TJN is an independent organization launched in March 2003, dedicated to high-level research, analysis and advocacy in the field of tax and regulation, with regional networks in Asia, Africa Europe and Latin America. We map, analyse and explain the role of tax and the harmful impacts of tax evasion, tax avoidance, tax competition and tax havens. We aim to encourage reform at the global and national levels. We are aligned to no political party.

Briefing on

BASE EROSION AND PROFIT-SHIFTING (BEPS) IMPLICATIONS FOR DEVELOPING COUNTRIES

February 2014

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Base Erosion and Profit-Shifting (BEPS): Implications for Developing Countries

1. Main Issues for Developing Countries

Many commentators have long recognized that the international tax system is broken, especially in relation to corporate taxation. A major effort has begun to try to fix it. This is led by developed countries, but it has major implications for developing countries:

- they are generally more reliant on corporate tax revenues (on average close to 20% of tax revenues, compared to 8-10% for developed countries);
- it is harder for them to devote scarce resources, especially of skilled specialists, to administer complex international tax rules;
- their desire to attract foreign investment makes it hard to enact and enforce strict tax rules;
- in addition to the revenue losses, international corporate tax avoidance sustains the offshore tax haven and secrecy system, which also facilitates capital flight and money-laundering.

The main initiative is from G20 leaders, working through the Organization for Economic Cooperation and Development (OECD), whose so-called Action Plan on Base Erosion and Profit Shifting aims to produce reform proposals, with a final deadline of December 2015. The OECD has pledged to consult developing countries, and if the Action Plan results in effective action they would also benefit, so engagement with the OECD is necessary. Yet developing countries may consider some proposals undesirable, such as compulsory **arbitration of transfer pricing disputes** without adequate safeguards. In any case, the OECD will not prioritise developing country concerns.

It has also made it clear that its proposals do not aim to change the existing balance of allocation of tax rights between "residence" and "source" countries, which has long been a major point of disagreement between developed and developing countries. The OECD's Action Plan does not include some types of measures that could be particularly helpful for developing countries, such as **withholding taxes**, and **taxation of services**.

For some measures in the Action Plan the OECD is unlikely to propose solutions that would be strong enough or appropriate for developing countries, especially the definition and attribution of profits to a **permanent establishment**, and **limitation of deductions.** Developing countries may appropriately tackle some problems jointly, for example to persuade the Netherlands to revise its tax treaties and internal law to end its use as a conduit for untaxed profits. So it is important for developing countries to make their own evaluations of measures that would be suitable for them to adopt, either alone or, preferably, jointly.

The OECD is limiting its consideration to reform of existing rules. Developing countries should investigate more radical measures that could be more effective and easier to administer, in particular assessment of multinational corporations on a unitary basis. This type of more comprehensive approach can be based on expanding existing methods, especially the profit split method[1] in transfer pricing, and facilitated by the move towards country-by-country reporting, which is part of the OECD Action Plan.

[1] Under the profit split method, the combined profits earned from a transaction or transactions are split between jurisdictions based on the genuine economic activity in different jurisdictions. The split is determined by the geographical division that independent parties would expect to realise from those transactions.

2. Background and Context

Political pressures strengthened by the recent fiscal crisis led world leaders of the G20 group to request action to reform the international tax system through the OECD's Committee on Fiscal Affairs (CFA). The Tax Annex of the G20 St Petersburg Declaration said:

> First, changes to international tax rules must be designed to address the gaps between different countries' tax systems, while still respecting the sovereignty of each country to design its own rules.
>
> Second, the existing international tax rules on tax treaties, permanent establishment, and transfer pricing will be examined to ensure that profits are taxed where economic activities occur and value is created.
>
> Third, more transparency will be established, including through a common template for companies to report to tax administrations on their worldwide allocation of profits and tax.
>
> Fourth, all the actions are expected to be delivered in the coming 18 to 24 months.
>
> Developing countries must reap the benefits of the G20 tax agenda.

2.1 Transparency

This G20 initiative should be considered also in relation to the earlier one, launched in response to a request by the then G7 leaders in 1996, which resulted in the OECD's report in 1998 on *Harmful Tax Competition: An Emerging Issue*. This project was effectively derailed by a change in US policy, when the new Bush administration accepted arguments that the initiative as first formulated entailed dictating tax policy to other states.

The project then refocused on obtaining information from tax havens, pursued at first through negotiation of bilateral tax information exchange agreements (TIEAs), overseen by the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes.

Since our foundation in 2003 the Tax Justice Network has argued for a multilateral framework including exchange of information automatically, as well as on request. We have also continually stressed the need for all states to introduce effective measures of transparency for tax enforcement purposes, such as registers of ownership, without which there can little information to exchange about tax evaders. The lack of such provisions has in practice meant that leading states such as the USA and the UK have in practice been among the main secrecy jurisdictions.

Only now has this effort for fiscal transparency produced the commitment at this year's G8 summit meeting to establish a new global standard of multilateral and automatic exchange of tax information, as well as transparency of beneficial ownership.[2] This is now being taken forward by the OECD in parallel with the work on BEPS. The multilateral Convention on Mutual Administrative Assistance in Tax Matters (developed jointly by the Council of Europe and the OECD) has been thrown open to all states, and the OECD is encouraging all states to join. Membership can be particularly helpful to developing countries, since it

[2] See 2013 Lough Erne Leaders' Communiqué: `We commit to establish the automatic exchange of information between tax authorities as the new global standard, and will work with the Organization for Economic Cooperation and Development (OECD) to develop rapidly a multilateral model which will make it easier for Governments to find and punish tax evaders. … We agree to publish national Action Plans to make information on who really owns and profits from companies and trusts available to tax collection and law enforcement agencies, for example through central registries of company beneficial ownership.'

establishes a basis for exchange of information on request without the need for a bilateral double tax treaty.

