

TAX COMPETITION, TAX CO-OPERATION AND BEPS

Richard Collier¹

Abstract

The OECD Base Erosion and Profit Shifting (BEPS) project was initiated to tackle the cross-country tax avoidance practices of multinational companies (MNEs). We argue that the BEPS project inevitably impacts a range of existing tax competition policies pursued by states to lower the costs of capital with a view to attracting mobile investment and profits, and, hence, MNEs. Despite the measures to be introduced by BEPS, tax competition practices will continue, mainly because coordination is not incentive-compatible. However, the nature of tax competition will change as a result of BEPS. Before BEPS, tax competition policies were a mix of low statutory rates and specialised regimes designed to accommodate specific activities or transactions. After BEPS, tax competition policies are likely to become more rate-based. Governments will have to tighten some specific regimes aimed at attracting highly mobile capital and profits, such as the patent box regime, rulings arrangements and interest deductions. At the same time, they may reduce the tax burden on mobile and non-mobile activities by implementing economy-wide cuts (chiefly through tax rate cuts) allowed under BEPS. Many countries, including France, Italy, Japan, Spain and the UK, have announced cuts in the corporate statutory tax rate. To foster real investment, governments could also increase depreciation allowances or introduce an Allowance for Corporate Equity (ACE). The interesting feature of the ACE in the context of BEPS is that it reduces the incentive to classify financing instruments as tax-advantaged debt.²

1. INTRODUCTION

The Organisation for Economic Cooperation and Development (OECD) has, since 2012, worked on a major overhaul of the international tax system through the Base Erosion and Profit Shifting (BEPS) project. The BEPS project was initiated with the primary aim of combating cross-border tax avoidance by multinational firms (MNEs). The various measures proposed by the BEPS Action Plan will highlight the tensions between tax competition and anti-avoidance measures operated by states, with the former generally lowering the costs of capital and the latter increasing it. Governments could theoretically make a binary choice between tax competition and anti-avoidance policies but, as we argue in this paper, the more likely result is that they will seek to comply with the specific measures proposed under the BEPS project, whilst lowering the cost of capital for all factors, whether they are mobile or not. In other words, for those states which seek to maintain tax competition agendas, the result of BEPS is likely to be a reduction in general tax rates.

Multinational corporations are able to reduce their tax liabilities by exploiting specific regimes put in place by sovereign states with the aim of operating tax competition agendas to attract mobile profits and capital. Many of these tax competition-inspired specific measures and

¹ Associate Fellow, Oxford University Centre for Business Taxation.

² I should like to thank my co-author, Giorgia Maffini, who has recently taken up a position at the OECD, for her extensive collaboration in the preparation of this article, which is based on our earlier working paper, Collier and Maffini (2015).

tailored tax regimes have been targeted by BEPS, hence explaining why it is considered that the project is, in fact, addressing tax competition between states.

We argue that the OECD BEPS project will not put a stop to tax competition between countries as, in the current environment, coordination between states is not incentive-compatible. There will always be a country, such as Ireland or the UK, for which there are gains to be made by competing against other jurisdictions. Nonetheless, the nature of the tax competition game will change.

Before the BEPS project, many countries, such as Ireland, the Netherlands and the United Kingdom, were very active in pursuing tax competition agendas with dual “rate-based” and “regime-based” approaches. Low general rates of corporate income tax were coupled with the introduction or maintenance of specific preferential tax regimes, such as the patent box rules that apply a lower corporation tax rate to income derived from patents or, in the case of Ireland, arrangements exploiting tax residence rules designed to allow income to be channelled to zero-tax jurisdictions.

Since the BEPS project is concerned with closing down these specific or tailored regimes which accommodate specific forms of business or transactions, it is expected that countries will tax compete on the basis of the dimensions of their tax systems to which BEPS is inapplicable.

To be compliant with BEPS, governments will have to tighten some specific measures aimed at attracting highly mobile capital and profits, such as the patent box regime and interest deductions. At the same time, they may reduce the general tax burden on both mobile and less mobile activities by implementing economy-wide cuts allowed under BEPS. Most likely, such cuts would come from reductions in the headline corporate tax rates. At the time of writing, many OECD and G20 countries have planned cuts in their corporate statutory tax rates. Such countries include Denmark, Estonia, France, India, Israel, Italy, Japan, Luxembourg, Norway, Spain, Portugal and the UK.³

Making cuts to the headline rate essentially reduces the taxation on profits, but it ignores the fact that for other decisions, such as real investment, including information and communication technology (ICT), other elements of the tax code (such as tax depreciation allowances) are important. To foster real investment, governments might also wish to consider the introduction of an Allowance for Corporate Equity (ACE). In the current environment of low growth and low productivity, encouraging investment is crucial: investment is a component of GDP and higher investment generally leads to higher labour productivity and, therefore, better living standards.

The remainder of the paper is organised as follows. The next section discusses the relationship between tax competition and anti-avoidance policies. Section 3 discusses how the OECD BEPS project affects tax competition policies. Section 4 details a case study investigating the position of the UK. Finally, section 5 draws relevant conclusions.

³ See generally, OECD (2016), pp. 41-42.

2. TAX COMPETITION AND ANTI-AVOIDANCE MEASURES - ARE THEY RELATED?

Are tax competition and tax avoidance related? If so, how?

Tax competition practices occur when, through amendments to the tax system, countries lower the cost of capital for foreign direct investment (FDI) or for their multinationals operating abroad. The intention is typically to attract mobile investment or to make domestic multinationals more competitive in foreign markets.

Conventional economic theory suggests that unconstrained tax competition will lead to under-provision of public goods, relative to what is regarded as the social optimum: on this view, in equilibrium, the tax rate is too low and all countries would benefit from a small, uniform increase in tax rates. In other words, under tax competition, the government will only be able to charge a low tax rate and this will not generate enough revenue to provide what is regarded as the optimal level of public services, such as education and health care. Hence, it is argued, coordination among countries would improve the citizens' overall welfare (Keen and Konrad, 2012). Nonetheless, coordination across countries is not incentive-compatible and, therefore, it has proved very difficult to achieve. Smaller jurisdictions have an incentive to undercut larger countries so as to attract investment and profits. When coordination is not possible and countries pursue disparate approaches, economic theory suggests that individual countries have an incentive to reduce their tax burden to attract mobile activities from other jurisdictions, i.e. they tax compete to attract investment. In equilibrium, there will be different tax rates across countries. More generally, equilibrium tax rates will be lower in jurisdictions with smaller endowments of capital, which are more productive and value public spending less (Keen and Konrad, 2012).

In broad terms, anti-avoidance measures increase the tax burden for some companies instead and, therefore, they tend to increase their cost of capital. This would lead to the opposite result than is achieved by tax competition practices and, hence, be in conflict with it. Nonetheless, the relationship between anti-avoidance legislation and tax competition is more nuanced.

Anti-avoidance legislation can be seen as a way to address distortions in the economy: companies with aggressive tax planning strategies can lower their tax burden, for example, by shifting profits to low tax jurisdictions whilst less aggressive companies are unwilling (or less willing) to do so. Because of a lower tax burden, tax-aggressive companies could, in principle, sell at lower prices and gain market share, and also pay higher salaries and guarantee higher returns to their shareholders than other companies. In this sense, avoidance distorts competition; hence a state's anti-avoidance actions may not necessarily and in principle be at odds with the intention to make that state highly competitive. This would be on the basis that tax competitiveness is understood as providing generally (i.e. across the market) a lower cost of capital and that anti-avoidance action is a way to resolve distortions (that apply unevenly across the market) created by the tax system.

In the public domain, competitiveness and anti-avoidance are often seen at odds with each other, with respect to their distributional effects on society. The argument is simple and initially might seem appealing: a competitive tax system lowers the burden on rich corporations whilst anti-avoidance action makes wealthy companies pay their fair share of tax. Leaving aside the notion of the "fair" amount of tax, the argument is misconceived, as it does not consider that corporations are legal entities and hence cannot, ultimately, bear the burden of the tax. The tax

is borne by individuals connected to the company: its shareholders, its employees and its customers. There are two reasons why the corporate income tax has uncertain distributional effects. Firstly, there is uncertainty with respect to the real incidence of the corporate income tax. Much of the literature points to a large proportion of corporation tax being passed on in lower wages, although there are mixed results on this point.⁴ Secondly, even if we knew who effectively bears the tax, we would not necessarily know whether such an individual is rich or poor. For example, the distributional implications of a tax borne by employees would be different depending on whether the employees were top managers or general employees.⁵ For these reasons, it is difficult to draw straightforward distributional implications of either a tax competitiveness or an anti-avoidance agenda targeted at corporations. In summary, the benefits of tax competition depend on who the ultimate beneficiaries of the tax cuts are.

Anti-avoidance measures and tax competition policies generally have opposite effects on revenues: broadly, the former tend to increase revenues, whilst the latter tend to reduce them. Overall, this means that tax competition constrains the government's choice of optimal policies (i.e. the policies which could deliver the largest welfare gains for the population). If we assume we are dealing with a benevolent government that, before competition-induced tax cuts, was already implementing optimal policies, this could reduce welfare.

If, instead, there is room for improving the efficiency⁶ and distributional properties of the tax system, the impact of changes in tax revenues will depend on how extra or fewer revenues are used, and which taxes are increased (or decreased), following a reduction (or an increase) in revenues from business taxation. The literature generally points to corporation tax as being one of the least efficient taxes, while taxes on consumption, land and immovable property are thought to be more efficient. Empirical evidence shows that an increase in recurrent property and land taxes, or in taxes on consumption, could generate an increase in the GDP growth, if accompanied by a reduction of the taxation of labour and profits. A change from income to property taxes generates a more positive effect than a shift from income to consumption taxes, and would also have the benefit of better distributional properties (Arnold et al., 2011). Other empirical evidence finds a strong, positive effect on per capita income of a tax shift from labour and capital taxation towards consumption taxation, but only in the short run (Arachi, Bucci, & Casarico, 2015). Overall, the evidence suggests that a change in the tax mix could therefore increase the efficiency of the system, at least in the short run. Distributional concerns should be addressed with personal income tax, inheritance tax and possibly recurrent taxes on property, as these taxes can be targeted more directly to the individual taxpayer's income and wealth.

In summary, raising more revenues from corporate taxation does not automatically mean a better distributional outcome for society.

How do tax competition and avoidance interact?

There are different ways in which a jurisdiction can compete. In an open economy, the government can attract capital in two ways. Firstly, it can lower the tax burden for all investors. Secondly, it can target the most mobile factors, such as productive capital and paper profits.

⁴ See, amongst others, Arulampalam et al. (2012) and Fuest et al. (2015).

⁵ Recent research shows that CEOs are able to shift increases in their personal tax burden onto the company, and possibly to other employees and shareholders (Ruf & Schmider, 2015).

⁶ Efficiency should be intended as a state in which all resources in the economic system are allocated in the best way possible, so as to maximise the citizens' welfare.

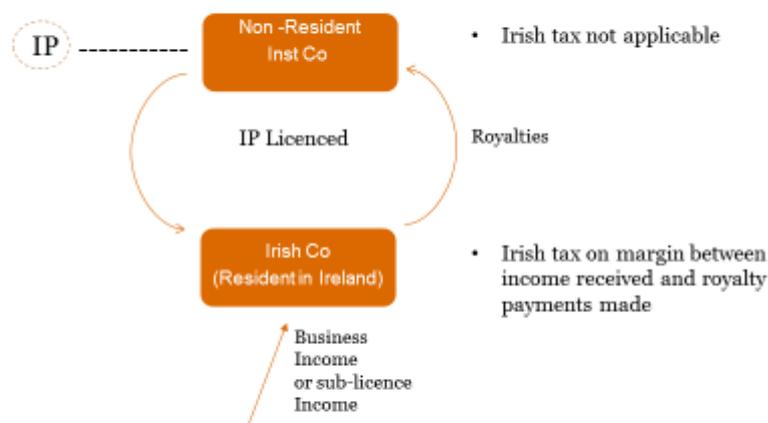
Economic theory suggests that it may be optimal to reduce the cost of capital only on the most mobile factors (Keen, 2001), such as the capital of multinationals deciding to invest in one jurisdiction out of many possible choices. The implication is that governments should compete only on mobile factors. This policy approach would have two main advantages. Firstly, it would attract mobile productive capital, and hence investment, which would instead leave or avoid a high-tax jurisdiction. Secondly, by only targeting a group of firms and taxpayers, it would allow revenues to be maintained. It would be more costly in terms of lost tax revenues to lower the tax burden for the whole economy, including the less-mobile factors (Keen & Konrad, 2013). It must be noted that targeting only mobile factors could also create inefficiencies: mobile firms could be given an advantage with respect to immobile ones, creating distortions in the market, and this could offset the aforementioned efficiency gains. We will discuss this point further below.

