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Abstract

In the last few years, the UK has adopted a fiercely competitive business tax policy by reducing the general tax burden on business and by expanding individual regimes targeted to mobile factors: CFC rules, interest deductibility rules and the Patent Box have made the UK very attractive for internationally mobile capital and profits. As the same time, the UK has strongly supported the OECD BEPS project aimed at reducing multinationals' tax avoidance and, hence, we argue, at eliminating or constraining forms of tax competition among countries based on individual regimes targeted to mobile capital and profits.

We claim that, especially in the implementation phase of the BEPS recommendations, there will be tensions between the UK competitiveness agenda and its support for the BEPS. Such tensions will be reconciled by shifting the UK tax competition policy from a mix of rate-based plus individual regimes policy to more of a rate-based approach. In this scenario, the government will have to tighten 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, it will reduce the tax burden on both mobile and less mobile activities by implementing economy-wide cuts, allowed under BEPS. Most likely, such cuts would come from a further reduction in the headline corporate tax rate and the cuts announced in the July 2015 Budget should be interpreted in this light. Cuts in the headline rate essentially reduce the taxation on profits but they do not take account of the fact that for other decisions such as investment in tangible assets and information and communications technology, other elements of the tax code such as capital allowances are more important. To foster real investment, the government could consider an increase in capital allowances. Another option would be the introduction of 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.

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Introduction

With the first Budget of the majority Conservative government now delivered, certain aspects of the direction of tax policy under the new Conservative government are becoming clearer. This paper seeks to address one element of that overall approach to tax policy, namely the international tax agenda for business. This is a highly topical area in the light of the OECD's Base Erosion and Profit Shifting (BEPS) project, which the UK has to date so actively sponsored. Of particular interest here is the impact of that BEPS project on UK international tax policy given that the UK's strong support for BEPS does not sit easily with its pursuit of an aggressive tax competition policy.

Notwithstanding the corporation tax rate cutting agenda seen in the July Budget 2015,[1] no comprehensive programme or statement relating to the new government's approach to the international tax agenda for business has been released.[2] Recently, David Gauke, Financial Secretary to the Treasury stated that the new government views the tax system as a key tool to attract business and foster productivity but, at the same time, it values anti-avoidance action as crucial for a fairer business environment.[3] This confirms that there will be a very significant level of continuity with the policies pursued by the previous Coalition government,[4] which prioritized three areas – simplification of the tax system, tackling avoidance and creating the most competitive corporate tax regime in the G20.[5]

There is little evidence of progress having been made with the aim of simplifying the UK tax system,[6] though the area of tax simplification has already emerged as a priority area for the new UK government.[7] The two remaining aims, tackling avoidance and delivering the most competitive corporate tax regime in the G20, have led to a number of actions. In relation to tackling avoidance, one of the most significant of these actions has been – and remains - the government's role in delivering the OECD BEPS project. The UK role in BEPS, which began in 2012, has

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[1] The Budget of 8 July 2015 announced a corporation tax rate cut to 19% in 2017 and 18% in 2020.

[2] During the July Budget, the Chancellor committed to publish a business tax road map in April 2016.

[3] Davide Gauke speaking of "Business taxation plans for the new government", ETPF/IFS Conference: Britain, Europe and Tax Competition, London, 1 June 2015. Jim Harra, HMRC Director General for Business Taxation has recently repeated that the view of the government on business taxation is centered on two main concepts, competitiveness and fairness, as it was for the previous Coalition government (International Fiscal Association – UK branch - Joint meeting with HM Treasury and HM Revenue and Customs, London, 19 June 2015).

[4] The 2015 Conservative manifesto puts significant emphasis on the need to stick to the long term economic plan (of which the prior Coalition tax agenda would have been a component part) and it also makes clear that the Conservative government will continue to crack down on tax avoidance and, in a reference to the BEPS project, will also continue to "lead international efforts to ensure global companies pay their fair share in tax" – see the manifesto at pages 7 and 11.

[5] Coalition agreement, May 2010. For a fuller description of the Coalition approach to business tax, see OUCBT (2015).

[6] Indeed, the Office of Tax Simplification (OTS) identified that since 2010, the government has abolished 57 reliefs, but added 151 new ones (OUCBT (2015), at p.5).

[7] As confirmed by David Gauke speaking at ETPF/IFS Conference: Britain, Europe and Tax Competition, London, 1 June 2015. In particular, the Conservative government plans to make the OTS a permanent watchdog in charge of simplifying the tax system. See also Freedman, Judith, "Tax policy making: beyond simplification", *The Tax Journal*, 28 May 2015 and "Gauke confirms office of Tax Simplification expansion", *Accountancy Age*, 3 June 2015.

become the main plank in its aim to counter cross border tax avoidance and it is clear that the Conservative government intends to continue to pursue its sponsorship of this project.[8] The Coalition government was also very active in pursuing a tax competition agenda, with a dual "rate-based" and "regime-based" approach. It progressively reduced the main rate of corporation tax from 28 to a rate of 20% in 2015. This was coupled with the introduction or maintenance of specific preferential tax regimes, such as the patent box rules which apply a 10% corporation tax rate to income derived from patents and the new controlled foreign corporation (CFC) rules.

The discussion in this paper is concerned with the international tax agenda of the new UK government, and in particular with the relationship – and potential clash - between its goal to maintain a competitive corporate tax regime and its leading role in countering international tax avoidance through the government's continued strong support for the BEPS project.

This paper claims that there are tensions between the UK competitiveness agenda and its support for the BEPS. Such tensions will become more acute when the OECD BEPS recommendations will have to be implemented by the UK government. We argue that it is likely that such tensions will be reconciled by shifting the UK tax competition agenda from a mix of rate-based plus individual regimes policy to more of a rate-based approach. In this scenario, the government will have to tighten 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, it will 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 a further reduction in the headline corporate tax rate. The recent announcement of a reduction of the rate to 18% in 2020 should be interpreted as an attempt to keep the UK business tax system competitive and at the same time, compliant with the OECD BEPS proposals.

Cuts in the headline rate essentially reduce the taxation on profits but they ignore the fact that for other decisions such as real investment, including information and communication technology (ICT) other elements of the tax code such as capital allowances are important. To foster real investment, the government should also consider an increase in capital allowances and the introduction of an Allowance for Corporate Equity.

[8] See footnote 1.

2. The UK tax competition and anti-avoidance agenda

Tax competition

On setting its approach to international tax competition, the current and previous 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 to prevent the growing head of steam for "inversions", i.e. the moving of the "tax domicile" or headquarters of such multinationals abroad.[9] 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 present government – and those of the predecessor Coalition government - of creating a highly competitive tax regime and countering tax avoidance are not new but broadly a continuation of the agenda from the previous Labour government.[10] It was the previous Labour administration which introduced a number of important reforms which are today regarded as the bedrock to 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 overseas investments giving rise to tax exempt income; and the foreign branch exemption[11] initially canvassed by a Labour government but enacted by the Coalition in 2011. It was the previous Labour government that also started the long-running reform of the UK CFC rules and which brought the rate of corporation tax down to 28% from its previous rate of 33% in the previous John Major administration. There has therefore been a high level of consistency in the approach of the UK government to matters of international tax policy going back a number of years.

Not surprisingly, the tax competition agenda pursued by successive UK governments is widely supported by business and it is 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

[9] At this time, a number of UK companies took steps to do just this, with WPP, Henderson Group, United Business Media, Shire, 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– Financial Times (2009). See further, Clements (2013).

[10] The previous Labour government did not identify as its goal the most competitive tax regime in the G20 but as far back as 1999, the tax competitive position of the UK was an important priority for Gordon Brown. In that year, following the reduction of the corporation tax rate (to 30%), he emphasised 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 the Budget Speech of the Chancellor of the Exchequer, 16 March 1999, available at http://news.bbc.co.uk/1/hi/events/budget_99/news/293864.stm

[11] 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.

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).

The statutory tax rate measures the attractiveness of a jurisdiction for mobile paper profits.[12] Figure 1 shows that in 2015 the UK rate is about 7.5 percentage points lower than the OECD average[13] 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 have had lower rates which have attracted activities and structures yielding after-tax benefits. Such small jurisdictions have now become relatively less attractive if compared to the current UK corporate tax rate of 20%, reducing to 18% in 2020 or to the 10% rate available with the Patent Box.

Figure 2 shows the evolution of the EATR[14] which affects the location of investment in the UK, i.e. it affects inward foreign direct investment (FDI). In 2015, the UK EATR is well below the OECD average and it will be even lower in 2020.

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 which affects the size of investment remains relatively high.[15] 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.[16] The UK EMTR declined after 2011 but in 2020 it will still remain above the OECD average (figure 3). This could be problematic. Historically, the UK has had low levels of investment if compared to other developed economies such as France, Germany and the US. This could also partially explain why labour productivity is also low.

Although relatively less attractive for industries with large investment in tangible assets because of a relatively high EMTR, overall, today's UK tax system is very attractive for the location of company headquarters and more generally for the location of activities of multinational companies. There are seven main reasons. First, the exemption system of taxation of foreign profits introduced under the Labour government allows parent companies located in the UK to

[12] 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.

[13] The OECD average excludes the UK and is unweighted. The same applies for the OECD average EATR and the EMTR shown in figure 2 and 3.

