



INTERNATIONAL TIDBIT:

California Dreamin' at the OECD

As highlighted during UHY's Fall Tax Forum, the Organization for Economic Cooperation and Development (OECD) published its report on February 14, 2013 entitled *Addressing Base Erosion and Profit Shifting* (the BEPS Report), a shot across the bow of international tax planning as we've known it for the last 30 years or so. It followed up with an *Action Plan on Base Erosion and Profit Shifting* ("Action Plan"), issued on July 19, 2013, laying out concrete steps to end the perceived unfair advantage enjoyed by global groups that can readily shift profits from high-tax to low-tax countries, compared to companies operating exclusively in their home country.

SCRAPPING THE ARM'S LENGTH PRINCIPLE?

Comprised of 34 of the world's industrialized countries and based in Paris, France, the OECD has long spurred transformation in such policy areas as relief of double taxation through tax treaties and the allocation of income among related parties through transfer pricing based on the arm's length principle. It has also campaigned against low-tax jurisdictions and their lack of transparency, resulting in its black, gray and white lists of cooperating (and uncooperative) jurisdictions while championing the exchange of tax information between governments and discouraging harmful tax competition between countries. Now it looks set to transform international tax planning as we know it.

ZEROING IN ON INTANGIBLE PROPERTY

The BEPS Report focuses on multinational enterprises ("MNEs") in general but takes aim in particular at those whose business involves intangible property ("IP"). It posits that profits from exploiting IP are not subjected to tax appropriately, considering the countries in which MNEs have substantial activities and add value to IP compared to those where IP is owned and profits are accumulated. This is in contrast to current rules in the U.S. and other jurisdictions that consider factors such as ownership of IP, risks assumed, and functions performed when applying the arm's length principle for allocation of income among related entities.

Anchoring transfer pricing for decades is the application of the arm's length principle. Typically, companies are required to demonstrate through an economic study that royalty payments are, for example, in line with what an unrelated party might pay under similar circumstances. The tendency for international tax planners has been to concentrate profits from IP in lower-tax jurisdictions, where it is owned, and expenses in higher-tax jurisdictions (such as OECD member countries), where business infrastructure is centered. Achieving a lower worldwide effective tax rate is the goal, meaning higher earnings per share and presumably greater value for shareholders.

INAPPROPRIATE SHIFTING OF PROFITS?

While the BEPS Report acknowledges that the duties of a company to its shareholders include minimizing expenses such as taxes, its over-arching concern is that higher-tax countries are being denied the tax revenue they expect because of inappropriate tax planning that erodes their tax base and shifts profits to lower-tax jurisdictions. The Report includes several examples of the tax planning the OECD would like to curtail even though the techniques described are in line with current laws and treaties. Especially in the area of technology and the digital economy, the BEPS Report and Action Plan express concerns about the proclivity of multinational enterprises to use transfer pricing to achieve a lower worldwide effective tax rate.

*In many instances, the existing transfer pricing rules, based on the arm's length principle, effectively and efficiently allocate the income of multinationals among taxing jurisdictions. **In other instances, however, multinationals have been able to use and/or misapply those rules to separate income from the economic activities that produce that income and to shift it into low-tax environments.** This most often results from transfers of intangibles and other mobile assets for less than full value, the over-capitalisation of lowly taxed group companies and from contractual allocations of risk to low-tax environments in transactions that would be unlikely to occur between unrelated parties. (Action Plan at page 19 – emphasis supplied).*

The Report concludes that an objective of the Action Plan is alignment of rights to tax with economic activity.

UNITARY TAXATION AFTER ALL?

Reading the BEPS Report and the Action Plan struck a familiar chord. When I started my career in Public Accounting a quarter century ago, the big debate was about California's worldwide unitary tax system and whether a so-called water's edge election would be permitted. Based on determining the ratio of property, sales, and payroll in California, to the total for each factor in all the countries where a unitary business operated, lawmakers expected to yield more tax revenue than if businesses were taxed in accordance with the arm's length principle across state and national borders.

I recall an impromptu conversation with one of the leading international tax gurus of the day. He opined that unitary taxation was superior where the goal was for jurisdictions to generate tax revenue in accordance with economic activity. He suggested that it be adopted at the federal level while jettisoning transfer pricing based on the arm's length principle. Reviewing the BEPS report, it looks like the OECD agrees or at least seeks to move the debate in that direction for its member states including the U.S.

CHAOS THEORY?

In its Action Plan, the OECD advocates swift action and consensus by OECD members and non-members in confronting base erosion and profit shifting, worrying that unilateral action by individual countries could lead to “global tax chaos marked by the massive re-emergence of double taxation.” Indeed, it is hard to imagine how chaos could be averted, given the number of statutes that would need to be amended in the U.S. and other countries, not to mention renegotiation of double taxation treaties. The prospect seems daunting, especially at a time when the U.S. Congress is considering whether to undertake sweeping changes in the Internal Revenue Code in directions not aligned with the OECD’s proposals.

MNES ON NOTICE

Regardless of whether the Action Plan is implemented and leads to sweeping changes in tax laws and treaties around the globe, MNEs are on notice that their adherence to the arm’s length principle to justify accumulation of profits in lower-tax jurisdictions could be under assault.

Especially where IP is involved, the focus will shift from ownership, and the risks it entails, to substantive activities and “boots on the ground.”

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