If economic theory provides some foundation for the strategy of targeting internationally mobile capital and profits, the political reality is that a country acts in an international environment, where jurisdictions with different economic structures and different tastes for public spending levy different tax burdens on capital and profits. In this context, measures that may be justifiable from a purely domestic perspective - such as lowering the tax burden on mobile activities - are, in fact, often regarded by other countries as providing unfair, or at least questionable, opportunities for shifting profits away from their higher tax jurisdictions. In other words, tax competition measures for one jurisdiction are seen as measures facilitating tax avoidance by other jurisdictions.

For example, the competitiveness of the tax regimes in Ireland and the Netherlands has been crucial when it comes to those nations attracting FDI and profits. In 2014, Ireland had the highest share of FDI flows over GDP in the OECD (34.6%) and, in 2013, it had the second largest share of FDI stock over GDP (231%) after Luxembourg (301%).⁷ In 2014, the Netherlands attracted the largest amount of FDI flows in the world, with 4 million USD (5.5% of GDP)⁸, whilst in 2013, it ranked fourth in the OECD in terms of FDI stock as a share of GDP (134%), after Luxembourg, Ireland and Switzerland (194%).

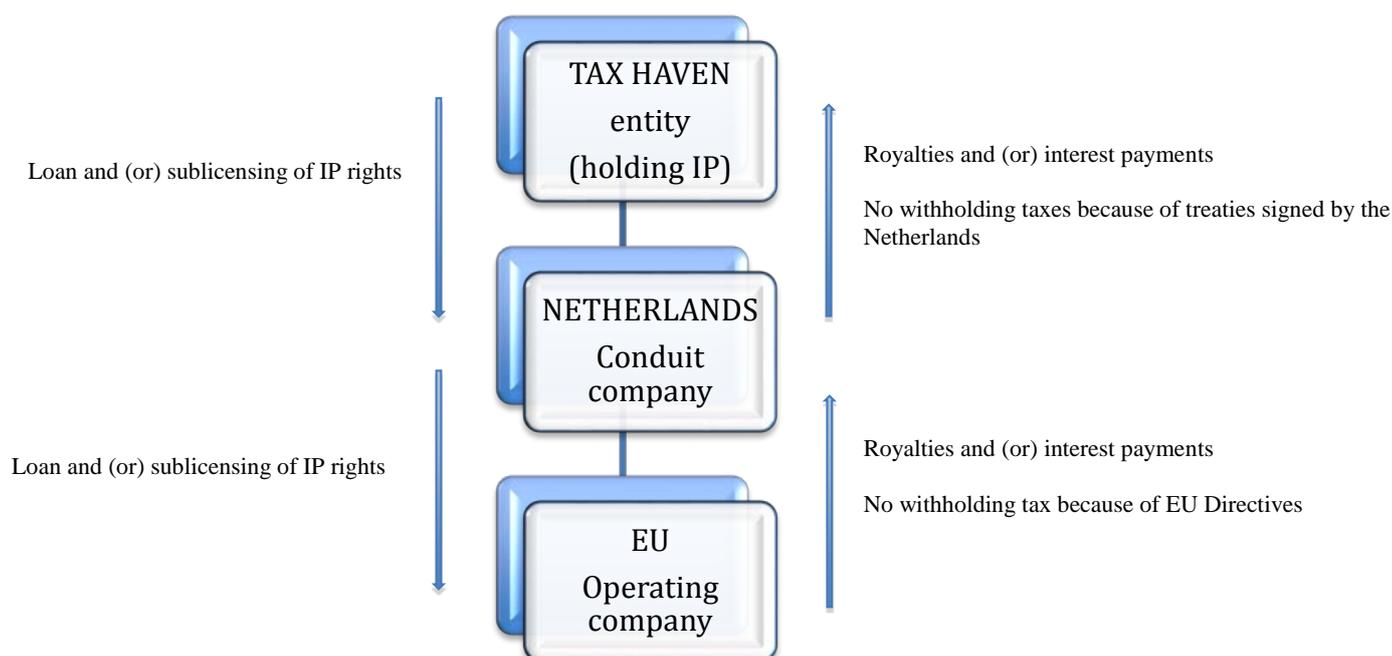
⁷ As a reference, in 2014, outside of the OECD, the only developed economy with a higher share of FDI over GDP is Hong Kong (39.9%). Germany, France, the UK and the US instead display ratios of 0.2%, 0.3%, 1.5% and 0.8% respectively. This is not surprising, because these are large countries which are traditionally capital exporters.

⁸ In 2014, the US attracted 2.9 million USD, China and Luxembourg 2.3 million USD, and the UK 1.7 million USD.

Figure 1. Double Irish Structure

At the same time, both Ireland and the Netherlands have been seen as encouraging companies to avoid tax in other, high-tax, jurisdictions. One recent high profile case involved the so-called “double Irish” structure, which delivers an effective tax rate that is competitive with what might otherwise be achieved by the use of a no-, or very low-, tax state, notwithstanding the general 12.5% Irish corporate tax rate. As illustrated in Figure 1, in broad terms, the structure involves two Irish companies, one of which is not resident (and therefore not taxable) in Ireland as a result of the Irish “central management and control” test of residence. As far as the Irish tax authority is concerned, the company is incorporated in Ireland, but is resident in a tax haven because its central management and control is located there. Typically, it is this company that holds valuable intellectual property (IP), which it licences to the second Irish company, which in turn either uses the IP in its business or on-licences the right to use the IP to the rest of the MNC group. In such a case, this second Irish company, which is resident in Ireland for tax purposes, will receive and pay tax on the income it receives but may claim a deduction for the onward payments to the second Irish company, which is outside the scope of Irish taxation. The result is that Irish tax at the 12.5% rate is levied only on any margin arising from the receipt and payment of royalties in the hands of this second Irish company and the bulk of the income escapes Irish taxation. In the face of significant international pressure, the Irish government has now accepted that the structure should be countered (McDonald, 2014). A new rule therefore provides that companies will no longer be able to incorporate in Ireland without also being tax-resident there.⁹

⁹ The new rule took effect from 1 January 2015. (See section 23A Taxes Consolidation Act 1997, as amended by s.43(1)(a) Finance Act 2014). It also provided that companies already using these arrangements would have a five-year window in which exit them (see s.43 (2) Finance Act 2014).

Figure 2. Dutch Entity

Another example relates to the Netherlands. The tax system of that country: facilitates the use of Dutch companies for the holding and financing of international groups, given that the Netherlands has a very wide tax treaty network that will reduce withholding taxes on inbound payments; allows the tax-exempt receipt of dividends and capital gains from overseas subsidiaries; has no CFC rules;¹⁰ and imposes no withholding tax on interest and royalties, and limited withholding tax on dividends paid out of the country. Figure 2 shows how a Dutch conduit company could be employed to shift income out of a high-tax EU jurisdiction. In 2013, international treaty-shopping concerns, relating to the ease with which these Dutch tax benefits might be accessed, led to the Netherlands acting unilaterally to tighten the circumstances under which Dutch treaty benefits may be available.¹¹ The package of unilateral measures included: substance requirements; more pro-active exchange of information arrangements with foreign states; curtailed tax rulings for companies without sufficient substance; and anti-abuse measures in tax treaties with developing countries.

Other examples relating to the UK may also be cited, such as the pressure from other states on what are perceived to be the UK's over-limited CFC rules, the over-generous interest deduction that has been available under existing UK tax law and, of course, the UK Patent Box rules, the latter of which have already been redrawn due to international pressure in the BEPS process. All of these UK examples are discussed further below.

¹⁰ It should be noted, however, that an overseas low-tax or no-tax company holding portfolio/passive assets may be taxed in the Netherlands on a fair value basis by way of exception to the Dutch participation exemption under Art. 13a Corporate Income Tax Act.

¹¹ See the announcement contained in the letter to Parliament from the Dutch Minister for Foreign Trade and Development Co-operation and the Deputy Minister of Finance, dated 30 August 2013. The measures were made effective from 1 January 2014 – Decree of 18 December 2013, Stb 569, 2013, published 30 December 2013.

As the examples discussed above illustrate, the competitiveness and the anti-avoidance agendas will often conflict in the international arena when specific measures lowering the cost of capital for mobile activities (competitiveness) attract tax bases from high-tax jurisdictions, facilitating what is perceived by other states as aggressive tax avoidance.

It is also important to clarify that, unlike other commentators and policymakers, we make no distinction in this discussion between “harmful” and “non-harmful” tax competition. Those using this distinction usually intend the latter term to refer to policies that are generally meant to attract “real” investment, whereas the former term is typically used to refer to tax incentives that function more like formal “loopholes”, attracting mere “financial” investment without directly involving a great deal of economic activity or substance.¹² The distinction is arguably a long way from being so straightforward. Tax competition is designed to lower the cost of capital to stimulate real investment (whether domestic investment or foreign direct investment). It is possible to lower the cost of capital with measures that either directly target real investment or that lower the cost of financing such investment, i.e. with measures that target financial investment that will therefore indirectly target real investment. Given that targeting both financial and real investment lowers the cost of capital, in this context, any attempt to distinguish the two different types of tax competition or investment will not obviously be founded on economic principle. Accordingly, it is considered that there is no useful distinction to be drawn between harmful and non-harmful tax competition, or between real and financial investment.

3. TAX COMPETITION POLICIES AND BEPS

Having considered the general relationship between anti-avoidance measures and competition policies, it is now appropriate to turn to the particular issues for such policies raised by the BEPS project.

In the first BEPS paper released by the OECD, it is acknowledged that jurisdictions are free to set up their own tax systems as they choose and it is their sovereign right to implement the tax measures that they judge to be right (OECD, 2013a, pp28-29, OECD 2013b, p15) .

This could be taken to suggest that the BEPS project has no impact on tax competition, particularly as neither of the initial papers on BEPS released by the OECD (OECD 2013a, 2013b) (which set out the OECD’s concerns relating to BEPS practices) contain any extended discussion on the need to address tax competition practices.¹³ However, despite not seeking to tackle tax competition practices head-on, most of the individual action points that are being pursued as part of the BEPS project have the potential to create an adverse impact on tax rules that are designed to give effect to a tax competition policy. This is because, although the proposed BEPS changes are directed largely at situations where the existing international tax rules are regarded as either not working or as being too vulnerable to aggressive tax avoidance by MNEs, the effect of the proposed countermanding action will hit tax competition practices by states. This should not be particularly surprising, as many of the practices of MNEs, which are seen as aggressive tax avoidance (and which are therefore targeted by BEPS), are simply cases of MNEs making full use of tax regimes created by states in pursuit of a tax competition policy.

¹² We thank Wolfgang Schön for his comments on this point.

¹³ There is a brief discussion of the historical work of the OECD on harmful tax practices, but little discussion about the tension contribution of tax competition policies to the creation of BEPS opportunities - see OECD (2013a), pp. 28-29.