[14] The EMTR 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.

[15] 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 focuses on a project that just breaks even by earning a return equal to the cost of capital.

[16] See OUCBT (2015).

receive dividends from subsidiaries which 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 18% 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 locate them in a low-tax entity. Fourth, the new and limited CFC regime allows important exemptions which essentially lower the tax burden on CFCs located in low-tax jurisdictions. In particular, the finance company exemption allows 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, 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 generous rules for the deduction of interest payments. Although a worldwide debt cap[17] for large companies was introduced in 2009 under the Labour government, current interest rules remain relatively generous by international standards.

Avoidance

Turning to the 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. The Chancellor George Osborne has described the UK as having "led the way" in this international action, with the UK "pushing […] for global solutions".[18] The message is echoed from all quarters of government. For example, David Cameron has spoken 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.[19] David Gauke has also commented in relation to the government that "we've taken a lead role so far on the international stage through the base erosion and profit shifting– or BEPS – project which seeks to address tax avoidance. And that's why we will continue to work through the G20

[17] 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 affects only 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.

[18] HM Treasury, HMRC, "Taxing aggressive tax planning in the global economy: UK priorities for the G 20 – OECD project for countering Base Erosion and Profit Shifting', March 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 Shauble, at the time of the November 2012 G 20 meeting.

[19] David Cameron statement, available at https://www.gov.uk/government/news/pm-praises-oecd-action-plan-to-tackle-tax-evasion-and-avoidance.

and OECD to make sure that this area is properly reformed".[20] More recently, he has confirmed that the new Conservative government is determined to take the BEPS project ahead and keep momentum to create a coherent tax system which is fit for purpose for the 21st century.[21] Shortly after, Fergus Herradance, Deputy Director of Corporate Tax at HM Treasury stated that the UK fully supports BEPS and is pleased with its progress.[22] The strong UK championing of BEPS has led to the UK being the first country to commit publicly to adopting the country-by-country reporting (CBCR) template developed under the BEPS Action Plan.

Given that the BEPS project was initiated in 2012, it post-dated the previous Labour government, but the Labour Party in opposition has expressed strong support for the initiative.[23]

3. Tax competition and anti-avoidance measures.

Having noted the government's wish to "lead international efforts to ensure global companies pay their fair share in tax" (reflected in their wish to take a leading role in sponsoring and advancing the OECD BEPS project) and also noted the high UK priority that is given to a tax competition strategy, it is appropriate to turn to the question of the relationship between competitive policies and anti-avoidance measures (which is essentially the nature of BEPS). In particular, it is relevant to address the question whether they are necessarily at odds or whether they could be complementary.

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 and hence, the government's anti-avoidance action is not necessarily and in principle at odds with the intention to make the UK 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 respect to their distributional effects on society. The argument is simple and

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[20] David Gauke, Speech to the Securities Industry Conference, 3 October 2014, available at https://www.gov.uk/government/speeches/david-gaukes-speech-to-the-securities-industry-conference.

[21] Davide Gauke speaking of "Business taxation plans for the new government", ETPF/IFS Conference: Britain, Europe and Tax Competition, London, 1 June 2015.

[22] International Fiscal Association – UK branch - Joint meeting with HM Treasury and HM Revenue and Customs, London, 19 June 2015.

[23] See, for example, the comments on BEPS of Shabana Mahmood, then Shadow Minister (Treasury) in the debate on the diverted profits tax, available at http://www.theyworkforyou.com/whall/?id=2015-01-07a.92.0 and the Labour's Policy Review, Delivering Long-term Prosperity-Reform of Business taxation, 30 June 2014, at p.18.

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. However, and 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, they 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. First, there is uncertainty with respect to the real incidence of the corporate income tax. Much of the literature points to a large part of corporation tax being passed on in lower wages, although there are mixed results on that point.[24] Second, even if we knew who effectively bears the tax, we would not know whether such individual is rich or poor. For example, the distributional implications of a tax borne by employees would be different, depending on whether such employees are top managers or general employees. For these reasons, it is difficult to draw straightforward distributional implications of a competitiveness, and of an anti-avoidance, agenda targeted at corporations. In summary, the benefits of tax competition depend on who gets the final benefit of the tax cuts.

On revenues, anti-avoidance measures and tax competition policies generally have opposite effects: 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 and this could reduce welfare if we assume a benevolent government that, before competition-induced tax cuts, was already implementing optimal policies.
If instead there is room for improving the efficiency 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 for a shift from income to consumption taxes, and would also have the benefit of better distributional properties.[25] 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.[26] 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

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[24] See among others, Arulampalam , Wiji, Devereux, Michael and Maffini, Giorgia (2012) The Direct Incidence of Corporate Income Tax on Wages. *European Economic Review*, 56 (6). pp. 1038-1054 and Do Higher Corporate Taxes Reduce Wages? Micro Evidence from Germany
Fuest, C., Peichl, Andreas and Seigloch, Sebastian (2015) Do Higher Corporate Taxes Reduce Wages? Micro Evidence from Germany, *American Economic Review*, *forthcoming*.

[25] Tax policy for economic recovery and growth’ (Jens Matthias Arnold, Bert Brys, Christopher Heady, Åsa Johansson, Cyrille Schwellnus and Laura Vartia), *Economic Journal* (2011) 121, 59–80.

[26] Arachi, Giampaolo, Valeria Bucci and Alessandra Casarico, Tax structure and macroeconomic performance, *International Tax and Public Finance, forthcoming.*

be addressed with the personal income tax, the inheritance tax and possibly recurrent taxes on property as they can be targeted more directly to the individual taxpayer's income and wealth.

In an open economy, the government can attract capital in two ways. First, it can lower the tax burden for all investors. Second, it can target the most mobile factors such as productive capital and paper profits. In relation to corporates, both policies have been pursued by UK governments in recent years: for example, the Coalition government lowered the statutory corporate rate by 8 percentage points in five years (from 28% to 20%) for all companies and this approach is being continued by the Conservative government's planned further reductions in the rate to 18% by 2020. At the same time, the introduction of the Patent Box, the new CFC rules and the preservation of a generous regime for interest deductions all specifically target internationally-mobile capital.

Economic theory suggests that it may be optimal to reduce the cost of capital only on the most mobile factors.[27] The implication is that governments should compete only on mobile factors. This policy approach would have two main advantages. First, it would attract mobile productive capital and hence investment which would instead leave or avoid a high tax jurisdiction. Second, by targeting only 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.[28] It has to 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.

If economic theory provides some ground 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. The BEPS project is putting a number of such favourable domestic measures under considerable international pressure, in many cases leading to change being introduced unilaterally. This can be seen in a number of cases.

One of the most high-profile of recent cases has been the "double Irish" structure, which delivers an effective tax rate which 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 4, 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

[27] Keen, Michael, Preferential Regimes can Make Tax Competition Less Harmful, *National Tax Journal* (2001), p.757-762.

[28] Keen, Michael and Kai A. Konrad, The Theory of International Tax Competition and Coordination, Handbook of Public Economics, (2013) 5, p. 257-328.

management and control" test of residence. The company is incorporated in Ireland but 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.[29] A new rule therefore provides that companies will no longer be able to incorporate in Ireland without also being tax resident there.[30]

Another example relates to the Netherlands. The tax system of that country facilitates the use of Dutch companies for holding and financing of international groups given that the Netherlands: has a very wide tax treaty network which will reduce withholding taxes on in-bound payments; allows the tax-exempt receipt of dividends and capital gains from overseas subsidiaries; has no CFC rules;[31] and imposes no withholding tax on interest and royalties and limited withholding tax on dividends paid out of the country. Figure 5 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.[32] 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.

There are also a number of other examples relating to the UK, such as the pressure from other states on what are perceived as the UK's over-limited CFC rules, the over-generous interest deduction that is available and of course the UK patent box rules, which latter have already been re-drawn due to international pressure in the BEPS process. All of these UK examples are discussed further below.

[29] See Ireland to abolish controversial "double Irish" tax arrangement, The Guardian, 14 October 2014 - http://www.theguardian.com/world/2014/oct/14/ireland-abolish-double-irish-tax-scheme-apple

[30] The new rule takes effect from 1 January 2015. (see now section 23A Taxes Consolidation Act 1997, as amended by s.43(1)(a) Finance Act 2014). It is also provided that companies already using these arrangements will have a five year window to exit them (see s.43(2) Finance Act 2014).

[31] It should be noted though that an overseas low 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.

[32] 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, it is in the international arena that the competitiveness and the anti-avoidance agendas will often conflict when specific measures lowering the cost of capital for mobile activities (competitiveness) attract tax base from high tax jurisdictions, facilitating what is perceived by other states as aggressive tax avoidance.

4. BEPS and Tax Competition Policies

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, before proceeding to consider the particular issues for the UK.

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 tax measures they judge to be right.[33]
This could be taken to suggest the BEPS project has no impact on tax competition, particularly as both the initial papers on BEPS released by the OECD[34] (which set out the OECD's concerns relating to BEPS practices) do not contain any extended discussion on the need to address tax competition practices.[35] However, despite not seeking to tackle tax competition practices head on, most of the individual action points which are being pursued as part of the BEPS project have a significant potential to impact adversely tax rules which 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.

