check-the-box rules have caused damage all over the world, and U.S. companies benefit the most from them. Hybrid entities[70] have enabled multinationals to beat CFC rules and arbitrage different tax systems. Hybrids are a huge problem that is relatively easy to fix with rules like Denmark's, which treat a hybrid entity the way it is treated in its home country.[71] The OECD is contemplating a tiebreaker rule for entity classification.[72]

European laws also enable hybrid transactions and securities, like repos and debt/equity hybrids.[73] There is no excuse for leaving laws in place that enable this kind of arbitrage. The trouble is that civil law is highly formal.

Not to be outdone by the OECD, the European Commission recently proposed an amendment to the EU parent-subsidiary directive (2011/96/EU), which excuses dividends from taxation when paid to a parent company. The proposed amendment would deny exemption when the payer deducted the payment.[74] The trouble is that many EU countries have separate, broadly applicable participation exemptions in domestic law.[75] The action plan states

---

67. Classification of Certain Business Entities, 26 C.F.R. § 301.7701-3 (2013).

68. *See* Lee A. Sheppard, *News Analysis: Defending the Obama International Proposals*, 123 TAX NOTES 1391 (2009) [hereinafter Sheppard, *Defending the Obama International Proposals*].

69. Jamie Arora & Matthew R. Madara, *Ways and Means Considers Base Erosion and Profit Shifting*, TAX ANALYSTS (June 24, 2013), *available at* www.taxanalysts.com/www/features.nsf/Articles/61C07CBCD545C07A85257B94005CC5EA?OpenDocument.

70. Hybrid entities are those entities treated as a corporate taxpayer in one country and as fiscally transparent in another *See, e.g.*, Adam H. Rosenzweig, *Harnessing the Costs of International Tax Arbitrage*, 26 VA. TAX REV. 555 (2006).

71. *See* Ole Steen Schmidt, *The Scope of the New Danish Anti-Check-the-Box Regulations*, 55 TAX NOTES INT'L 939 (2009).

72. *See* Sheppard, *Trying to Save the System*, *supra* note 61.

73. *See* Lee A. Sheppard, *News Analysis: Things We Never Said About Debt, Equity, and Hybrids*, 137 TAX NOTES 230 (2012).

74. *Commission Proposal for a Council Directive Amending Directive 2011/96/EU on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States*, COM (2013) 814 final (Nov. 25, 2013).

75. *See* Lee A. Sheppard, *News Analysis: Location, Location, Location for Minimizing*

that the OECD will develop model domestic law provisions that deny a deduction, deny an exemption, or deny a double deduction.[76]

Interest deductions are a widely and easily abused form of intragroup payment. The BEPS action plan hints that the OECD may propose a model domestic law that denies a deduction for related-party interest that is not taxed to the recipient.[77] European countries are already moving toward the German approach of restricting interest deductions to 30 percent of earnings before interest, taxes, and depreciation.[78] The German rules have loopholes, particularly for companies with no external debt, so some adjustment is required.

Section 163(j),[79] the U.S. limitation rule for interest deductions, was intended to discriminate against Europeans.[80] It is toothless, and occasional attempts to fix it have been successfully rebuffed by foreign company lobbying. But the United States does have a rational method for allocation of interest expenses.[81] At the OECD, a consensus appears to be forming around a version of the British worldwide debt cap, which prevents British interest deductions from exceeding the group's net external interest expense.[82]

TREATY CHANGES

Anti-abuse rules are also on the BEPS agenda. Recently, there has been considerable debate about whether it is even possible to abuse a treaty.[83] In most European countries, a treaty trumps national law, and taxpayers are entitled to rely on the literal language of the treaty.[84] In the United States, taxpayers are allowed to choose

---

Taxes, 102 TAX NOTES 1592 (2004).

76. OECD ACTION PLAN, *supra* note 8, at 30, Annex A.

77. *Id.*

78. *See generally* Lee A. Sheppard, *News Analysis: The Fashion in Interest Deduction Restrictions*, 133 TAX NOTES 1061 (2011). *See also* Abgabenordnung [AO] [Fiscal Code], Oct. 1, 2002, BGBL. I at 3866, as amended, § 8A (Ger.).

79. 26 U.S.C.S. § 163(j) (2014).