Apart from the digital business issue (which is recognised as raising some specific issues), the BEPS Action Plan groups the bulk of its identified actions to address BEPS practices by referencing three main themes:

- (1) increasing transparency;
- (2) realigning taxation with substance, which means taxing profits where they are substantively created;
- (3) ensuring the “coherence” of the system, which means getting rid of loopholes, gaps or mismatches in the interaction of countries’ domestic tax laws that can be exploited.

Each of these themes, which will be considered briefly in turn, contains specific actions that may impact tax competition practices.

3.1 Transparency

The BEPS work on transparency includes a wide variety of new measures pursuant to: Action 11 on the collection and analysis of data on BEPS; Action 12 on the disclosure of aggressive tax planning arrangements; and Action 13 on the overhaul of transfer pricing documentation, including the new country-by-country reporting obligations, and the broadening of the reporting required in the “local file” and the “master file” for each business.¹⁴ Work on the BEPS transparency package is likely to have a material impact on the operation of tax competition policies by states, because it will lead to the ready identification and broad disclosure of tax rulings and subsidies etc. that are otherwise intended to remain private, and of specific tax authority practices that vary from accepted standards. This, in turn, is likely to lead to increased challenges, most likely for MNEs taking advantage of the relevant tax rules, but possibly to the states operating those regimes.¹⁵

3.2 Taxation and economic substance

The BEPS work on “realigning taxation with substance” is based on the desire to restore the intended effects and benefits of international tax standards by ensuring that the allocation of income for tax purposes is closely aligned with the economic activity that generates that income.¹⁶ This includes work streams on: treaty abuse (Action 6 of the Action Plan); preventing

¹⁴ See further OECD (2015j). This document sets out the two-tiered approach to transfer pricing documentation involving a master file (which would contain common standardised information relevant for all MNE group members, and set out a “blueprint” of the MNE group and its business) and a local file that supplements the master file and helps to meet the objective of ensuring the taxpayer concerned has complied with the arm’s length principle in its material transfer pricing positions affecting a specific jurisdiction.

¹⁵ Challenges to MNEs might be made on the basis of the specific BEPS action points, such as treaty abuse, permanent establishments, transfer pricing etc., and challenges to states might be possible under Action Point 5, the revamping of the harmful tax practices work. It is likely that the impact of the transparency measures will vary from state to state. It is not thought that the measures will be of special significance in relation to the UK. The European Commission has also been especially active in the area of transparency requirements – see, for example, European Commission (2015) and, more recently, the European Commission’s Anti-Tax Avoidance Package of 28 January 2016, which includes a proposal for public country-by-country reporting (European Commission, 2016).

¹⁶ For a discussion of the problems relating to aligning taxation with substance, see Vella and Devereux (2014). It should also be noted that the European Commission has recently identified various key areas for action, including a focus on “bringing taxation closer to where profits are generated and ensuring effective taxation of profits,” which is to involve further work on the PE and CFC rules - see European Commission (2015b). Further

artificial avoidance of the permanent establishment (PE) threshold (Action 7); and a cluster of transfer pricing actions, including work on intangibles, re-characterisation of transactions, risk, and capital (Actions 8, 9, and 10). These actions are very likely to impact cases where a tax base has been “poached” as a result of the operation of a tax competition policy. Such cases would be nullified by the realignment of taxing rights with the substantive activity giving rise to the income concerned. For example, where IP is legally owned by a company resident in a low-tax jurisdiction, or in a jurisdiction where a patent box or similar relief is available, but all the development work on that IP is subcontracted to a European affiliate, the actions referred to above will make that structure much more difficult to sustain in light of the beefed-up BEPS transfer pricing and PE rules.¹⁷ The same would be true in cases where specific risks - and, therefore, more income - are allocated to a low-tax company, but all risk management functions are subcontracted to an affiliate. The BEPS proposals on treaty abuse will also make the intermediation of tax-advantaged legal entities more difficult to defend, e.g. in the case of regional holding companies or single asset holding companies, where the choice of location of the entity is driven mainly by tax factors. Variants of these types of challenges have been seen already¹⁸, but they are likely to increase due to BEPS changes to the international tax rules.

3.3 Coherence

For the OECD, the aim of restoring “coherence” to the international tax system as a whole is about dealing with the unintended and distorting gaps or mismatches between tax systems that can make income disappear for tax purposes. What this means in practice includes ensuring that a payment that is deductible in one state is taxable when received in another.

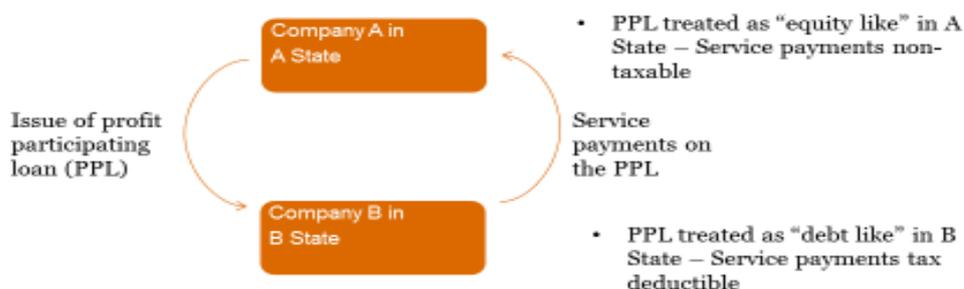
Four action points are grouped under the coherence theme:

1. Neutralising hybrid mismatch arrangements (Action 2);
2. Strengthening CFC rules (Action 3);
3. Limiting interest deductions and other financial payments (Action 4);
4. Revamping the harmful tax practices work itself (Action 5).

detailed measures have also been proposed under the European Commission’s Anti-Tax Avoidance Package of 28 January 2016 – see generally European Commission (2016).

¹⁷ The BEPS transfer pricing work may mean that the financial rewards from the legal ownership of the IP are not respected for tax purposes, or that the amount due to the affiliate under the transfer pricing rules for its work on developing the IP represents the overwhelming bulk of the IP profits arising. The PE measures may alternatively mean that the low-tax company has a taxable presence in the jurisdiction of the affiliate and is taxable there on all, or most of, its profits.

¹⁸ See, for example, the Canadian case of *Velcro Canada v The Queen*, 2009 DTC 5053 (FCA).

Figure 3. Example of Hybrid Financial Instrument

The BEPS work on hybrids is arguably the most complex of the BEPS action points. Broadly, the hybrids targeted include hybrid instruments and hybrid entities. Hybrid instruments are typically characterised differently as equity or debt for tax purposes in the jurisdictions of investor and issuer. Hybrid entities are again characterised differently for tax purposes in two or more jurisdictions, typically by reference to whether the entity concerned is transparent or not for tax purposes. The work on neutralising hybrids intends to reverse the intended tax effect of such instruments (for example, in the case of cross-border hybrid financial instruments such as profit participating loans). The usual objective for such instruments, as illustrated in Figure 3, has been to secure tax deductions for the relevant service payments in the hands of the payer (on the basis that the payer's jurisdiction treats the instrument concerned as "debt-like") yet with those service payments being regarded as non-taxable receipts in the hands of the recipient (on the basis that the recipient's jurisdiction would characterise the instrument as "equity-like" giving rise to receipts akin to dividends). The reversal of the expected tax benefits of such instruments is achieved either by denying a tax deduction for a payment under the instrument or by taxing the corresponding income.

The aim of the work on limiting interest deductions is to hit what the OECD sees as unwarranted tax deductions for such payments, given that the corresponding payments may not be taxed (or may be taxed at a low rate) and this will obviously affect regimes to the extent that their tax rules for interest deductions are at the generous end of the scale.

The BEPS work on CFC rules is intended to lead to a more comprehensive countering of BEPS practices, protecting the parent jurisdiction as well as having positive spillover effects for tax revenues in source countries (such as developing countries), because the effect of such rules should mean that taxpayers have a much-reduced incentive to shift profits into any third, low-tax jurisdiction, given that any such shifted profits would fall within - and therefore immediately be taxed by - a comprehensive CFC regime of the type favoured by the OECD.

The "coherence" actions also include the specific BEPS work stream, conducted under point 5 of the Action Plan (OECD, 2013b, pp17-18, OECD, 2015e.), on revamping the OECD's

harmful tax practices initiative of the late 1990s. This is the only part of the Action Plan that directly targets certain tax competition practices by states, specifically those regarded as “harmful tax practices” that represent a subset of tax competition practices.¹⁹ In the BEPS interim report on this topic, it is stated that: “...the work is about reducing the distortionary influence of taxation on the location of mobile financial and service activities, thereby encouraging an environment in which free and fair tax competition can take place” (OECD, 2014b, 2015e).

This work stream within BEPS focusses on individual tax regimes for particular types of geographically mobile activity and a key theme is to ensure that any such tax regime is suitably substance-based, in that any tax benefit is commensurate with the level of substantive activity that may be involved.²⁰

Given the direct focus of the BEPS work on certain tax competition practices of states, it will be obvious that, if successfully pursued, the work is likely to have an adverse impact on at least some tax competition practices carried out by states. For example, as will be discussed further below, this harmful tax practices work of the OECD has already been in conflict with what has been one of the primary features of the UK tax competition policy, namely the UK Patent Box.

It should be emphasised that the discussion here is not seeking to assess the effectiveness of responses to tax competition through the BEPS project, but rather simply to establish that the work on BEPS will clearly have an effect on tax competition policies, even though it is usually interpreted as reining back the activities of multinationals. The conclusion on the BEPS action points is therefore that, as a general matter, there will be a number of different BEPS actions that are likely to have negative impacts on measures that are created in pursuit of tax competition policies, even though those action points are not, apart from the specific work on harmful tax practices, dealing with “tax competition” issues head-on.

It is also relevant to note that economic theory already forecasts that closing preferential regimes for highly mobile activities could shift tax competition to other parts of the tax systems, possibly involving larger welfare losses (Keen, 2001).

¹⁹ The landmark OECD (1998) report referred to “Harmful Tax Competition” in its title.

²⁰ The substance requirement here seems to be based on the distinction between tax measures attracting “real” investment (which are regarded by the BEPS project as potentially acceptable) and tax incentives that function more like formal “loopholes” attracting mere financial investment but that do not directly involve a great deal of economic activity or substance (which tend to be regarded as unacceptable by BEPS). As we have argued in Section 2, the distinction is not based on economic principles, as lowering the tax burden on both financial and real investment reduces the cost of capital and hence stimulates real investment. At a practical level, it may well be that countries with a lot of real investment (such as Germany) or a lot of consumers (such as the UK) have concerns that jurisdictions like Ireland can extract tax base from them, even if almost nothing is produced or consumed in Ireland. It is therefore not, in practice, surprising that substance requirements are introduced into the debate with a view to constraining this type of “financial investment” form of tax competition. However, the concern remains that the contrast so created between financial and “real investment” will add yet another questionable distinction to the international tax framework, particularly as it is, in turn, founded on the vague notion of adequate “substance.” Rather, it may ultimately prove difficult to distinguish the two types of investment meaningfully.

4. A CASE STUDY: THE UK TAX COMPETITION AND ANTI-AVOIDANCE AGENDAS

Over the years, various OECD countries have pursued tax competition agendas, with varying degrees of aggressiveness. Smaller jurisdictions, such as Belgium, Ireland, Luxembourg, the Netherlands and Switzerland, have openly employed their tax systems as key tools to attract investment. Larger countries, such as the US, have employed their tax systems in less visible ways, in order to make their multinationals more competitive in foreign markets.²¹ In this section, we will focus on the case of the UK, a jurisdiction in which the tension between the competitiveness and the anti-avoidance agendas is particularly apparent. The conclusions are potentially valid for any other country engaged in tax competition, at least at some level, and at the same time, trying to conform to the measures proposed by the OECD BEPS project, and more generally to the public pressure in support of introducing more rigid anti-avoidance measures. For example, the conclusions drawn will have some relevance to Ireland, which has recently decided to reform its rules on corporate tax residence and, at the same time, has announced the intention to bring in a “knowledge development box” at a rate of 5% for income derived from patents. Both measures are part of a clear (and ongoing) effort on the part of Ireland to remain as competitive as it can be in attracting and retaining FDI (Department of Finance, Ireland, 2014).