Apart from the digital business issue (which is recognized as raising some particular issues), the BEPS Action Plan groups the bulk of its identified actions to address BEPS practices by reference to three main themes:
(1) increasing transparency;
(2) realigning taxation with substance (which means taxing profits where they are substantively created);

[33] OECD (2013), Addressing Base Erosion and Profit Shifting, OECD Publishing, pp. 28 and 39. See also OECD (2013) Action Plan on Base Erosion and Profit Shifting, OECD Publishing, p. 15 which repeats the point.
[34] OECD (2013), Addressing Base Erosion and Profit Shifting, OECD Publishing and OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing.
[35] There is a brief discussion of the historical work of the OECD on harmful tax practices but little discussion of the tension contribution of tax competition policies to the creation of BEPS opportunities – see pp 28-29 OECD (2013), Addressing Base Erosion and Profit Shifting, OECD Publishing.

(3) ensuring the "coherence" of the system which means getting rid of loopholes, gaps or mismatches in the interaction of countries' domestic tax laws which can be exploited.

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

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.[36] 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, subsidies, etc. that are otherwise intended to remain private and of specific tax authority practices which are variance with accepted standards. This in turn is likely to lead to increased challenges, most likely to MNEs taking advantage of the relevant tax rules, but possibly to the states operating those regimes.[37]

Taxation and economic substance

The BEPS work on "realigning taxation with substance" is based on the wish 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.[38] This includes work streams on treaty abuse (Action 6 of the Action Plan); preventing artificial avoidance of the permanent establishment (PE) threshold (Action 7); and a cluster of transfer

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[36] See further, OECD Discussion Draft of Transfer Pricing Documentation and CbC Reporting, 30 January 2014, pp 5-6. This document sets out the two-tiered approach to transfer pricing documentation involving a master file (which would contain common standardized information relevant for all MNE group members and setting out a "blueprint" of the MNE group and its business) and a local file which 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.

[37] 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 especial 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, Communication from the Commission to the European Parliament and the Council on Tax Transparency to Fight Tax Evasion and Avoidance, Brussels, 18 March 2015, COM (2015) 136 Final.

[38] For a discussion of the problems relating to aligning taxation with substance, see Vella, John and Michael Devereux, 'Are we heading towards a corporate tax system fit for the 21st century?' (2014) 35, *Fiscal Studies*. It should also be noted that The European Commission has recently identified 5 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 Communication from the Commission to the European Parliament and the Council, Brussels, 17 June 2015, COM (2015) 302 final

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 given that the intention is that 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 very much more difficult to sustain in the light of the beefed-up transfer pricing and PE rules that the BEPS project is seeking to introduce.[39] The same would be true in cases where specific risks 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, for example 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 already[40] but are likely to increase due to BEPS changes to the international tax rules.

Coherence

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

Four action points are grouped under the coherence theme:
1) neutralize hybrid mismatch arrangements (Action 2);
2) strengthen CFC rules (Action 3);
3) limit interest deductions and other financial payments (Action 4);
4) revamp of the harmful tax practices work itself (Action 5).

The BEPS work on hybrids is arguably the most complex part of the BEPS action points. Broadly, the hybrids targeted include hybrid instruments and hybrid entities. Hybrid instruments are typically characterized differently as equity or debt for tax purposes in the jurisdictions of investor and issuer. Hybrid entities are again characterized 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 neutralizing 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 6, has been to secure tax deductions for

[39] The BEPS transfer pricing work may mean that the legal ownership of the IP is not respected for tax purposes or that, even if it is so respected, 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.
[40] See for example the Canadian case of Velcro Canada v The Queen, 2009 DTC 5053 (FCA).

the relevant service payments in the hands of the payor (on the basis the payor'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 the recipient's jurisdiction would characterize 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 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 payment may not be taxed (or be taxed at a low rate) and this will obviously affect regimes to the extent 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 both the parent jurisdiction and having also positive spillover effects for tax revenues in source countries (such as developing countries) because the effect of such rules should mean 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 action point 5 of the Action Plan,[41] on revamping the OECD's harmful tax practices initiative of the late 1990s. This is the only part of the Action Plan which is directly targeting certain tax competition practices by states, specifically what are regarded as "harmful tax practices", which represent a subset of tax competition practices.[42] In the recent BEPS interim report on this topic, it is stated: "…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."[43]

The focus of this work stream within BEPS is 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.[44]

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[41] OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing, pp 17-18 and see also OECD (2014), Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, OECD/ G20 Base Erosion and Profit Shifting Project, OECD Publishing.

[42] The landmark 1998 report referred to "Harmful Tax Competition" in its title -OECD (1998), Harmful Tax Competition: An Emerging Global Issue, OECD Publishing.

[43] OECD (2014), Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, OECD/ G20 Base Erosion and Profit Shifting Project, OECD Publishing, p. 14.

[44] 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 which do not directly involve a great deal of economic activity or substance (which tend to be regarded as unacceptable by BEPS). The distinction is arguably not so straight forward. Essentially, tax competition is a device or mechanism 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 are directly targeted to real investment or that lower the cost of financing such investment, that is with measures which target financial investment which will therefore indirectly target real investment. An example of tax competition rules

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 impact adversely at least some tax competition practices of states. As will be discussed further below, this harmful tax practices work of the OECD has already been in conflict with one of the primary features of the UK tax competition policy, namely the UK Patent Box.

It should be emphasized 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 which are likely to have a negative impact 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).

5. Impact of BEPS on Existing UK Policies[45]

Having considered at a general level the potential impact of BEPS on tax competition policies operated by states, it is now appropriate to return to the UK's international corporation tax agenda. 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. To a large degree, the point has not so far been directly tested, largely because the debate to date has been about the *positioning* of the

lowering the cost of capital by targeting the cost of financing are the UK CFC rules and their offshore financial companies reduced rate of tax. 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 investment will not obviously be founded on economic principle. 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.

[45] 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 an 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.

government on these issues: there have been relatively limited instances in which *actions* have been taken which highlight this clash of agendas. This state of affairs is now very likely to change, particularly as the OECD moves from the policy phase of BEPS (when new measures are under development in the BEPS programme of work and which is to conclude by the end of 2015), to the implementation stage, which for some measures is already underway but which is the priority for 2016.

A key feature of multilateral, as compared with 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 which are quite different to those of the UK. Germany, for example, has historically been strongly opposed to tax competition. The US is known to favour a tougher and more extensive CFC approach 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. Not surprisingly, the result is that the proposed actions under the BEPS project are not aligned with the domestic UK agenda to create the most tax competitive tax regime in the G20. As discussed in the previous section, the BEPS project is leading to required 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 for the UK to maintain simultaneously both its leadership role in delivering BEPS *and* its objective of maintaining a highly competitive tax system. Rather, it seems likely that it will have to make choices on its real priorities.

This point can be tested by considering various examples of specific rules being developed under the BEPS project which would seem to present material difficulties to the UK if it seeks 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 from an early stage recognized that whilst many countries have introduced CFC and other anti-deferral rules, they do not always counter BEPS practices in a comprehensive way.[46] 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 recognizes that CFC rules may be used to prevent shifting of income either from the parent jurisdiction or from the parent and other tax jurisdictions.[47] The OECD document draws a clear conclusion on 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

[46] See for example, OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing, p 16. The point is also emphasized repeatedly in the Public Discussion Draft of 12 May 2015 – Public Discussion Draft, BEPS Action 3: Strengthening CFC Rules, 12 May 2015, pp 2, 6.

[47] OECD, Public Discussion Draft, BEPS Action 3: Strengthening CFC Rules, 12 May 2015, p 8.

particular relevance for developing countries."[48] These points, and CFC issues more generally, are highly relevant to the position of the UK given that they raise significant competitiveness issues.[49] As it 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) 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 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.[50] The BEPS work on CFC rules therefore raises some important issues on the trade-offs between the anti-avoidance agenda and competitiveness issues for the UK.[51] The OECD work also leads to three immediate issues for the UK. First, there may be additional pressures on the UK to beef up its CFC rules. Second, the increased focus on CFC measures may make other states more inclined to bring UK activity within the ambit of their own CFC rules.[52] Third, it is possible (but does not currently seem likely in practice) that the OECD's investigation of "special measures" to supplement the CFC rules may progress, resulting in increased foreign taxation by third party states where an effective CFC rule is not in place.[53] All these issues have the potential to reduce the competitiveness position of the UK, 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 where 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 OECD Forum on Harmful Tax Practices (FHTP) has now reached agreement on the new rules that will determine what will constitute the required level of "substantial activities" in the context of preferential IP regimes.[54] The compromise agreement

[48] OECD, Public Discussion Draft, BEPS Action 3: Strengthening CFC Rules, 12 May 2015, pp 12-13.

[49] 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, Public Discussion Draft, BEPS Action 3: Strengthening CFC Rules, 12 May 2015, p 8.

[50] 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.

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

[52] 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 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.

[53] This work is being pursued by Working Party 6 in the area of transfer pricing as part of Actions 8-10 of the BEPS Action Plan.