80. Square D Co. v. Comm'r, 438 F.3d 739 (7th Cir. 2006).

81. Determination of Interest Deductions, 26 C.F.R. § 1.882-5 (2013).

82. Sheppard, *Defending the Obama International Proposals*, s*upra* note 68.

83. Lee A. Sheppard, *News Analysis: Beyond Nondiscrimination—Should the ECJ Do More?*, 62 TAX NOTES INT'L 927 (2011).

84. *See* Lee A. Sheppard, *News Analysis: Treaty Countries' Right to Use Domestic Law*, 137 TAX NOTES 347 (Oct. 22, 2012).

between the treaty and national law.[85] Congress frequently overrides treaties.[86]

But the OECD accepts that treaties can be abused.[87] The OECD will draft an anti-abuse provision for treaties. In this context, abuse refers to the use of third countries to gain unwarranted treaty benefits. The provision will clarify that treaties are not meant to facilitate double non-taxation—something the OECD has never done before in its great service to multinationals.[88]

The best way to address this problem is to put a subject-to-tax clause in a treaty or in domestic law. Sadly, the OECD appears headed in the direction of the American limitation on benefits clauses, which, in their more complicated versions, do not restrain public companies.[89]

The Germans have figured out how to do it better. German domestic law denies exemption when a German resident's foreign income is not effectively taxed in the partner country.[90] This rule is reiterated in some recent German treaties (which take precedence over domestic law).[91] Under Germany's recently negotiated treaties with Hungary and Luxembourg, dividends received would not be exempt in Germany if they are deductible by the payer.[92] Moreover, the residence clause of those treaties requires that an entity be resident by virtue of being liable to tax on all income.[93]

The OECD has also announced a mechanism to amend OECD model treaties by mutual agreement, so a couple thousand treaties do

85. Nat'l Westminster Bank, PLC v. United States, 512 F.3d 1347 (Fed. Cir. 2008).

86. *See, e.g.*, I.R.C. § 894 (1997).

87. OECD ACTION PLAN, *supra* note 8, at 18.

88. *Id.*

89. Model Income Tax Convention, U.S., art. 22, Nov. 15, 2006, *available at* www.irs.gov/pub/irs-trty/model006.pdf.

90. Aussensteuergesetz [AStG] [Law on External Tax Relations], 1972, BGBL. I at § 8 (Ger.).

91. *See* Sheppard, *Defending the Obama International Proposals*, *supra* note 68.

92. Abkommen zwischen der Bundesrepublik Deutschland und dem Grossherzogtum Luxemburg zur Vermeidung der Dobbelbesteuereng und Verhinderung der Steuerhinterziehung au dem Gebiet der Steuern vom Einkommen und vom Vermogen [Agreement Between the Federal Republic of Germany and the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Tax Evasion], Apr. 23, 2012, BGBL. II at art. 22, § 1(a).

93. *Id.* at art. 4, § 1. *See also* Eugen Bogenschutz & Jean Schaffner, *The New Germany-Luxembourg Income Tax Treaty*, 67 TAX NOTES INT'L 255 (2012).

not have to be arduously renegotiated. The OECD proposes to make existing bilateral OECD model treaties ambulatory by creating a multilateral treaty amendment.[94] Signatories will automatically accept amendments and treaty interpretations contained in the document for their in-force treaties.[95]

This is a procedural thing, but it's huge. Essentially, the OECD model treaty itself is a highly inefficient form of multilateral agreement. Making the treaty function like the International Swaps and Derivatives Association master swaps agreement[96] would be a great improvement. It would also enhance the OECD's credibility, which has suffered from an unworkable redrafting of Article 7, the business profits article.[97]

The presence of European havens, many of which are European Union members, throws a spanner in the BEPS works. The OECD doesn't have a good answer to this problem, but the action plan identified corporate rate reductions and preferential regimes (such as patent boxes) as harmful.[98] The OECD backed off its previous assertion that countries must compete on corporate income tax rates to gain the favor of multinationals.[99] Businesses compete with each other. Countries do not compete.

The United Kingdom wants its banking haven to be a tax haven—or at least to prevent British companies from headquartering next door in Ireland or offshoring their intellectual property.[100] Ireland is a tax haven and an EU member.[101] The Netherlands is a tax haven and

---

94. OECD ACTION PLAN, *supra* note 8, at 24.

95. *Id.*

96. The ISDA Master Form Agreement is a form published by the International Swaps and Derivatives Association that is used by parties to facilitate entering into financial derivative transactions, and any changes made to the master agreement have immediate effect. *See* Lee A. Sheppard, *U.S. Sells Europeans on FATCA Intergovernmental Agreements*, 136 TAX NOTES 1504 (Sept. 24, 2012).

97. *See* OECD MODEL TAX CONVENTION, *supra* note 12. No country has incorporated the new Article 7 in a treaty.

98. OECD ACTION PLAN, *supra* note 8, at 17.

99. OECD ADDRESSING BASE EROSION, *supra* note 16, at 30–32.

100. *See* Lee A. Sheppard, *News Analysis: FATCA Arbitrage Through London*, 140 TAX NOTES 854 (Aug. 26, 2013).