4.1 Tax competition

On setting its approach to international tax competition, the current and previous UK governments have been responding to two complementary issues. One has been the need to placate the concerns of UK-headquartered multinationals (MNEs). This became particularly important in the period 2007 to 2010 in order to prevent the growing head of steam for “inversions”, i.e. the moving of the “tax domicile” or headquarters of such multinationals abroad.²² The second was what came to be known as the “open for business” agenda of creating an attractive, competitive UK tax regime to bring new investment to the UK, with a particular focus on activities related to innovation and intellectual property.

It is worth noting at the outset that the aims of the Conservative government - and those of its predecessor, the Coalition government - of creating a highly competitive tax regime and countering tax avoidance are not new, but are, broadly, a continuation of the agenda from the earlier Labour government.²³ It was the earlier Labour administration that introduced a number of important reforms which are today regarded as the bedrock of the UK’s competitive corporate tax position, such as: the capital gains exemption for substantial shareholdings in 2002; the “foreign profits” reform of 2009, which introduced an exemption for foreign dividends received in the UK; the decision to maintain interest deductions for the financing of

²¹ The US check-the-box rules often allow US multinationals' foreign income to go untaxed if located in a low or zero tax jurisdiction.

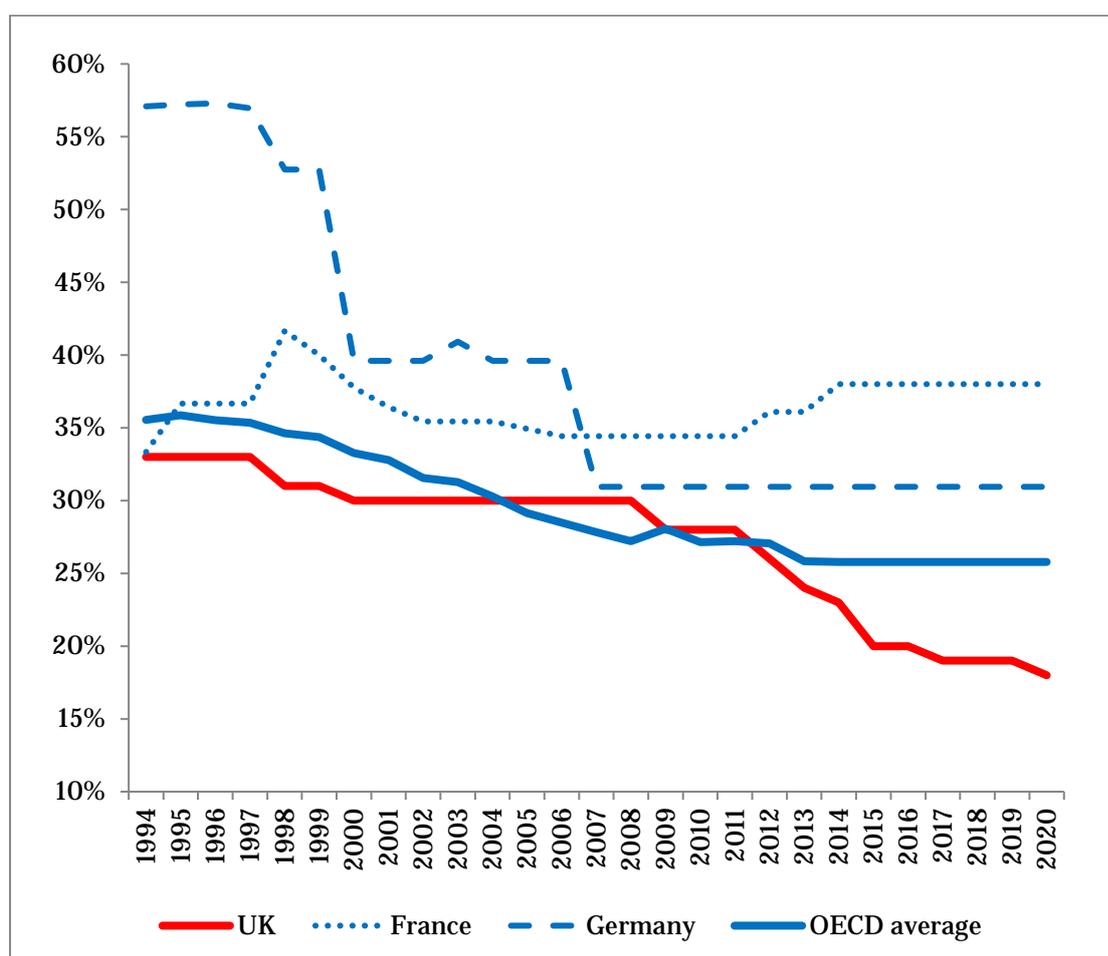
²² At this time, a number of UK companies took steps to do just this, with WPP, Henderson Group, United Business Media, Shire and Ineos etc. all moving from the UK. In December 2009, the *Financial Times* reported that a number of FTSE heavyweights were considering leaving the UK (Houlder, 2009). See further, Clements (2013).

²³ The previous Labour government did not identify becoming the most competitive tax regime in the G20 as its goal, but the tax competitiveness of the UK was an important priority for Gordon Brown as far back as 1999. In that year, following the reduction of the corporation tax rate (to 30%), he emphasised that it was: "now the lowest rate in the history of British corporation tax, the lowest rate of any major country in Europe and the lowest rate of any major industrialised country anywhere including Japan and the US". See HM Treasury (1999).

overseas investments, giving rise to tax exempt income; and the foreign branch exemption²⁴ initially canvassed by a Labour government but enacted by the Coalition in 2011. It was the earlier Labour government that also started the long-running reform of the UK CFC rules and that brought the rate of corporation tax down to 28% from its previous rate of 33% in the previous John Major administration. The approaches taken by UK governments to matters of international tax policy have therefore been extremely consistent for a number of years.

Unsurprisingly, the tax competition agendas pursued by successive UK governments have been widely supported by business and are generally regarded as having been successful. Many indicators show that the UK tax system has become more competitive in the last few years. Three measures are used to assess the tax costs associated with corporation tax and hence the competitiveness of the UK system versus that of other countries: the main statutory rate, and two summary measures that account for both the statutory rate and the tax base. These are the effective average tax rate (EATR) and the effective marginal tax rate (EMTR).

Figure 4. Statutory Corporate Tax Rates (1994-2020)

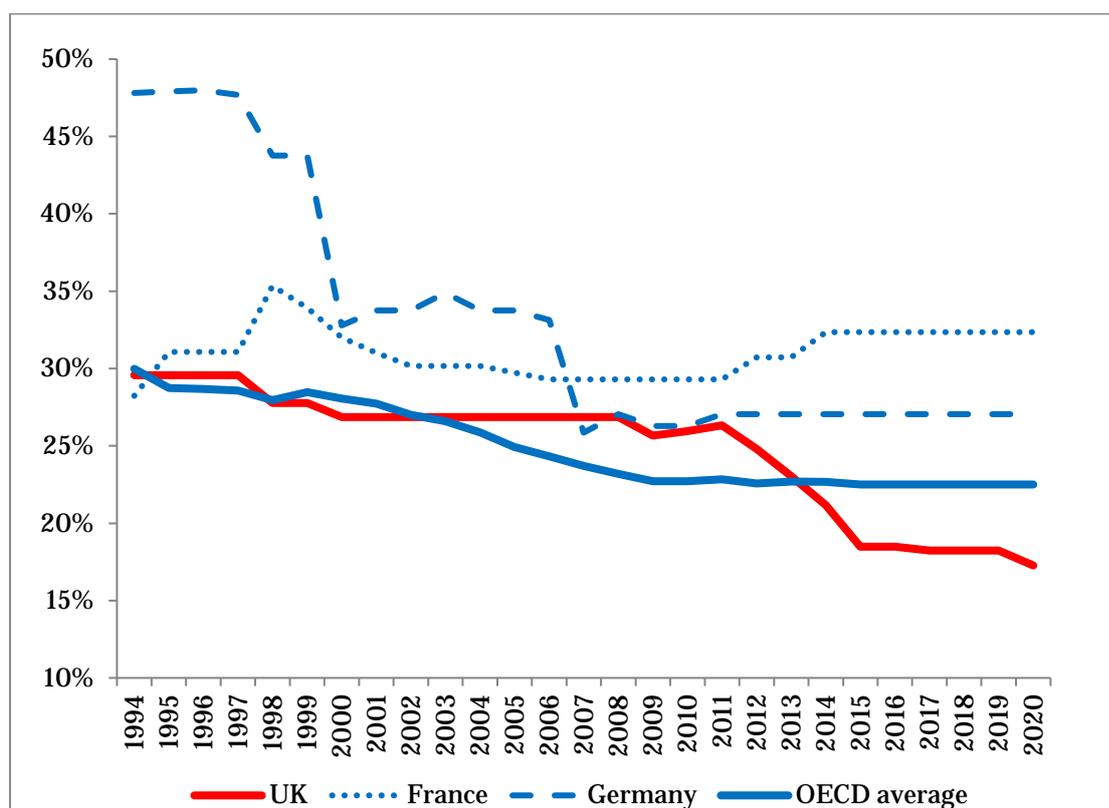


Source: OUCBT tax database. www.sbs.ox.ac.uk/ideas/impact/tax/publications/data

²⁴ UK resident companies can elect that the future results of their present and future non-UK branches be excluded from UK taxable profits, with the exception of non-trading branches. The election is irrevocable and applies to all of a company's branches.

The statutory tax rate measures the attractiveness of a jurisdiction for mobile paper profits.²⁵ Figure 4 shows that in 2015, the UK rate was about 7.5 percentage points lower than the OECD average²⁶ and it will be 7.8 percentage points lower in 2020. Although the UK rate is consistently lower than the French and German rates, smaller, low-tax jurisdictions (such as Ireland) have had lower rates that have attracted activities and structures yielding after-tax benefits. Such small jurisdictions have now become relatively less attractive when compared to the current UK corporate tax rate of 20%, reducing to 17% in 2020²⁷, or to the 10% rate available with the Patent Box.

Figure 5. Effective Average Tax Rates (1994-2020)



Source: OUCBT tax database. www.sbs.ox.ac.uk/ideas-impact/tax/publications/data

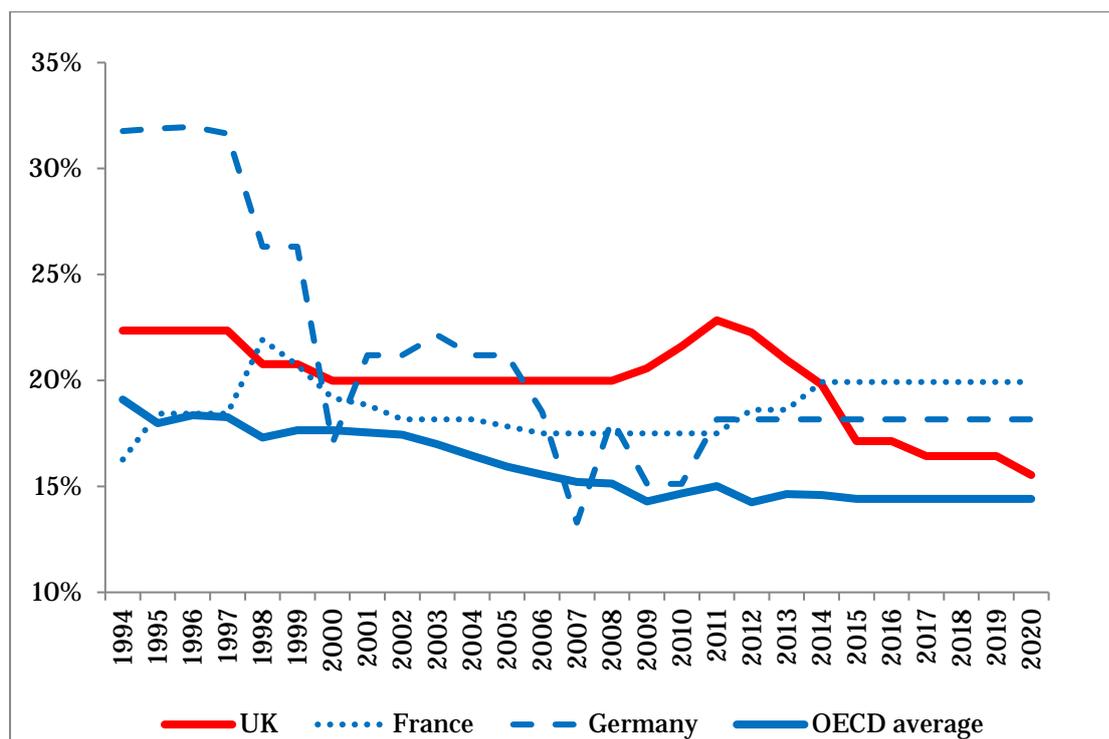
Figure 5 shows the evolution of the EATR²⁸ that affects the location of investment in the UK, i.e. it affects inward foreign direct investment (FDI). In 2015, the UK EATR was well below the OECD average and it will be even lower in 2020.