[54] OECD/G20 Base Erosion and Profit Shifting Project, Action 5: Agreement on Modified Nexus Approach for IP regimes, OECD, 6 February 2015.

was in turn based on a UK– German agreement for a proposal[55] 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.[56] 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.[57] The UK-German agreement was the result of some intense pressure from a number of countries on the position of the UK (which was seen as over-generous) 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.[58] One practical result 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, represents a key area of concern in the BEPS project.[59] The discussion of the issue in the Action Plan identifies two situations (both are illustrated in Figure 7) where 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.[60] The relevance of these situations to the tax competition agenda of the UK is centered on the second – outbound – perspective because the UK rules potentially facilitate the exact situation that is targeted by the OECD. The inbound concern would clearly be relevant to the offshore finance entities that are treated benignly by the UK CFC rules.

Under 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 (as a result of the UK's 2009 "foreign profits" reforms). In many other countries, however, where such tax-exempt foreign income is received, an interest deduction would not be available in these circumstances. The availability of an interest deduction in these circumstances has been a significant

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[55] The UK-German proposal may be seen at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/373135/GERMANY_UK_STATEMENT.pdf.

[56] OECD, Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, OECD Publishing, 16 September 2014.

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

[58] 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.

[59] OECD (2013), Addressing Base Erosion and Profit Shifting, OECD Publishing, pp 6, 10,37,43,48.

[60] OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing, p. 16.

factor in encouraging businesses to use the UK as a regional holding location (section 2). The OECD proposals on interest are intended to lead to significant reductions in the level of interest deductions available to MNEs. The Discussion Draft released in December 2014 considers two options. First, a fixed ratio test, for example allowing a deduction for interest up to a given percentage of an entity's taxable earnings before interest, taxes, depreciation, and amortization (EBITDA). Second, a group wide allocation of interest based on the external interest expense (i.e., loans form unrelated parties) but with the worldwide interest expense being allocated globally rather than fully deductible in each territory, as the rather more generous UK debt cap allows.[61] Targeted rules are considered appropriate to combine with a general rule, but not sufficient on their own to prevent BEPS.[62] The implications for the UK are therefore that a new general rule would need to sit alongside the current rules (such as for unallowable purposes, arm's-length provisions, anti-arbitrage, etc.). 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 interest deductibility provisions are generally more relevant.[63] This position would be expected to change markedly in the event the OECD proposals were fully applied.[64]

Increased Source Country Taxation: Although the BEPS project has not set out to deliver a change in taxing rights as between source and residence countries,[65] it is widely acknowledged, including implicitly by the OECD,[66] 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

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[61] OECD (2014), Public Discussion Draft, BEPS Action 4: Interest Deductions and Other Financial Payments, OECD, 18 December 2014.

[62] OECD (2014), Public Discussion Draft, BEPS Action 4: Interest Deductions and Other Financial Payments, OECD, 18 December 2014, pp 55-57. At the time of writing, it seems that the final OECD proposal on this topic will be for an interest restriction based on a fixed ratio of interest: EPITDA (10-30% at a country's choosing) though subject to the actual ratio of a group's external debt if higher and certain other exemptions.

[63] The 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 capitalization doctrine (see TIOPA 2010, Part 4) or the unallowable purposes rule of CTA 2009, s.441.

[64] The OECD proposals also suggest that a general rule 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 (2014), Public Discussion Draft, BEPS Action 4: Interest Deductions and Other Financial Payments, OECD, 18 December 2014, pp 19-20. 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.

[65] A "source" country is one in which the income of a nonresident arises and is 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 nonresident in that state. See further J F Avery Jones and others, Tax Treaty Problems Relating to Source, European Taxation, March 1998, p78.

[66] See, for example, Discussion Draft on Action 7 (Prevent The Artificial Avoidance of PE Status), OECD 15 May 2015, p 9 at para.3 and the more general discussion of source taxing rights at OECD (2013) Addressing Base Erosion and Profit Shifting, OECD Publishing, pp35-36. The initial OECD position was a greater enthusiasm to take head on the source v residence allocation of taxing rights – see further OECD (2013), Addressing Base Erosion and Profit Shifting, OECD Publishing, p 7 – though this was soon modified

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, e.g. 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. 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 recognized 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 would probably increase but investment may decrease because of higher local taxation. This is relevant for both developed and developing economies. Developing and least developing economies tend to have higher inbound than outbound FDI as a share of their GDP (figure 8 and 9) but inbound FDI is also vary 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 they will shift their investment to a different jurisdiction to get to the same post-tax return to capital.

OECD proposals on treaty abuse: A similar point to the one made above on 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 to reduce or remove withholding tax that is otherwise levied in the source country (figure 5). This follows from the BEPS work on Action 6, Prevent Treaty Abuse, which is designed to prevent the granting of treaty benefits in inappropriate circumstances.[67] Given that UK tax competition policies are directed at attracting businesses which often use the type of vehicles referred to above, it seems likely that there would be some level of impact on inbound payments to the UK.[68] It might also be argued that any such change would also benefit the UK, in case using other jurisdictions for intermediate vehicles becomes more difficult.

Wider Impact of Harmful Tax Practices Work: the harmful tax practices work has been considered above in relation to the agreement reached on 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

[67] It is proposed to achieve this by three possible approaches states could follow 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, Public Discussion Draft, Follow Up Work on BEPS Action 6: Preventing Treaty Abuse, OECD, 21 November 2014 and also Revised Discussion Draft, BEPS Action 6: Prevent Treaty Abuse, OECD, 22 May 2015.

[68] 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 2014 Update to the OECD Model Tax Convention, available at http://www.oecd.org/tax/treaties/2014-update-model-tax-concention.pdf.

this may in future raise further issues of relevance to the UK, though at this stage there is nothing to suggest this result. The general point, however, is that the revamping in the BEPS project of the OECD focus on harmful tax practices may be unhelpful to those states wishing to pursue an aggressive tax competition agenda.

The likely effect of each of the above examples of work under the BEPS project is 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 in the absence of either a tempering of the ambition of the BEPS project or some material changes to the way in which the UK seeks to deliver on its tax competition ambition (see further 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 tax competition/open for business agenda of the UK, primarily by bringing about the relocation to the UK of capital, entities and activities that were formerly based in tax haven or low 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 as compared to operating in the UK, coupled with the attraction of the relatively low UK tax rate, as now prospectively reduced to 18% by 2020 by the recent Budget. The likelihood of this result is not considered to be especially strong, particularly given that the UK is heavily reliant for its competitiveness on a number of measures which are being pressured by the OECD BEPS project, such as the UK's generous interest deduction and its CFC rules. Also, some countries, like Ireland, currently compete largely on a rate-based approach, rather than the mixed approach of rate plus specific regimes like the Patent Box as is the case with the UK. This would suggest that such countries would be less vulnerable to the BEPS agenda which is much more focused on specific tax regimes than the level of the tax rate itself.

Even if these comments underestimate the force of this alternative line of argument and that argument does correctly reflect the future result on the UK from BEPS, there would presumably still be some level of change in the UK tax competition landscape given that the UK regime would need to have adapted to more of a rate-based competition approach. This is because BEPS makes the operation by states of individual regimes designed to attract mobile capital harder to sustain, and this has a clear relevance for the UK. As noted, the UK has been pursuing a mixed tax competition policy focused on tax rate and "individual regime" approaches (Patent Box, generous interest deduction, CFC rules). The BEPS output will make the UK's "individual regime" approach less effective – either because it is constrained (as with the current Patent Box, and possibly interest deduction rules) or because it becomes commoditized (as with the patent box under the broadly agreed modified nexus approach). Thus, a successful completion of the BEPS project is more likely to lead the UK to move from its mixed approach to more of a rate-based approach if the aggressive tax competition ambition is to be retained. In this context, the recently announced

prospective reduction in corporation tax rate is hardly surprising – indeed, the cuts announced to the UK corporation tax rate seem inevitable as a by-product of the BEPS project. Remaining competitive whilst implementing BEPS requires a general, not targeted reduction of the tax burden which can be delivered through a cut on the headline corporate tax rate, among other measures.
The recently announced cuts also signal a strong statement of intention to continue the pursuit of an aggressive tax competition policy, irrespective of the BEPS project.

6. Options for the UK

There has not been a great deal of discussion on whether tax competition is the best way forward for the UK. Rather, competitiveness seems to be widely accepted as an important tool to attract investment, increase growth and ultimately, increase living standards. However, economic theory suggests that unconstrained tax competition will lead to under-provision of public goods, relative to what is regarded as the social optimum: in equilibrium, the tax rate is too low and all countries would benefit from a small, uniform increase in tax rates. Hence, it is argued, coordination among countries would improve welfare (Keen and Konrad, 2012). Coordination has proved very difficult to achieve. 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. In equilibrium there will be different tax rates across countries. More generally, equilibrium tax rates will be lower in jurisdictions with a smaller endowment of capital, which are more productive and value public spending less (Keen and Konrad, 2012).

Also, there has been little discussion of what kind of investment 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 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. In the wake of the global financial crisis, investment levels have dropped substantially. Whilst UK economic growth and employment have resumed after the crisis, productivity growth has stalled and output per hour is still well below its pre-crisis trend.[69] Economists debate on which factors can have contributed to the low UK productivity growth.[70] Views differ but there is consensus on one factor: low investment and especially low investment in equipment which includes information and communications technology (ITC) is a key, although not the sole, determinant. New, more technologically advanced plant and machinery and ITC would produce efficiency gains which increase labour productivity.