101. *See* Sheppard, *Income Shifting*, *supra* note 9. Ireland promised to change its residence rules so that Irish-incorporated entities are treated as Irish residents, unless they can only be treated as resident in a treaty country by reason of being managed and controlled there. Finance Bill (No. 2/2013) (Ir.), *available at* http://www.oireachtas.ie/documents/bills28/bills/2013/

an EU member.[102] Luxembourg is a tax haven and an EU member.[103] Switzerland is a tax haven, but not an EU member, and is currently distracted by U.S. ire over its banking practices.[104] None of these countries have effective CFC rules.[105]

These little enablers of multinational tax avoidance are very protective of their dubious international role and their corporate customers. The BEPS action plan calls for requiring the enablers to be transparent about the deals they cut with multinationals.[106] Of course, the United States cuts deals with multinationals approving their transfer prices.[107] These deals, called advance pricing agreements, are an admission that transfer pricing cannot be enforced. Multinationals, nearly all of which are publicly traded, can be expected to argue that some amorphous concept of corporate privacy should prevent disclosure of these grubby deals.

INTANGIBLES

The OECD wants to define the concept of intangibles broadly, with the aim of discouraging transfers to tax havens while continuing to recognize self-serving contracts between multinational affiliates.[108] The idea is that legal ownership would be subsumed in a set of factors gauging whether the tax haven entity participated in the

---

10213/b10213d.pdf. This bill is addressed to Apple's claim that its Irish subsidiary's income cannot be taxable anywhere.

102. *See* Sheppard, *Income Shifting*, *supra* note 9. By decree, the Dutch Parliament has reiterated meaningless requirements for minimum substance for Dutch intermediary companies that collect interest and royalties for advance ruling purposes. The requirements include local board members, Dutch books and bank accounts, and Dutch management decisions.

103. *See id.* Luxembourg will end bank secrecy for individuals. This can be read as a move to retain corporate and investment fund business.

104. *See* Lee A. Sheppard, *News Analysis: Don't Ask, Don't Tell: Swiss Behavioral Patterns*, 135 TAX NOTES 7 (Apr. 2, 2012).

105. Ireland has no CFC rules whatsoever.

106. *See, e.g.*, OECD ACTION PLAN, *supra* note 8, at 18. The European Commission has also reportedly begun investigating tax ruling practices in Ireland, Luxembourg, and the Netherlands for violation of the state aid article of the Treaty on the Functioning of the European Union. *See generally* Lee A. Sheppard et al., *OECD Official Defends BEPS Action Plan*, 141 TAX NOTES 149 (2013).

107. Rev. Proc. 2006-9, 2006-1 C.B. 278; Rev. Proc. 2008-31, 2008-1 C.B. 1133.

108. ORG. ECON. COOP. DEV., REVISED DISCUSSION DRAFT ON TRANSFER PRICING ASPECTS OF INTANGIBLES (July 3, 2013), *available at* http://www.oecd.org/ctp/transfer-pricing/revised-discussion-draft-intangibles.pdf.

development of the transferred intangible. The OECD wants to allocate excess returns to where value is created.[109]

It is very important to multinationals that these contracts be respected, and the 1995 OECD transfer pricing guidelines call for them to be respected.[110] Tax auditors in some countries are ignoring intangibles transfers that they believe cannot be properly priced, taking their inspiration from the BEPS action plan.[111] The OECD party line remains that there is no transaction that cannot be priced, and that everything will fall into place when the correct price is assigned.

These contracts are a real problem. Certainly, if affiliates do not behave according to contractual terms and payments are not made, contracts can be ignored. But proving that entails a trip to court on the part of the tax administrator, and well-advised multinationals do spend money to babysit their contracts.

The problem with focusing on the transfer of the intangible, like focusing on substance in tax havens, is that it asks the wrong question. It assumes that the residence country of the parent of a multinational group—usually where the intangible was developed—has a superior right to tax the excess returns from the intangible, and that the haven has no right to shelter them. It is a two-actor analysis.

But the problem has three actors, as the discussion at Washington University demonstrated. The third and most important actor is the market country in which the intangible is exploited. Fairness demands that the market country get to tax some of the profits attributable to exploitation of the intangible. There is value creation when an intangible is exploited, in addition to when it is developed.

Of course, the OECD model was designed to deprive these very countries of the right to tax income from all but local factories. But the OECD used the word "fair" in its February BEPS report.[112] It is impossible to read anything into this statement, given the

109. *OECD Consults on Revised Transfer Pricing of Intangibles*, Draft, 2013 WORLDWIDE TAX DAILY 147–18 (July 30, 2013).

110. *See* ORG. ECON. COOP. DEV., *supra* note 34.

111. *See generally* Lee A. Sheppard, *News Analysis: Transfer Pricing Rubric Questioned*, 135 TAX NOTES 1561 (2012).

112. *See, e.g.*, OECD ADDRESSING BASE EROSION, *supra* note 16, at 36.

determination of the participants to preserve the international consensus, but here it is:

> In an era where non-resident taxpayers can derive substantial profits from transactions with customers located in another country, questions are being raised as to whether the current rules ensure a fair allocation of taxing rights on business profits, especially where [sic] the profits from such transactions go untaxed anywhere.[113]

113. *Id.*