²⁵ The statutory corporate tax rate affects profit-shifting as the marginal incentive to shift an additional unit of corporate profits after all deductions depends on the corporate statutory tax rate.

²⁶ The OECD average excludes the UK and is unweighted. The same applies for the OECD average EATR and the EMTR shown in Figures 2 and 3.

²⁷ The further reduction in the UK corporation tax rate to 17% (from the previously planned 18%) was announced in the UK Budget on 16 March 2016.

²⁸ The EATR depends on the statutory rate and on capital allowances. It is the proportion of pre-tax profit of a typical investment project that would be taken in tax.

Figure 6. Effective Marginal Tax Rates (1994-2020)

Source: OUCBT tax database. www.sbs.ox.ac.uk/ideas-impact/tax/publications/data

Since Nigel Lawson's 1984 Budget, the UK has pursued a corporate tax policy of rate cuts and base broadening. Such a policy has a less direct effect on decisions such as expanding investment, in relation to which other elements of the tax code, such as the availability of capital allowances, are more important at the margin than the statutory corporate tax rate. For this reason, if the UK has improved its competitive position substantially in terms of attracting profits and FDI, the EMTR that affects the size of investment remains relatively high.²⁹ The tax base and hence capital allowances are very important for the marginal investment project and that is why the UK ranks low on this measure: the UK capital allowances regime is one of the least generous in the OECD.³⁰ The UK EMTR declined after 2011, but in 2020 it will still remain above the OECD average (Figure 6). This could be problematic. Historically, the UK has had low levels of investment when compared to other developed economies, such as France, Germany and the United States.³¹ This could also partially explain why labour productivity is also low.

Although relatively less attractive to industries with large investments in tangible assets because of a relatively high EMTR, overall, today's UK tax system makes the nation a very attractive location for companies to have their headquarters and, more generally, for multinational companies to carry out activities. There are seven main reasons. First, the

²⁹ The EMTR measures the proportionate increase in the cost of capital due to the tax. It accounts for both the statutory rate and for capital allowances. It affects the size of investment, given the decision to locate in the UK. The EMTR focuses on the margin, i.e. it focusses on a project that just breaks even by earning a return equal to the cost of capital.

³⁰ See Oxford University Centre for Business Taxation (2015).

³¹ London School of Economics Growth Commission (2013).

exemption system of taxation of foreign profits introduced under the Labour government allows parent companies located in the UK to receive dividends from subsidiaries that are exempt from UK corporate income tax. Because of the substantial shareholding exemption introduced in 2002, foreign capital gains are also exempt. Second, the rate of corporate income tax is low with respect to other OECD countries, being 20% in 2015 and with a planned further reduction to 17% by 2020. Third, the presence of a patent box regime with a rate of 10% lowers the tax burden on very mobile factors, such as intangibles and, together with a relatively generous and simple research and development (R&D) tax incentives regime, makes it more attractive to research and own UK-developed patents in the UK, rather than locating them in a low-tax entity.

Fourth, the new and limited CFC regime allows important exemptions that essentially lower the tax burden on CFCs located in low-tax jurisdictions. In particular, the finance company exemption allows the financing of high-tax subsidiaries via a low-tax CFC. Fifth, historically the UK system does not charge withholding taxes on dividends paid from UK companies to their foreign shareholders. The UK has also signed a large number of tax treaties reducing withholding taxes on dividend and interest payments, and on royalties paid to the UK. Sixth, (although the position will, of course, change in due course as a consequence of Brexit, which is discussed later) the UK is part of the European Union: the EU Parent-Subsidiary Directive provides that intra-EU dividends paid by EU subsidiaries to an EU parent are exempt from withholding taxes, and the Interest and Royalties Directive provides that withholding taxes on intra-EU royalty and interest payments are set to zero. Finally, the UK has had generous rules for the deduction of interest payments. Although a worldwide debt cap³² for large companies was introduced in 2009 under the Labour government, current interest rules remain relatively generous by international standards, although these are to change and become more restrictive, as discussed later.

4.2 Avoidance

Turning to the UK government's stance against avoidance and its support for BEPS, the UK has been widely regarded as one of the leading and most enthusiastic states in the prosecution of that global initiative. George Osborne, Chancellor of the Exchequer between 2010 and 2016, described the UK as having "led the way" in this international action, with the UK "pushing [...] for global solutions".³³ The message is echoed from all quarters of government. For example, the Prime Minister at the time of the development of the BEPS policy measures, David Cameron, spoke of his putting the BEPS project at the heart of the G8 agenda and of his call to other G20 leaders to get behind the action plan (Cabinet Office, 2013). In June 2015, the then Financial Secretary to the Treasury (and later Chief Secretary to the Treasury), David Gauke, confirmed that the Conservative government was determined to take the BEPS project ahead and maintain its momentum in order to create a coherent tax system that is fit for purpose for the 21st century (HM Treasury & Gauke, D., 2015). The strong UK championing of BEPS

³² The debt cap disallows the deduction of costs of net borrowing by relevant UK companies where the finance expenses on these borrowings exceed the gross worldwide external group finance cost. It only affects large groups with 250 or more employees. The debt cap only applies where the aggregate net debt of each relevant group company (calculated on an entity-by-entity basis, excluding debt of less than £3m in any company) exceeds 75% of the worldwide gross debt of the group.

³³ See HM Treasury and HM Revenue and Customs (2014), Foreword by George Osborne, pp 3-4. Also, an early call for action on BEPS was made by George Osborne and Germany's Minister of Finance, Wolfgang Schäuble, at the time of the November 2012 G20 meeting.

has led to the UK being the first country to commit publicly to adopting the country-by-country reporting (CBCR) template developed as part of the BEPS Action Plan.

Given that the BEPS project was initiated in 2012, it post-dated the previous Labour government, but the Labour Party has expressed strong support for the initiative whilst in opposition.³⁴

4.3 Impact of BEPS on Existing UK Policies³⁵

Given the discussion above, it is perhaps not surprising that it has been widely observed that there is a contradiction, or at least a major tension, between the UK's leading role on BEPS and its aggressive tax competition agenda. The government, HM Treasury, and HM Revenue and Customs have all consistently argued that there is no such contradiction or tension. Until very recently, the point has not been directly tested, largely because there have been relatively limited instances in which *actions* have been taken that highlight this clash of agendas. This state of affairs has now changed: the recent UK government proposal to restrict interest deductibility in compliance with BEPS Action 4, not to mention the changes made to the UK Patent Box rules (see further below), show how BEPS measures can affect the UK's competitiveness agenda because the UK regime on interest deductibility is one of the pillars of the UK's competitiveness position (see section 4.1).

A key feature of multilateral, rather than unilateral, measures directed at combatting tax avoidance is typically a loss of total control of the agenda by any single state. This is equally true in the case of the BEPS project, where the agenda is set by a large group of states, some with interests and priorities that are quite different from those of the UK. Germany, for example, has historically been strongly opposed to tax competition. In the BEPS discussions on CFC rules under Action Point 3 of the BEPS Action Plan, the United States is known to have favoured an appreciably tougher and more extensive application of CFC rules to BEPS practices than the more limited CFC approach taken by the UK. Non-OECD member countries directly participating in the BEPS project, such as India and China, wish to adopt a much more expansive approach to the transfer pricing rules than states like the UK. Unsurprisingly, the result is that the proposed actions under the BEPS project are not readily aligned with the domestic UK agenda to create the most competitive tax regime in the G20. As discussed in the previous section, the BEPS project is now heading towards required implementation actions by states, including the UK, that will actively constrain and hinder tax competition policies. This, in turn, means that it will be increasingly difficult, if not impossible, for the UK to maintain its leadership role in delivering BEPS *and* its objective of maintaining a highly competitive tax system simultaneously. It seems likely that it will have to make choices about its real priorities instead.³⁶ The tensions are likely to be amplified by the implications of Brexit (see below).

³⁴ See, for example, the comments made about BEPS by Shabana Mahmood, then Shadow Minister (Treasury) in the debate on the diverted profits tax (Hansard, 7 January 2015, c29WH), and the Labour Party (2014), p. 18.

³⁵ Whilst the UK may represent an interesting example of a country supporting BEPS and pursuing a tax competition policy, the analysis would, of course, be different in the case of a country generally opposed to tax competition but supporting BEPS. For example, a consideration of Germany, which has historically been a strong opponent of tax competition, would lead to different issues in relation to its support for BEPS, such as whether Germany may be forced into some level of tax competition (e.g. introducing patent box rules) as a result of the agreement in BEPS on patent boxes.

³⁶ Such choices are already emerging in period of implementation of the BEPS measures. Though a number of the BEPS proposals (such as those relating to hybrid mismatches, interest deductions and country-by-country

This point can be tested by considering various examples of specific rules from the BEPS project that would seem to present material difficulties to the UK if it were to seek to maintain both its leading role in advancing the BEPS project and its drive to maintain a highly competitive tax system.

CFC rules: The work on CFCs within BEPS is intended to strengthen CFC rules. The OECD has recognised, from an early stage, that whilst many countries have introduced CFC and other anti-deferral rules, they do not always counter BEPS practices in a comprehensive way.³⁷ The point is highly relevant to the OECD's discussion of the purpose of CFC rules. In the lengthy Discussion Draft of 12 May 2015, the OECD recognised that CFC rules may be used to prevent the shifting of income either from the parent jurisdiction alone or from the parent and other tax jurisdictions (OECD, 2015f) The OECD document draws a clear conclusion about the merits of these two approaches:

CFC rules that focus only on parent jurisdiction stripping may not be as effective against BEPS arrangements for two reasons. First, it may not be possible to determine which country's base has been stripped (for example, in the case of stateless income). Second, even if it were possible to determine which country's base was stripped, the BEPS Action Plan aims to prevent erosion of all tax bases, including those of third countries. This issue is of particular relevance for developing countries. (OECD, 2015f).

These points, and CFC issues more generally, are highly relevant to the UK's position, given that they raise significant competitiveness issues.³⁸ As is well known, the UK has taken what is essentially a tax competition-led decision (in response to the pressure for tax inversions in the period to 2010) in order to lighten the impact of its CFC regime, so that it functions only to prevent the artificial diversion of profits from the UK, not from third countries. The competitiveness basis of the UK's CFC measures is also reflected in the rules accommodating offshore treasury operations, whereby only a quarter of the profits of a controlled foreign finance company are subject to the UK corporate tax, resulting in a tax charge at the level of 5% or less in 2015.³⁹ The BEPS work on CFC rules therefore raises some important issues with regard to the UK's trade-offs between its anti-avoidance agenda and competitiveness issues.⁴⁰ The OECD work also raises three immediate issues for the UK. Firstly, there may be some degree of pressure on the UK to beef up its CFC rules⁴¹. Secondly, the increased focus on CFC measures may make other states more inclined to bring UK activity within the ambit of their own CFC rules.⁴² Thirdly, it is possible (but does not currently seem very likely in practice)

reporting) are being taken up by the UK government, there are some BEPS measures (such as the package of CFC measures and certain proposals on permanent establishments) which are not.