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[69] London School of Economics Growth Commission, Report – Investing in Prosperity, 2013.

[70] See for example, Peter Goodridge, Jonathan Haskel, Gavin Wallis, "Accounting for the UK productivity puzzle: a decomposition and predictions", Imperial College Business School, Discussion Paper 2015/02, February 2015; Pessoa and Van Reenen "The UK Productivity and Jobs Puzzle: Does the Answer Lie in Does the Answer Lie in in Labour Market Flexibility?", Centre for Economic Performance, Special Paper No. 31, June 2013.

Given that remaining highly competitive is a key part of the UK government economic policy agenda, we investigate the different ways in which the UK tax 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 has been immediately pursued by the Conservative Government, with its Budget announcement of 8 July 2015 that the UK corporation tax rate is to be reduced to 19% in 2017 and to 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 rate for corporates.[71] Reductions in the rate of corporation tax will increase the incentive to locate profits and FDI in the UK and, to a smaller extent, it will increase the incentive to expand physical investment, once investment is 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 the current 17.14% in 2015 to 12.77% (bottom panel). The UK EATR would become the lowest in the G20 (versus the fifth lowest in 2015) and the EMTR the fifth lowest (up from the tenth lowest).
2) **Increase in capital allowances**. In an environment of low corporate rates, it is unclear how low the rate should go.[72] Further cuts will entail additional revenue losses but, given that a 20% rate was already lower than that of many other UK competitors, it is not clear how much extra capital a further reduction will attract.[73] Additionally, tax policy primarily based on headline rate cuts does not consider that for decisions such as expanding investment in physical capital and ITC, capital allowances are also important in reducing the user cost of capital.
   Increasing capital allowances affects the incentive to locate FDI in the UK and also, to expand investment once investment is located in the UK. Recent evidence from the UK and the US shows that an increase in capital allowances stimulates investment in equipment (including IT and software) substantially and also rather quickly.[74] Capital allowances could be important in increasing productivity growth in the UK via providing

[71] It seems likely that states such as Luxembourg, which have pursued a tax competition policy 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 US may, for quite different reasons – in particular, the long discussed US tax reform - reduce its rate of tax on corporates.

[72] It is recognized 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.

[73] The answer will clearly depend on the reaction of other jurisdictions.

[74] For the UK, see Giorgia Maffini, Jing Xing and Michael P. Devereux, "Capital allowances and investment: evidence from UK corporate tax returns", Oxford University Centre for Business Taxation, *mimeo*. For the US, see Erick Zwick and James Mahon, "Do Financial Frictions Amplify Fiscal Policy? Evidence from Business Investment Stimulus", *American Economic Review, forthcoming*.

extra incentive to increase capital stock. Raising general capital allowances for plant and machinery to 20% would reduce the EATR and the EMTR to 16.59% and 14.97% respectively (table 1). A more robust increase to 25% would reduce the EATR to 16.36% and the EMTR to 14.15%. 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).[75] Re-introducing capital allowances for commercial and industrial buildings at 4% would reduce the EATR to 15.88% and the EMTR to 12.40%. 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.[76]

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.[77] An ACE would affect the incentive to locate real investment in the UK and also, to expand investment once investment is 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: 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.
Restricting the generous UK interest deduction (in response to BEPS pressure under Action 4) whilst at the same time introducing an ACE would potentially assist in: complying 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. The interesting feature of the ACE in the context of BEPS is that it reduces the incentive to classify financing instruments as debt (instead of equity)

[75] 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.

[76] See Steve Bond and Jing Xing (2015) "Corporate taxation and capital accumulation: evidence from sectorial panel data for 14 OECD countries", Oxford University Centre for Business Taxation working paper 10/15.

[77] The ACE was first proposed by the IFS Capital Taxes Group. For more details, see IFS, Equity for Companies: A corporation tax for the 1990s, April 1991. The introduction of an ACE in the UK has also been proposed by the Mirrlees Review. James Mirrlees , Stuart Adam , Tim Besley , Richard Blundell , Steve Bond, Robert Chote , Malcolm Gammie , Paul Johnson , Gareth Myles and James Poterba, "Tax By Design", Oxford University Press, 2011.

because under an ACE, equity would enjoy more or less the same tax break as debt.

Introducing an ACE would reduce the EATR to 16.32% without affecting its G20 ranking. Instead, the EMTR would drop substantially from 15.54% (calculated using the 18% statutory rate available from 2020 onwards) to 4.36% and the UK EMTR would become the second lowest in the G20, up from the tenth lowest. 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.[78] One compromise would be to introduce an ACE only on new capital. This would limit revenue losses at the onset. Also, since new capital is more likely to flow to more efficient, more productive businesses with a better outlook, the tax system would allow for a better allocation of capital in the economy.

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 maintaining 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. For example, Ireland has recently decided to reform its rules on corporate tax residence and at the same time, it has announced the intention to bring in a "knowledge development box" at a rate of 5% for income derived from patents and 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.[79]

Given the short time since the UK election, there have been relatively limited, indications to date on the future direction that would be taken by the UK government when the BEPS recommendations will need to be implemented, though it is considered that the previous actions of the predecessor Coalition government are relevant in this regard. The March 2014 paper on the UK's priorities in relation to the BEPS project did not recognize the existence of tensions between the UK's commitment to an aggressive tax competition stance and its strong support for the BEPS agenda, though it did note that it would weigh the policy options produced by the BEPS work "according to circumstances, including where special rules may be needed in special circumstances", which is presumably intended to give it some latitude in the manner in which the package is adopted.[80] There has also been the announcement that the UK is to be the first of 44 countries to formally commit to implementing the new BEPS country-by-country reporting template,[81] though this might not be so revealing of ultimate priorities given that the issue relates to

[78] Ruud Mooij and Michael Devereux, "An applied analysis of ACE and CBIT reforms in the EU," International Tax and Public Finance, Springer, vol. 18(1), pages 93-120, 2011.

[79] See generally, Competing in a Changing World, A Road Map for Ireland's Tax Competitiveness, Department of Finance, October 2014, available at: http://budget.gov.ie/Budgets/2015/Documents/Competing_Changing_World_Tax_Road_Map_final.pdf

[80] HM Treasury, HMRC, Taxing aggressive tax planning in the global economy: UK priorities for the G 20 – OECD project for countering Base Erosion and Profit Shifting, March 2014, pp 13-14 at para 1.28.

[81] As announced by Financial Secretary to the Treasury David Gauke on 20 September 2014 – see https://www.gov.uk/government/news/britain-leads-clamp-down-on-international-tax-avoidance.

reporting arrangements and particularly given the expected commitment to this measure of all states.

Ultimate priorities are also not clear in relation to the announcement of the UK consultation process designed to implement Action 2 on hybrid mismatches,[82] given that this is likely to be seen as a simple anti-tax avoidance issue, rather than a matter also raising tax competitiveness concerns.[83]

The position is rather different in the case of the agreed changes to the UK patent box regime. Here the effect of the BEPS project is clear: the new rules will most likely reduce the attractiveness of the Patent Box. On the Patent Box, the UK was arguably in a difficult (minority) position, facing some fairly intense pressure on the point from a number of other countries and the OECD and at a relatively early stage in the BEPS process.[84] The real priorities of the UK government are more likely to become apparent from the decisions to be made on the BEPS proposals on CFCs and interest deductions. The view of the authors is that it is very unlikely that the UK will in fact choose to alter fundamentally (or at all) the existing CFC rules, largely because of the critical importance they have to the overall UK tax competition position. The position in relation to the interest deduction seems less clear-cut and it may be that the government feels that they have some room – or some obligation – to introduce a further restriction in this area. The prospective corporation tax rate reduction announced in the budget of 8 July 2015 indicates the continuation of the UK aggressive tax competition policy and possibly a move to counterbalance future changes due to the implementation of BEPS recommendations. This might suggest that the UK existing generous interest deduction will be maintained, though it might be taken to indicate the UK is prioritizing a rate-based policy alone, such that it feels less compunction in clawing back tax revenues through a more restrictive interest regime. As suggested above, one possible option would be to pare back the interest deduction, whilst at the same time introducing the ACE.

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[82] HM Treasury, HMRC, Tackling Aggressive Tax Planning: implementing the agreed G20-OECD approach for addressing hybrid mismatch arrangements, December 2014.

[83] Interestingly, however, the attitude of HM Treasury to the treatment of bank regulatory capital (and, to some extent, stock loans and repos giving rise to cross border manufactured payments), both of which are potentially caught by the proposed BEPS hybrid rules, has indicated the possibility of some form of carve-out from the implementation of the hybrids package. These are matters which are seen as significant to the UK competitiveness position. In the case of bank regulatory capital, a separate long-running UK consultation process had been pursued, leading to a result in favour of tax-deductible interest which is hard to square with the BEPS hybrid rules. See further https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/179245/tier_two_capital_of_banks.pdf.pdf.