³⁷ See, for example, OECD (2013b, p 16. The point is also emphasised repeatedly in the OECD (2015b), pp. 2 and 6.

³⁸ As is noted in the OECD Discussion Draft, states with CFC rules may be at a competitive disadvantage relative to jurisdictions without such rules (and, similarly, MNCs headquartered in states with robust CFC rules may find themselves at a disadvantage in competing in foreign markets with MNCs headquartered in countries without such rules). See OECD (2015f), pp. 15-16

³⁹ It is understood that the level of the (5%) tax charge set for finance companies is the result of a wholly pragmatic approach being reflected in the law.

⁴⁰ For this reason, it may prove difficult for states that currently have no CFC measures, such as Ireland and Switzerland, to be persuaded by the BEPS process to adopt them.

⁴¹ At the time of writing, this seems a distant prospect, as the UK seems committed to maintaining its current approach to the operation of CFC rules.

⁴² By being less than 25%, the rate of UK corporation tax already brings UK activities potentially within the CFC regime of Germany, where the relevant German conditions of passive income (being all income that is not

that the OECD's investigation of "special measures" to supplement the CFC rules may at some point in the future be revisited, resulting in increased foreign taxation by third party states where an effective CFC rule is not in place.⁴³ Each of these issues has the potential to reduce the UK's competitiveness position, also based on light CFC rules.

Harmful tax practices work and the UK Patent Box: The harmful tax practices work under Action 5 has already led to an instance in which the BEPS project has had the effect of reining back an important component of the UK's tax competition measures; in this case, the Patent Box. Specifically, the 2015 OECD Forum on Harmful Tax Practices (FHTP) reached an agreement about the new rules that will determine what will constitute the required level of "substantial activities" in the context of preferential IP regimes (OECD, 2015a). The compromise agreement was, in turn, based on a UK-German agreement for a proposal (HM Treasury, 2014), which adopted, though in a varied form, the "modified nexus approach" as set out in the earlier OECD BEPS paper, "Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance" (OECD, 2014b). The modified nexus approach essentially provides that the development of the patents has to be carried out in the jurisdiction granting the patent box benefits.⁴⁴ The UK-German agreement was the result of some intense pressure from a number of countries about the position of the UK (which was seen as overgenerous) in relation to the scope of the UK Patent Box regime. The FHTP agreement will mean that all preferential IP regimes are applicable only to patents (or patent-like assets) and may only confer benefits in line with the modified nexus approach.⁴⁵ One practical result of this is that the preferential IP regimes covered by the FHTP agreement will become common in many countries, thus potentially reducing the benefits of more bespoke regimes, such as the one that has operated in the UK.

Interest deductions: The tax treatment of related party debt financing and, specifically, the tax deduction that is generally available for interest and other financial payments, has been a key area of concern since the BEPS project's inception.⁴⁶ The discussion of the issue in the Action Plan identifies two situations (both illustrated in Figure 7) in which the deduction of interest can give rise to double non-taxation. From an inbound perspective, the concern is primarily with lending from a related entity that benefits from a low-tax regime to create excessive interest deductions for the issuer without a corresponding interest income inclusion by the holder. From an outbound perspective, a company may use debt to finance the production of exempt or deferred income, thereby claiming a current deduction for interest expense while deferring or exempting the related income (OECD, 2013b). The relevance of these situations to the tax competition agenda of the UK is centred on the second (outbound) perspective, because the current UK rules potentially facilitate the exact situation that is targeted by the

mentioned in a list of activities that are considered active) and control are met. The UK rate would potentially bring UK entities within the scope of the Japanese CFC rules but for the fact that the effective tax rate threshold of those rules (which was, until recently, 20% or less) has now been changed to less than 20% by the recent Japanese tax reforms (applicable for fiscal years beginning on or after 1 April 2015) in order to ensure UK companies fall outside this threshold test. The Japanese CFC rules will again become an issue for UK entities when the projected corporation tax rate reductions scheduled for 2017 and 2020 are activated.

⁴³ In 2014-15, this work on special measures was pursued by Working Party 6 in the area of transfer pricing as part of Actions 8-10 of the BEPS Action Plan.

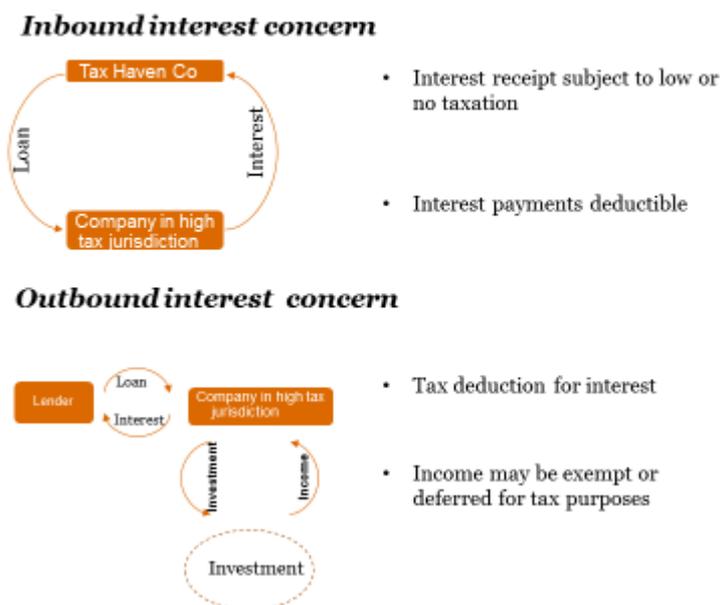
⁴⁴ The Germany-UK agreement provides that up to 30% of the patents can be developed in outsourcing.

⁴⁵ Under the proposal, new entrants will be allowed under existing patent box rules until 30 June 2016. To allow time to transition to the new regime based on the modified nexus approach, the IP that is within existing regimes will be able to retain the full benefits of these until June 2021. As with other aspects of the BEPS programme, there are open questions as to whether the OECD proposals on patent box regimes and the nexus approach can be readily reconciled with EU law. This matter is beyond the scope of this article.

⁴⁶ OECD (2013b), pp. 6, 10, 37, 43, and 48. See also the finalised report, OECD (2015g).

OECD. The inbound concern would clearly be relevant to the offshore finance entities that are treated benignly by the UK CFC rules.

Figure 7. Inbound and Outbound Interest Concern



Under the current UK tax rules, interest deductions are, in principle, available notwithstanding that the debt in respect of which that interest is paid may be financing overseas subsidiaries held from the UK that give rise to tax-exempt foreign income. For example, since 2009, foreign dividends have been exempt from the UK corporate income tax. In many other European countries, however, where such tax-exempt foreign income is received, an interest deduction would typically not be available. The availability of an interest deduction in these circumstances has been a significant factor in encouraging businesses to use the UK as a regional holding location (Section 4.1).

The OECD proposals on interest are intended to lead to significant reductions in the level of interest deductions available to MNEs. The Final Report, released in October 2015, considers two options. Firstly, a fixed ratio test, such as allowing a deduction for interest up to a given percentage of an entity's taxable earnings before interest, taxes, depreciation and amortization (EBITDA). Secondly, a group-wide allocation of interest based on the external interest expense (i.e. loans from unrelated parties) but with the worldwide interest expense being allocated globally rather than being fully deductible in each territory, as the rather more generous UK debt cap allows (OECD, 2015g).

Targeted anti-avoidance rules restricting deductibility in specific situations are considered appropriate when used in conjunction with a general rule, but are not sufficient to prevent BEPS on their own (OECD, 2015g, pp.71-72).⁴⁷ The implications for the UK are, therefore, that a new general rule would need to sit alongside the current targeted anti-avoidance rules.

⁴⁷ In broad terms, the final OECD proposal on this action point is for an interest restriction based on a fixed ratio of interest: EBITDA (10%-30% at a country's choosing) though potentially subject to the actual ratio of a group's external debt if higher and certain other exemptions apply.

Although the UK debt cap rule is in place, so far the restriction on deductibility has generally been pitched at such a high level that it has not affected a significant number of groups, meaning that other anti-avoidance, interest deductibility provisions are generally more relevant.⁴⁸ Just prior to the Brexit vote, it was announced that new rules were to be introduced in the UK from 1 April 2017 to apply the OECD BEPS measures on interest deductibility, resulting in a significant change from the previous position (discussed earlier).⁴⁹

Increased Source Country Taxation: Although the BEPS project has not set out to deliver a change in taxing rights between source and residence countries,⁵⁰ it has been widely acknowledged, including implicitly by the OECD,⁵¹ that this will be an incidental effect of a number of the BEPS action points, as a result of what it refers to as the restoration of both source and residence country taxing rights, given that source taxing rights typically take precedence.

Increased source taxation will arise from a number of the BEPS action points. This includes various proposed PE changes from the work on Action 7 of the Action Plan, including: the widening of the dependent agent PE rule; the narrowing of the independent agent exemption; the narrowing of the specific activity PE exemptions of Art. 5 (4) of the OECD Model; and the introduction of an anti-fragmentation test to prevent attempts to circumvent the application of the threshold PE test. Increasing source taxation will also arise from an increase in payments that are no longer to be tax-deductible, e.g. under the proposals for dealing with hybrid instruments under Action 2, or as a result of the focus on management fees and head office expenses under Action 10. Finally, increased source taxation will also arise from payments that are no longer recognised in whole or in part, e.g. under the various transfer pricing actions under Actions 8 - 10. There will be two effects for source countries: tax revenues will probably increase but, at the same time, investment may decrease because of higher local taxation. This is relevant for both developed and developing economies. Developing economies tend to have higher inbound than outbound FDI as a share of their GDP (Figures 8 and 9), but inbound FDI is also very large in developed economies (Figure 9). The effect on MNEs active in various source jurisdictions but headquartered in capital exporting countries, such as the UK, (Figure 8) will be that such multinationals will invest less or will shift their investments to different jurisdictions to get to the same post-tax return to capital.

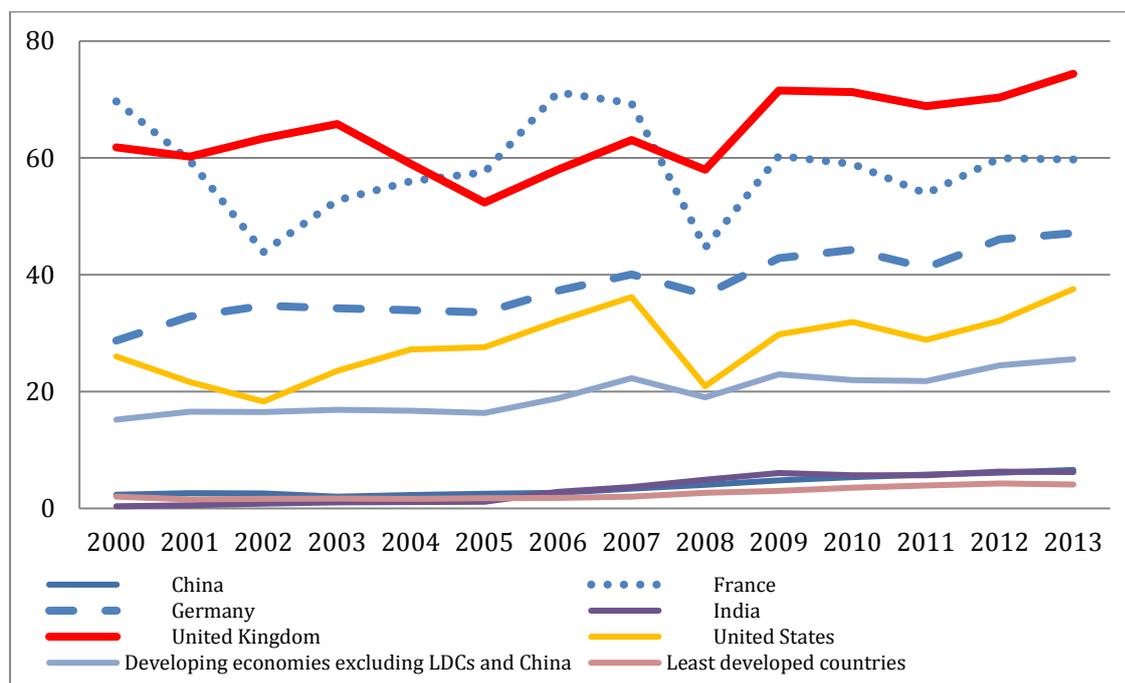
⁴⁸ The UK debt cap operates, broadly, by capping the amount of UK deductible interest by reference to the amount of total interest paid globally by the group as a whole to third parties - see Taxation (International and Other Provisions) Act (TIOPA) 2010, Part 7. Other interest deductibility anti-avoidance provisions that are more likely to apply include restrictions as a result of the transfer pricing/thin capitalisation doctrine (see TIOPA 2010, Part 4) or the unallowable purposes rule of CTA 2009, s.441.

⁴⁹ See further, HM Treasury & HM Revenue and Customs (2015). The OECD proposals on Action Point 4 also suggest that a general rule restricting interest deductibility should apply to: companies in a group, including PEs; connected parties not in a group (e.g. if there is control by an individual, fund, or trust); and related parties (e.g. where there is a significant relationship but not enough to establish control). Such a rule would therefore apply more widely than the UK debt cap and only single entities would be carved out - see OECD (2015g), Chapter 3. However, unlike a number of the other BEPS proposals, the work on interest deductions under Action Point 4 is designed to identify best practice options available to states. The non-mandatory nature of the output therefore gives states some flexibility - and the ability to not adopt the proposed options without being in breach of the BEPS requirements.

⁵⁰ A "source" country is one in which the income of a non-resident arises and is typically subject to tax in that country, whether as a result of that state specifying that the source of certain types of income is in that state or by specifying the items of income that are taxable in the hands of a non-resident in that state. See further Avery Jones et al. (1998), p. 78.

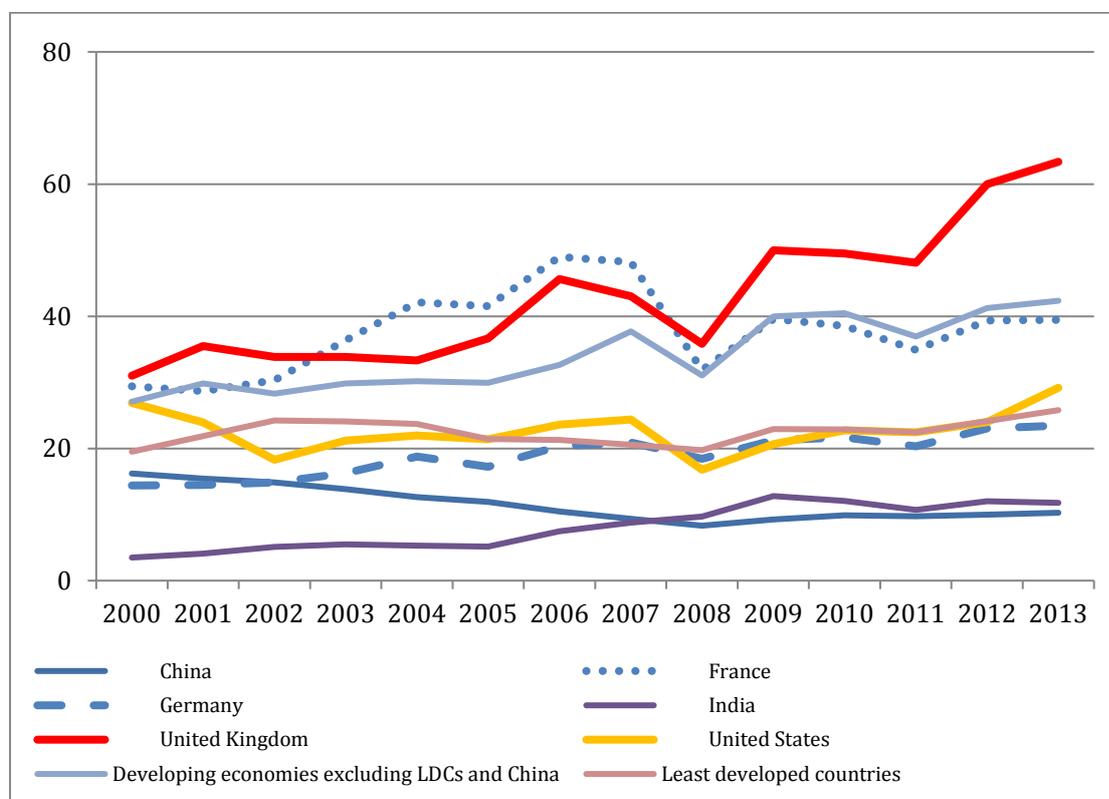
⁵¹ See, for example, OECD (2015c), p. 9, paragraph 3, and the more general discussion of source taxing rights at OECD (2013a) pp. 35-36. The initial OECD position was a greater enthusiasm to take the source versus residence allocation of taxing rights head-on. See further OECD (2013a), p. 7, although this was soon modified.

Figure 8. Outward Stock FDI (% GDP) (2000-2013)



Source: UNCTADStat, www.unctadstat.unctad.org

Figure 9. Inward stock FDI (% GDP) (2000-2013)



Source: UNCTADStat, www.unctadstat.unctad.org

OECD proposals on treaty abuse: A similar point to the one made earlier about increased source taxation relates, in particular, to the use of separate or intermediate vehicles, such as regional holding companies receiving dividends, group treasury companies receiving interest, or companies holding IP rights and receiving royalties. Such companies seek to benefit from tax treaties, usually in order to reduce or remove withholding tax that is otherwise levied in the source country (Figure 2). This follows on from the BEPS work on Action 6, Prevent Treaty Abuse, which is designed to prevent the granting of treaty benefits in inappropriate circumstances.⁵² Given that UK's tax competition policies are directed at attracting businesses that often use this type of vehicle, it seems likely that there would be some level of impact on inbound payments to the UK.⁵³ It might also be argued that any such change would also benefit the UK, if using other jurisdictions for intermediate vehicles were to become more difficult.

Wider Impact of Harmful Tax Practices Work: The harmful tax practices work has been considered earlier in relation to the agreement reached about using the modified nexus approach for IP regimes. However, the intention is that the work under Action 5 should proceed on a much broader footing, including ensuring an appropriate 'substantial activity' test in any preferential regime. It is possible that this may, in the future, raise further issues of relevance to the UK, although at this stage there is nothing to suggest this would be the result. The general point, however, is that the BEPS project's revamp of the OECD's focus on harmful tax practices may be unhelpful to those states wishing to pursue aggressive tax competition agendas.

The likely effect of each of the above examples of work under the BEPS project will be to challenge, to some degree, the competitiveness of the existing UK tax regime. The BEPS project will, therefore, clearly put pressure on the UK's tax competition agenda. This will make the UK's simultaneous championing of the two agendas (i.e. strong support for the BEPS agenda and the aggressive tax competition agenda) more difficult, if not impossible, in the absence of either a tempering of the ambitions of the BEPS project, or some material changes to the way in which the UK seeks to deliver on its tax competition ambition, or both (see below).

Notwithstanding these comments, it is possible to envisage a contrary line of argument to the effect that, in practice, the BEPS project will actually help the UK's tax competition/"open for business" agenda, primarily by bringing about the relocation to the UK of capital, entities, and activities that were formerly based in tax haven or low-tax states, such as Luxembourg and Ireland. The argument would presumably be based on the incremental difficulty - due to the OECD actions under the BEPS project - of operating in such states, when compared to operating in the UK, coupled with the attraction of the relatively low UK tax rate, as now prospectively reduced to 17% by 2020. The likelihood of this result is not considered to be especially strong, particularly given that the UK is heavily reliant on its competitiveness with regard to a number of measures that are targeted by the OECD BEPS project, such as the UK's generous interest deduction and its CFC rules. Also, some countries, like Ireland, currently

⁵² It is proposed that states could achieve this by taking one of three possible approaches to curb treaty abuse: namely by introducing (1) a limitation on benefits (LOB) provision accompanied by a principal purpose test (PPT); (2) a LOB accompanied by a narrower anti-abuse rule; or (3) a stand-alone PPT. See further, OECD (2015i).

⁵³ Though not a BEPS measure per se, the 2014 changes by the OECD to the beneficial ownership test in tax treaties (which, in practice, functions in a very similar way to the type of anti-abuse mechanisms being discussed in the work on Action Point 6) are already being advanced by some tax authorities as the reason for restricting treaty benefits, and this includes in relation to payments made to the UK. See further OECD (2014a).

compete largely on a rate-based approach. This would suggest that such countries would be less vulnerable to the BEPS agenda, which is much more focussed on specific tax regimes than on the level of the tax rate itself.

4.4 Options for the UK

There has not been a great deal of discussion as to whether or not tax competition is the best way forward for the UK. As we have highlighted in Section 2, depending on the circumstances, tax competition could reduce or increase welfare.

Also, there has been little discussion about the kind of investment that is worth attracting to the UK. Headquarters operations generally pay high salaries and employ highly skilled workers but, in an economy with low productivity and low investment, the composition and type of investment that the government wants to stimulate is very important. Historically, UK investment levels have been lower than those of other developed economies, such as France, Germany and Japan (London School of Economics Growth Commission, 2013). In the wake of the global financial crisis, investment levels have dropped substantially. Whilst economic growth and employment levels in the UK have recovered after the crisis, productivity growth has stalled and output per hour is still well below its pre-crisis trend (London School of Economics Growth Commission, 2013). Economists have debated which factors have contributed to the low UK productivity growth.⁵⁴ Views differ, but there is consensus about one factor: low investment especially low investment in equipment that includes information and communications technology (ICT), is a key, although not the sole, determinant. New, more technologically advanced, plant and machinery, and ITC would produce efficiency gains that would increase labour productivity.

A further factor to be considered is the impact of Brexit. As a general matter, the government has put material emphasis on the UK's "open for business" stance since the Brexit decision of 23 June 2016.⁵⁵ In that context, it has taken very little time for questions of tax policy, particularly the UK's intention to remain as tax-competitive as possible, to feature in the discussion. Within days of the Brexit vote, the then Chancellor of the Exchequer, George Osborne, was talking of the possibility of a 15% UK corporation tax rate (Parker, 2016). The corporation tax rate issue has arisen again more recently, in the context of a discussion about the possibility of a "hard" Brexit, this time with suggestions that it could be halved if necessary (Kentish, 2016), suggesting the possibility of a rate of less than 10%. Inevitably, much of this discussion is somewhat speculative, but it does underline the significance of tax measures to any general competitiveness or "open for business" agenda. It is also a salutary reminder of how swiftly (and emphatically) political agendas (including those related to tax policy) can change.⁵⁶

Given that remaining highly competitive is therefore a key part of the UK government's economic policy agenda, we will now investigate the different ways in which the UK tax

⁵⁴ See, for example, Goodridge, Haskel, and Wallis (2015); Pessoa and Van Reenen (2013).

⁵⁵ See, for example, amongst numerous instances, Prime Minister Theresa May reinforcing the UK's "open for business" stance to U.S. business leaders on 19 September 2016 ("Prime Minister Theresa May: Britain is Open for Business") and the same message being delivered to the G20 as reported in the Guardian (Khomami, 2016).