[84] The authors would take a similar view in relation to the UK's recent introduction of the Diverted Profits Tax (DPT). Although not strictly a measure in the OECD's BEPS project which tests the relative importance of the anti-avoidance and tax competition agendas, the introduction of the DPT might be taken to suggest a fiercely anti-avoidance agenda is being prioritised and signalled through this unilateral measure. However, the position of the DPT is complicated by the fact that, in the view of the authorities, it is deeply undermining of the BEPS approach and in any event it seems more likely that the DPT owes its existence to the domestic pre-election environment in the UK and it is not considered a reliable barometer of the government's strategic priorities.

Conclusions

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

1. The tension between the two government policies of a leading role and strong support for BEPS on the one hand and a wish to pursue an aggressive tax competition policy on the other have so far not been explicitly addressed by the government.[85]
2. The two policies are not *necessarily* or *logically* incompatible but in practice it will prove very difficult to deliver a leading position on both simultaneously: the pursuit of an aggressive tax policy runs high risks of compromising any leading role in delivering the BEPS package and such a leading role in BEPS potentially undermines an aggressive tax competition policy.
3. Even if such tensions can be reconciled, the BEPS package, specifically as implemented by other countries, is likely to affect the UK's pursuit of its tax competition agenda. In particular, the focus of the BEPS package on countering or constraining individual tax regimes (such as IP regimes, tax deductions for interest, CFC rules) rather than on general corporation tax rates is also likely to mean a rate-based policy becomes the primary mechanism for the pursuit of the UK's tax competition agenda. The recently announced further cuts in the corporate statutory rate should be seen in this light.
4. For the reasons discussed in this paper, it is considered very likely that hard choices on the real priorities of the two policies taken together (i.e. including in relation to points of tension) will have to be made going forward. This is especially the case as we approach the end of the "policy development" stage of BEPS and move into the implementation phase. In that regard, it does not seem possible to avoid choices and decisions that at some level modify the existing position. This may mean, for example, that, to retain the existing tax competition ambition, options such as further rate change, increase in capital allowances or the introduction of an ACE will need to be considered.
5. As already signaled in the recent July Budget, further cuts in the statutory rate are likely but, for the moment, the rate is already very low by international standards and extra cuts will remain costly but, at the same time, they will attract comparatively less and less investment and profits. Additionally, rate cut and base broadening policies fail to address the comparatively high UK marginal tax burden on investment, due to ungenerous capital allowances. Expanding capital allowances would reduce the EMTR and hence stimulate investment. This is important as, historically, the UK investment is low and this partially translates in low productivity. Another option is the introduction of an ACE. The ACE could partially compensate the possible tightening of the UK generous interest deductibility rules under the implementation of the BEPS proposals. The

[85] This is not to say that the UK's position in its work on BEPS does not take account of the tensions. For example, in contributing to the work on CFCs the authors understand that the UK has sought to defend a limited approach to the CFC rules and it has resisted the adoption of a general standard based on a more comprehensive approach to the CFC rules. The tension referred to would therefore clearly influence non-public choices made by the UK in pursuing its contribution to the BEPS project.

interesting feature of the ACE in the context of BEPS is that it reduces the incentive to classify financing instruments as debt (instead of equity) because under an ACE, equity would enjoy more or less the same tax break as debt.

6. It seems to the authors likely that there will in fact be "mixed" choices made, reflecting priorities from each of the two policies under discussion, rather than a prioritization of one agenda exclusively. Arguably, that result is already emerging given the agreement already reached to modify the terms of the UK Patent Box on the one hand and the expected resistance to change materially the UK CFC regime and the recently announced prospective corporation tax rate cut on the other. However, such an outcome would obviously modify, and to some degree constrain, each of the individual policies in isolation.
7. The position may be clouded in the very short term by the very high political pressure for a successful completion and delivery of the policy package of BEPS. This pressure may make it harder to see at an early stage the real choices that are being made by states, including the UK. However, those choices will become apparent as the focus shifts to the implementation stage of BEPS in 2016. In the view of the authors, it seems very likely that the UK's aggressive tax competition policy will in the medium term trump other international tax policy options.

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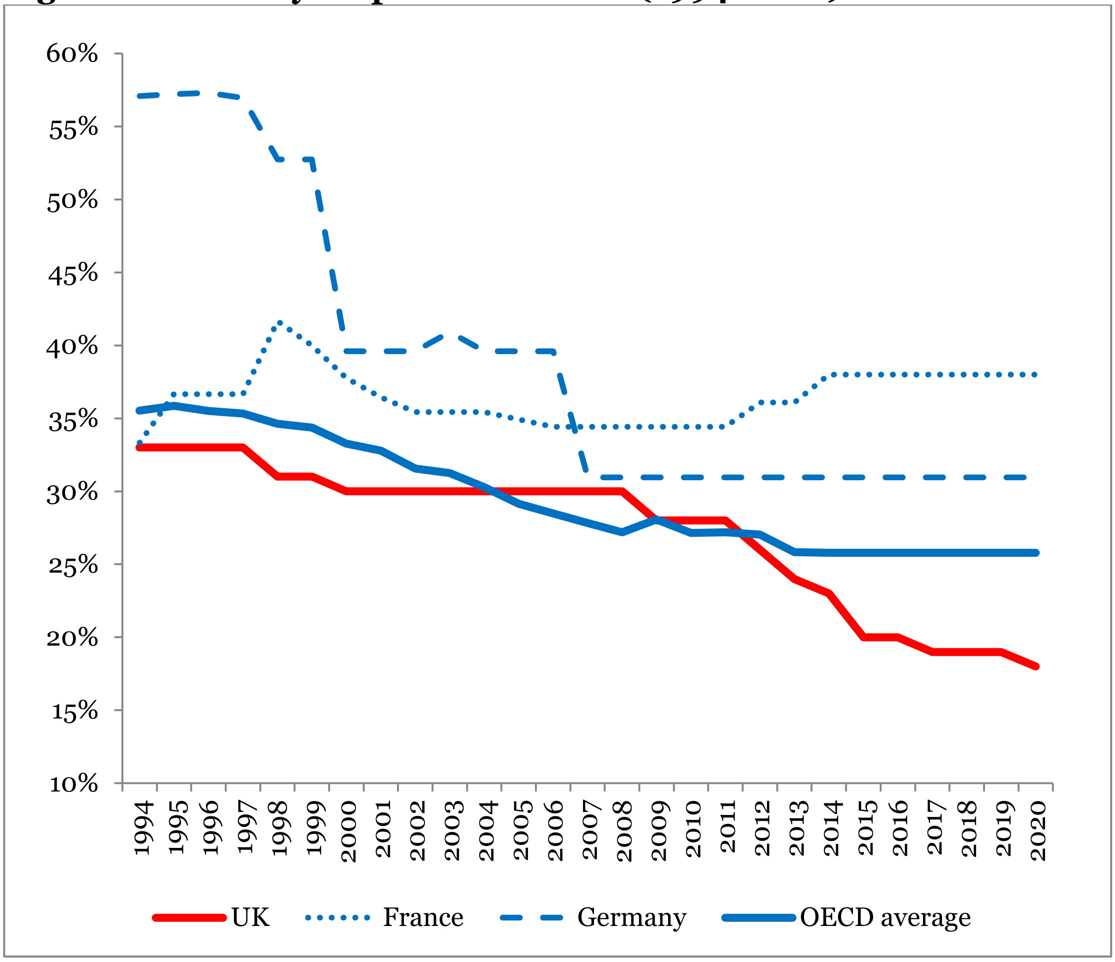
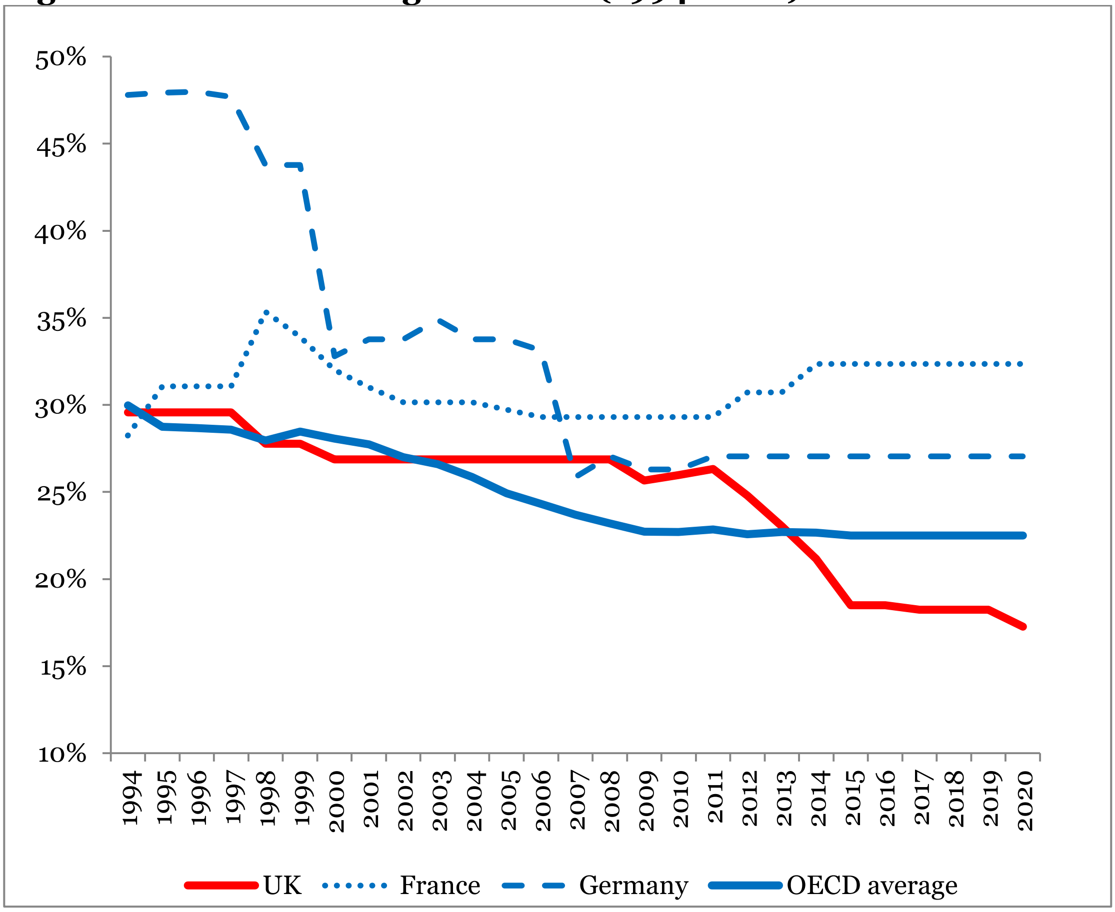
Figures and tables