⁵⁶ It is not suggested here that the UK government's wish to counter BEPS practices by MNEs has ceased, but it does seem likely, based on the emphasis from government on the "open for business" agenda, that the consequences of Brexit will affect the relative level of prioritisation of the tax competition agenda as compared with the position prior to the Brexit vote.

system can remain attractive whilst being compliant with the OECD BEPS initiative. In this scenario, the government will have to implement revisions to some specific measures aimed at attracting highly mobile capital and profits, such as the Patent Box regime and, possibly, interest deductions. At the same time, the UK would reduce the tax burden on both mobile and less mobile activities by implementing economy-wide cuts. Three main measures may be considered:

1. **Reduction in the headline corporate tax rate.** This is an option that was immediately pursued by the Conservative government, with the inclusion within its Budget announcement of 8 July 2015 of the intended reduction in the UK Corporation Tax rate to 19% in 2017 and 18% in 2020. Whilst, arguably, giving the UK an early-mover advantage in the post-BEPS environment, it seems likely that pressure on the UK corporation tax rate will continue as other states also reduce their tax rates for corporates.⁵⁷ This seems to have been borne out by the subsequent Budget announcement of 16 March 2016, which stated that the 18% rate planned for 2020 would be reduced further, to 17%. Reductions in the rate of corporation tax will increase the incentive for businesses to locate profits and FDI in the UK. It will also, to a lesser extent, increase the incentive to expand physical investments, once investments have been located in the UK. Table 1 shows that a further cut in the corporate statutory tax rate to 15% would substantially reduce the EATR from 18.49% in 2015 to 14.04%, and the EMTR from 17.14% in 2015 to 12.77% (bottom panel). The UK EATR would become the lowest in the G20 (having been the fifth lowest in 2015), and its EMTR would become the fifth lowest (up from the tenth lowest).

⁵⁷ It seems likely that states such as Luxembourg, which have pursued tax competition policies based on the availability of specific tax regimes, may find such an approach significantly harder as a result of the OECD BEPS project. The result is likely to be that, for such states, future competitiveness will be based more on the rate of tax, which is therefore likely to lead to future cuts in the headline rate. Also, the United States may, for quite different reasons (in particular, the long discussed US tax reform) reduce its rate of tax on corporates.

Table 1. UK EATRs and EMTRs Under Different Scenarios.

	EATR (18.49% in 2015)	EMTR (17.14% in 2015)
Capital Allowance 20%	15.71%	14.11%
Capital Allowance 25%	15.49%	13.33%
Corp. Tax Rate 17%	15.82%	14.51%
Corp. Tax Rate 15%	14.04%	12.77%
Allowance for buildings 4%	15.04%	11.67%
ACE	15.40%	4.08%
G20 Ranking		
	EATR (5th in 2015)	EMTR (10th in 2015)
Capital Allowance 20%	1 st	8 th
Capital Allowance 25%	1 st	6 th
Corp. Tax Rate 18%	1 st	8 th
Corp. Tax Rate 15%	1 st	5 th
Allowance for buildings 4%	1 st	5 th
ACE	1 st	2 nd

Note: With the exception of the case in which the corporate tax rate is 15% or 17%, the EATR and EMTR have been calculated using a corporate statutory tax rate of 17%.

- 2. Increase in capital allowances.** In an environment of low corporate rates, it is unclear how low the rate should go.⁵⁸ Further cuts will entail additional revenue losses but, given that the current 20% rate is (without taking account of the future reductions referred to above) already lower than that of many of the UK's competitors, it is not clear how much extra capital a further reduction would attract.⁵⁹ Additionally, tax policy primarily based on headline rate cuts does not take into account the fact that, when making decisions such as expanding investment in physical capital and ICT, capital allowances are also important in reducing the user cost of capital.

Increasing capital allowances affects the incentives to locate FDI in the UK and also to expand investment once investment has been located in the UK. Recent evidence from the UK and the United States shows that an increase in capital allowances stimulates investment in equipment (including IT and software) substantially and also rather quickly.⁶⁰ Capital allowances could be important in

⁵⁸ It is recognised that, in addition to any international tax aspects of the rate of tax, there will also be a number of very significant domestic matters that will need to be considered.

⁵⁹ The answer will clearly depend on the reaction of other jurisdictions.

⁶⁰ For the UK, see Maffini, Xing, and Devereux (2016). For the United States, see Zwick, and Mahon (2017).

increasing productivity growth in the UK via providing further incentive to increase capital stock. Raising general capital allowances for plant and machinery to 20% would reduce the EATR and the EMTR to 15.71% and 14.11% respectively (Table 1). A more robust increase to 25% would reduce the EATR to 15.49% and the EMTR to 13.33%. In this case, the UK EATR would become the lowest in the G20, but the EMTR would become the sixth lowest, up from the tenth lowest rate in the G20 (Table 1).⁶¹ Re-introducing capital allowances for commercial and industrial buildings at 4% would reduce the EATR to 15.04% and the EMTR to 11.67%. In principle, this would improve the competitive position of the UK: the EATR would become the lowest and the EMTR the fifth lowest. Nonetheless, evidence shows that, whilst investment in equipment is responsive to changes in the EMTR, investment in structures is rather insensitive to the EMTR (Bond & Xing, 2015).

3. **Introduction of an allowance for corporate equity (ACE).** Under an ACE, an imputed return on equity is deductible from the tax base, to mimic the tax break on debt.⁶² An ACE would affect the incentive to locate real investment in the UK and also to expand investment once investment has been located in Britain. The difference between increasing capital allowances and introducing an ACE is that the latter will affect incentives to locate and expand real investment in the UK only if such investment is financed by equity. Increasing capital allowances affects all types of investment, independently of their financing. The ACE has some interesting properties in the context of the BEPS project: since it allows a deduction for the costs of equity financing, it removes the traditional distortion of the corporate income tax system, which favours tax-driven excessive levels of debt. Additionally, since both debt and equity costs are deductible, in principle, there should not be any need to define debt and equity for corporate income tax purposes. This would make a major contribution to simplifying UK tax law, given the large number of separate provisions seeking to police the debt-equity border for tax purposes. This would also make tax planning based on such distinctions (such as hybrid financial instruments) otiose and, therefore, help with a key part of the BEPS agenda.

Restricting the generous UK interest deduction (in implementing the BEPS measures on the restriction of interest) whilst, at the same time, introducing an ACE would potentially assist with: compliance with a key part of the BEPS agenda; maintaining UK competitiveness; and generally improving the efficiency of the UK tax system by reducing the incentive to leverage.

Introducing an ACE would reduce the EATR to 15.40%, without affecting its G20 ranking. Instead, the EMTR would drop substantially from 15.82% (calculated using the 17% statutory rate available from 2020 onwards) to 4.08%, and the UK EMTR would become the second lowest in the G20 (up from the tenth lowest).

⁶¹ An increase in the threshold of the Annual Investment Allowance (AIA) will only affect the EMTR for firms with investment below the threshold. This implies that only firms with investment below such threshold will see their incentives increase. Overall such firms only contribute to a small share of aggregate investment and, hence, the effect of the overall AIA is likely to be small, unless the AIA threshold is set at very high levels.

⁶² The ACE was first proposed by the IFS Capital Taxes Group. For more details, see IFS Capital Taxes Group (1991). The introduction of an ACE in the UK has also been proposed by the Mirrlees Review (The Institute for Fiscal Studies (IFS) & Mirrlees, 2011).

Resistance to the introduction of an ACE seems to come from the idea that the corporate statutory tax rate would need to increase to compensate for the lost revenues (de Mooij & Devereux, 2011). One compromise would be to introduce an ACE only on new capital. This would limit revenue losses at the onset.⁶³ Also, since new capital is more likely to flow to more efficient, more productive businesses with better outlooks, the tax system would allow for a better allocation of capital in the economy.

In a submission to HM Treasury's consultation of October 2015 on restricting interest deductibility (see 4.3 above), we have suggested allowing the same notional deduction for debt and equity financing, so as to eliminate the tax incentive for debt financing relative to equity financing. The change would also remove the incentive for tax planning arrangements designed to exploit the inherent debt bias in the tax rules (Collier, Devereux & Maffini, 2016).

Since countries are constantly changing their own tax rates and bases, and will also need to address their own priorities in accepting and implementing the BEPS package, the maintenance of a highly competitive position for the UK will inevitably depend on what other countries decide to do when implementing the specific recommendations of the OECD BEPS project.

CONCLUSIONS

The following conclusions may be drawn on the basis of the above discussion:

- The OECD BEPS project set off to combat tax avoidance by multinational companies but, in fact, it is inherently a project about limiting tax competition between countries. Multinationals avoid corporate and other business taxes by exploiting specific tax regimes put in place by sovereign states in order to attract mobile capital and profits from other jurisdictions.
- Nonetheless, the OECD BEPS project is unlikely to stop tax competition. In the current climate, coordination is not incentive compatible. This means that there are countries, mostly small open economies, which will gain from tax competition with larger jurisdictions.
- With BEPS, the nature of the tax competition game will change, however. It will become more difficult to compete through individual tax regimes targeted at mobile capital and profits (i.e. multinationals). At the same time, countries will still have a number of tools at their disposal which will enable them to reduce the cost of capital and, hence, attract investment.
- Most likely, some countries will cut their corporate statutory tax rate in order to attract mobile capital and profits. In summer 2015, the UK announced a further 2 percentage point cut in the corporate statutory tax rate so as to reach 18% by 2020, with a further rate cut (to 17% by 2020) announced in the Spring of 2016. In a few years, because of BEPS, we may end up with a much lower average corporate statutory tax rate in the OECD. In fact, many OECD and G20 countries have recently implemented or planned

⁶³ Though this might be problematic whilst the UK is still a member of the EU, the position may be viable post-Brexit. For example, Turkey has introduced an ACE for newly-issued equity as from 1 July 2015 – see OECD (2016), p. 42.

cuts in their statutory corporate tax rates. Such countries include Denmark, France, India, Italy, Japan, Luxembourg, Spain, Portugal and the UK.

- In order to attract or retain mobile profits arising from the exploitation of patents, the countries which do not already have patent boxes will probably adopt versions which are compliant with the BEPS modified nexus approach. Ireland has announced the introduction of a knowledge development box with a rate of 5%. Despite not being particularly aggressive in terms of tax competition, Italy introduced a patent box with effect from 1 January 2015.
- Countries could also increase the depreciation allowances for investment. This would decrease the cost of capital and, hence, have the potential to boost both FDI and domestic investment.
- Another way of reducing the cost of capital under BEPS would be to introduce an Allowance for Corporate Equity (ACE). Surprisingly, the ACE was not discussed in the OECD BEPS project but it has characteristics in line with some of its key aims. In particular, the ACE reduces the incentives to finance investment and activities with debt instead of equity and, at the same time, by treating debt and equity in a similar way, it reduces the incentives to classify financing instruments as debt (instead of equity). To eliminate such incentives entirely, the tax system could give the same notional deduction for both debt and equity financing, as we argue in a parallel work.⁶⁴
- With the exception of the patent box, the tools mentioned above lower the tax burden on all types of capital and profits, whether they are mobile or not. This has the advantage of providing the same tax incentives for both domestic and multinational activities but, as shown in Keen (2001), this could entail larger welfare and revenue losses than a tax competition strategy that only targets mobile capital and profits. Hence, the overall effect of BEPS on citizens' welfare is unclear a priori. The distributional implications of BEPS and of a different type of tax competition are also unclear a priori. Since both BEPS and tax competition target corporations and not individuals directly, we cannot derive any implications as to whether or not BEPS will improve the distributional properties of the tax system.

⁶⁴ If adopted on a wider footing by states, such an approach would also potentially remove the incentive for tax-driven use of many hybrid financial instruments which are otherwise targeted by extremely complex rules. See further OECD (2015h).

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