Figure 1. Statutory corporate tax rates (1994-2020)



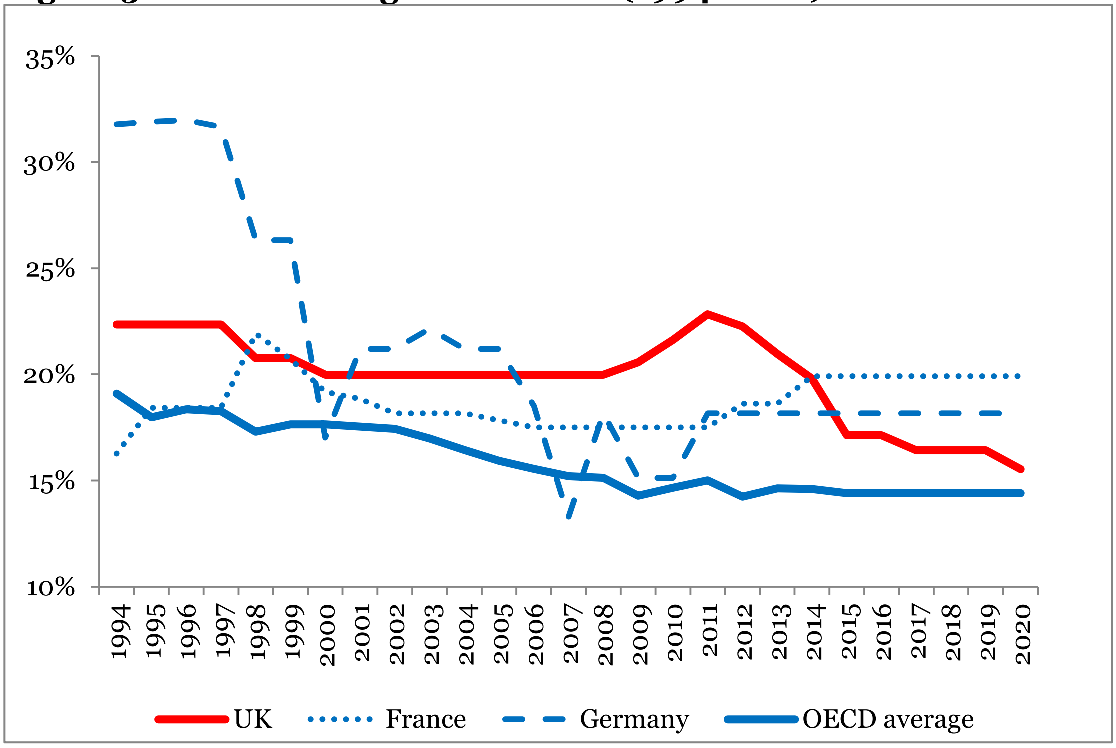
Source: OUCBT tax database. [www.sbs.ox.ac.uk/ideas impact/tax/publications/data](www.sbs.ox.ac.uk/ideas)

Figure 2. Effective average tax rates (1994-2020)



Source: OUCBT tax database. [*www.sbs.ox.ac.uk/ideas-impact/tax/publications/data*](http://www.sbs.ox.ac.uk/ideas-impact/tax/publications/data)

Figure 3. Effective marginal tax rates (1994-2020)



Source: OUCBT tax database. [*www.sbs.ox.ac.uk/ideas-impact/tax/publications/data*](www.sbs.ox.ac.uk/ideas-impact/tax/publications/data)

Figure 4 "Double Irish" Structure

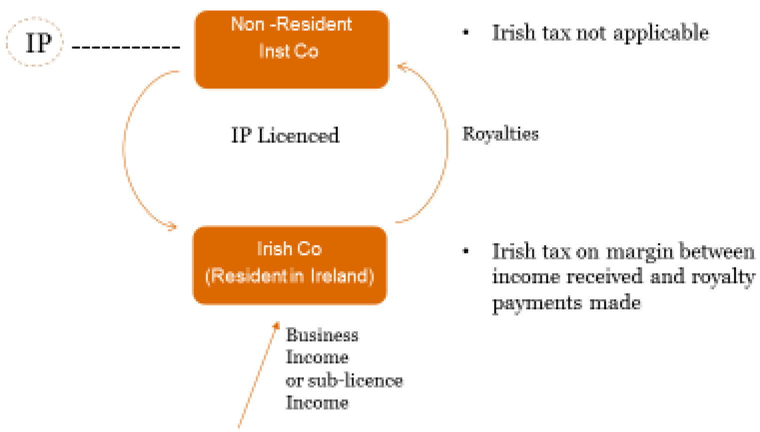


Figure 5. Dutch entity

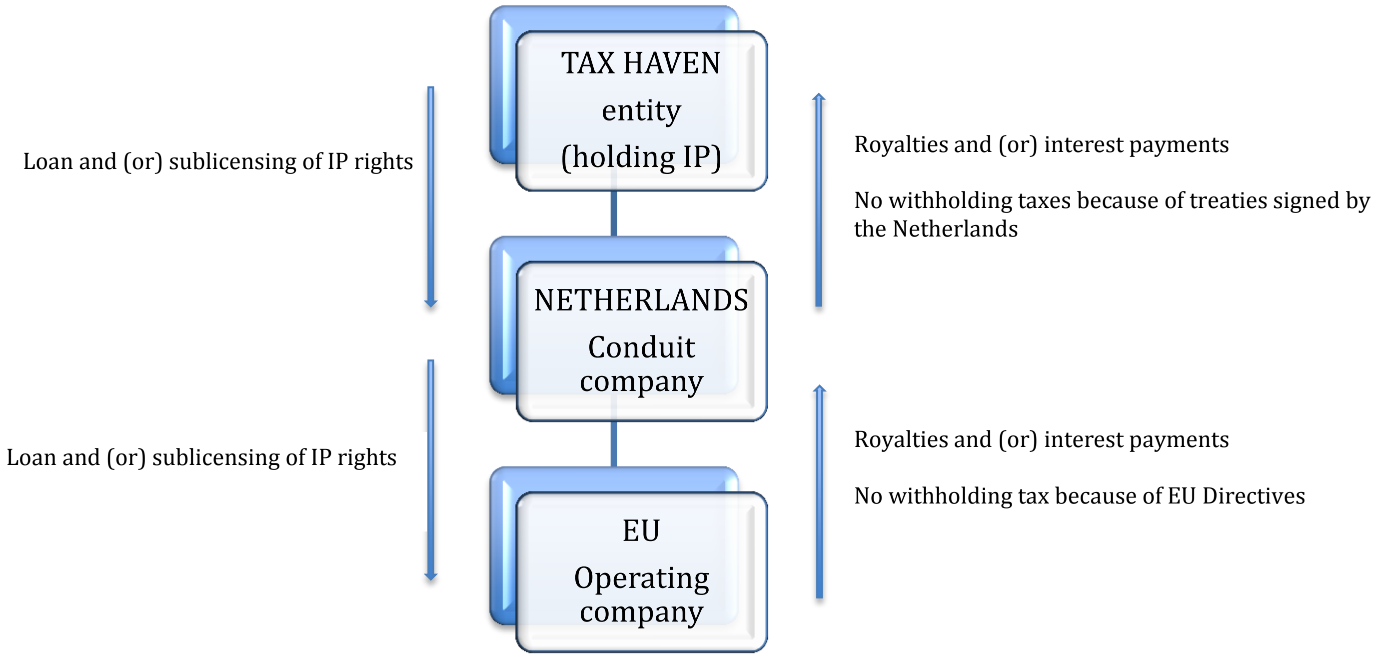


Figure X "Example of Hybrid Financial Instrument

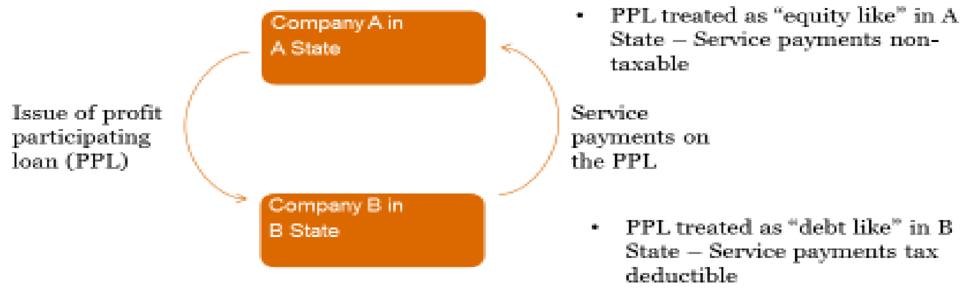
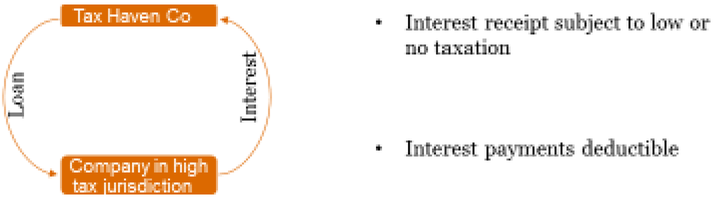


Figure 7
Inbound interest concern



Outbound interest concern

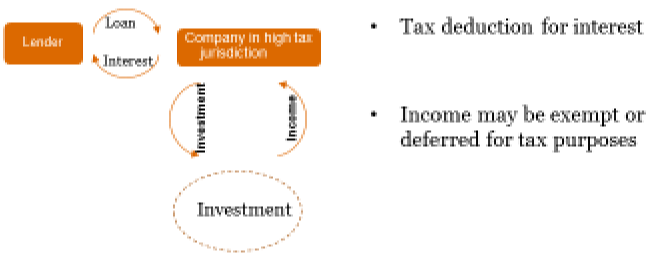
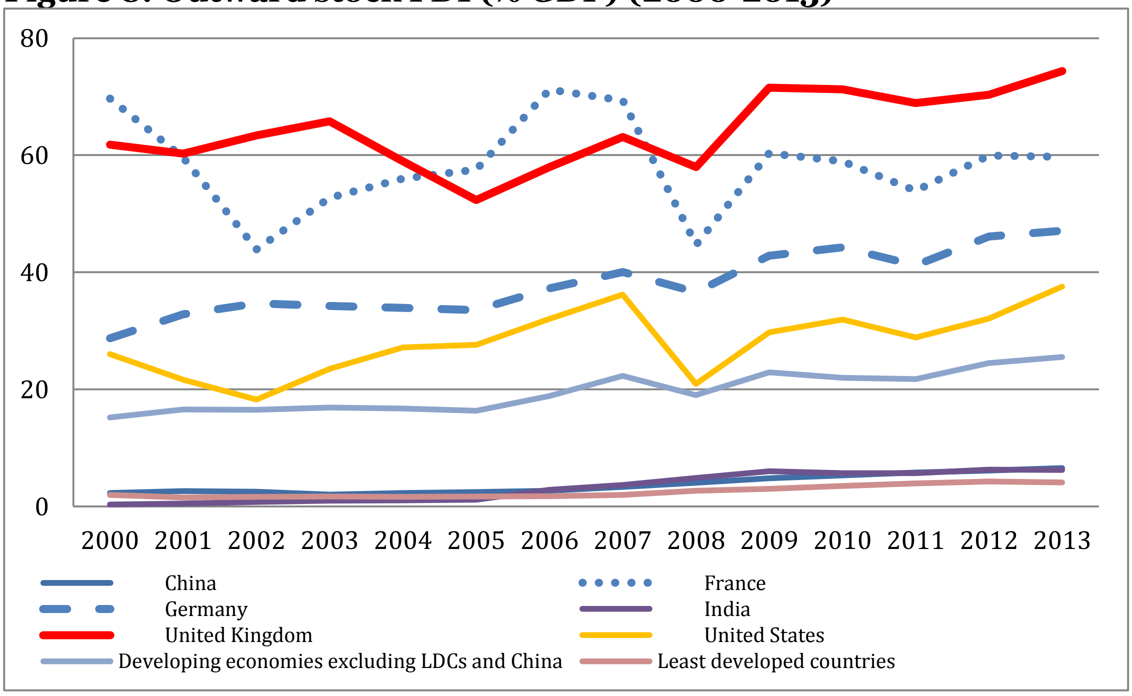
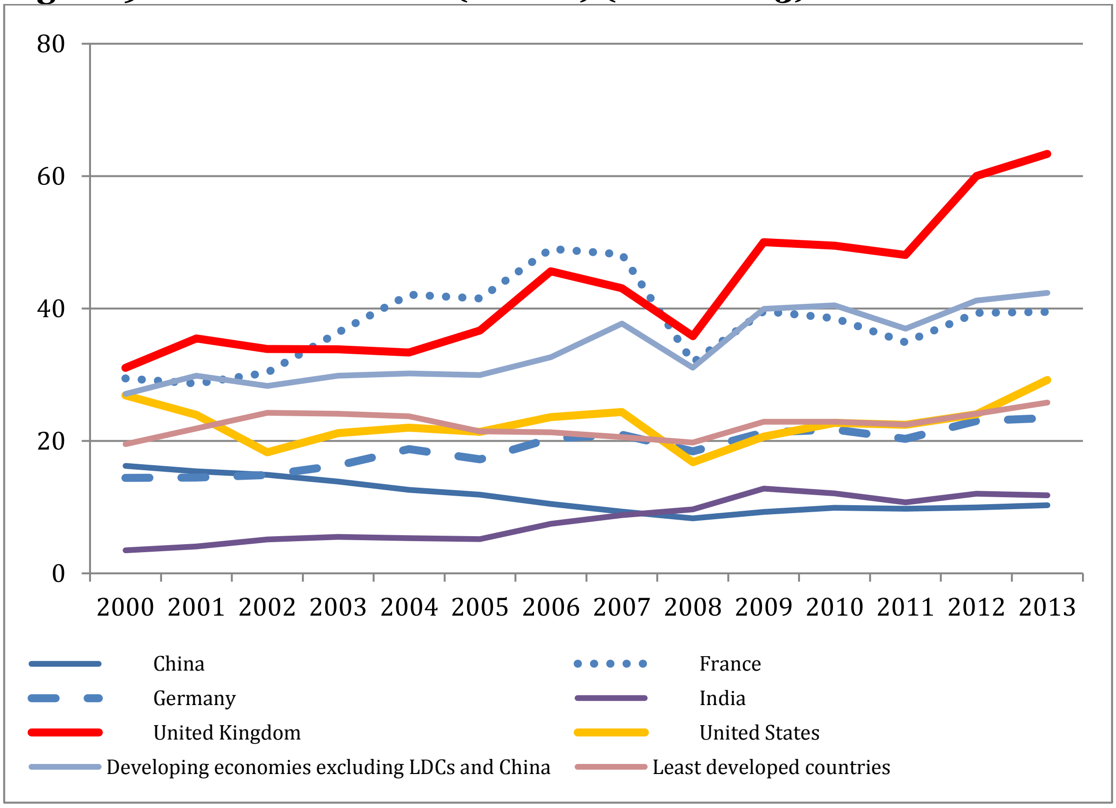


Figure 8. Outward stock FDI (% GDP) (2000-2013)



Source: UNCTADStat, www.unctadstat.unctad.org

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



Source: UNCTADStat, www.unctadstat.unctad.org

Figure 6 "Example of Hybrid Financial Instrument

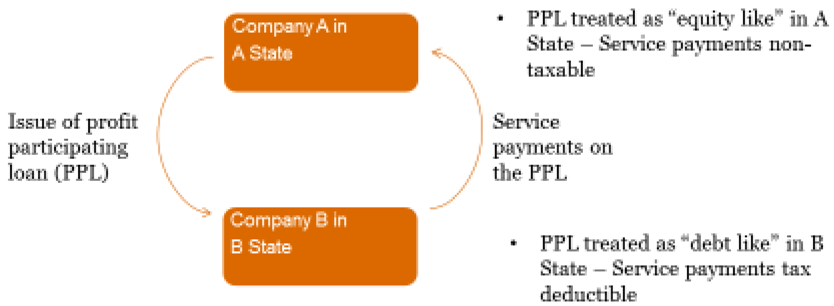


Table 1. UK EATRs and EATRs under different scenarios.

	EATR (18.49% in 2015)	EMTR (17.14% in 2015)
Capital Allowance 20%	16.59%	14.97%
Capital Allowance 25%	16.36%	14.15%
Corp. Tax Rate 18%	17.27%	15.54%
Corp. Tax Rate 15%	14.04%	12.77%
Allowance for buildings 4%	15.88%	12.40%
ACE	16.32%	4.36%

G20 Ranking	EATR (5th in 2015)	EMTR (10th in 2015)
Capital Allowance 20%	1st	8th
Capital Allowance 25%	1st	6th
Corp. Tax Rate 18%	1st	8th
Corp. Tax Rate 15%	1st	5th
Allowance for buildings 4%	1st	5th
ACE	1st	2nd

Note: With the exception of the case in which the corporate tax rate is 15% or 18%, the EATR and EMTR have been calculated using a corporate statutory tax rate of 18%.