Automatic exchange of information (AEI) is provided for in that convention, but it requires a supplementary agreement to establish procedures. However, the G20 asked for a common reporting model, including a Model Competent Authority Agreement, to be presented to a meeting of G20 Finance Ministers and Central Bank Governors in February 2014. The Global Forum has also established a Group on AEI, whose work will include `establishing a set of criteria to determine when it would be appropriate for jurisdictions to implement AEI having regard, in particular to capacity constraints, resource limitations and the need to ensure confidentiality and the proper use of information exchanged, and helping developing countries identify their needs for technical assistance and capacity building before engaging in AEI'. There is no formal requirement to join the Global Forum in order to adhere to the multilateral assistance convention, but doing so would facilitate negotiation of the agreements necessary to activate AEI.

2.2 Openings for Developing Countries

Since the BEPS project reports to the G20, non-OECD G20 member countries (Argentina, Brazil, China, India, Indonesia, Russia, Saudi Arabia and South Africa) have been accepted as full members of OECD working parties on BEPS. The OECD has also undertaken to consult developing countries on the BEPS project, through regional meetings, organized in cooperation with regional or national organizations (ATAF, CIAT, Korean Tax Centre), and the OECD's Task Force on Tax and Development.

Although the OECD's work is central, it is only part of the overall policy landscape. The UN Tax Committee at its meeting at the end of October 2013 decided to set up a subcommittee on BEPS. This will be concerned both with providing feedback into the OECD project from a developing country viewpoint, as well as considering possible remedies for BEPS for developing countries which go beyond the remit of the OECD project. The Committee's parent body, the Financing for Development Office, may be interested in this issue in the context of the post-2015 Millennium Development Goals. However, the resources of the UN Committee are very limited, both of staff and funding for meetings.

A wider perspective on international tax reform is being taken by the IMF. Its report of June 2013 *Issues in International Taxation and the Role of the IMF* discussed an expanded work programme on international tax, which was approved by the IMF Board. Its Fiscal Monitor of October 2013 stated that

> `Recognition that the international tax framework is broken is long overdue. Though the amount is hard to quantify, significant revenue can also be gained from reforming it. This is particularly important for developing countries, given their greater reliance on corporate taxation, with revenue from this taxation often coming from a handful of multinationals.'

Reports on research by the IMF Tax Policy Division will be submitted to the IMF Board in 2014. However, the IMF has no direct role in international tax policy-making.

3. THE OECD BEPS PROJECT[3]

The BEPS Action Plan proposes fifteen Action Points, of which nine are on substantive issues, and six are aspects of coordination or procedures. The latter include, first **a study on the Digital Economy**, which will in effect be a check on whether the other action points can deal effectively with this issue, perhaps supplemented by indirect taxes. Another is the **collection of better data** on the extent of international tax avoidance. Two more concern transparency: the development of **model provisions for disclosure of `aggressive tax planning' strategies**, and **improving transfer pricing documentation requirements**.

The latter is potentially very significant, as it has become linked with the mandate to establish a global template for multinationals to prepare and submit a Country-by-Country Report for all countries where they do business. The OECD is planning to issue a discussion draft of this proposal in February 2014, which should discuss both the format and procedures for access. Some business representatives have argued that such a report should initially be made available only to the parent company's tax authority and shared subject to guarantees of confidentiality. However, any country could establish a suitable requirement under its national law for submission of such a report, and members of the multilateral convention on administrative assistance could request other members to share such a report.

To help deal with conflicts between states, it is proposed to **strengthen the `mutual agreement procedure'**, probably by introducing compulsory arbitration, although this has been resisted until now especially by developing countries. Indeed, if there is little clarity or agreement on the rules to be applied, referring disputes to arbitrators to decide would be unhelpful, and perhaps dangerous. Further, the secrecy of these procedures undermines their legitimacy, and creates public distrust and suspicion of private deals by revenue authorities with big business.

Finally, and most ambitiously, a group of international lawyers will develop **a multilateral instrument,** as a means of more rapid implementation of proposals which would otherwise require renegotiation of many bilateral treaties. While this is potentially far-reaching, this idea is legally problematic. It would also act as a brake on developing radical proposals, since such a treaty would have to be accepted by states, so its content would tend to the least common denominator.

Of the nine substantive action points, the first group of four aim to establish `coherence of international tax standards' and concern issues on which the CFA has done little or no previous work. First is **`hybrid mismatches'**: entities (e.g. corporations) or instruments (e.g. bonds) which have a different legal status in different countries, thus allowing entities to be dual resident, or instruments to be treated differently, e.g. as debt in one country and equity in another. A report in 2012 by the CFA envisaged formulation of model national laws. The Action Plan now seems to suggest more coordinated action, especially through model treaty provisions, which will prove legally complex and only partially effective.

Action is proposed on **rules relating to Controlled Foreign Corporations (CFCs)**, which allow the home states of parent companies of TNCs to tax profits of CFCs, if they derive from `passive' income, and the CFC is in a low-tax jurisdiction. However, the Action point seems to envisage only the development of model national laws. This directly concerns more developed countries which have outbound investment, but this includes some developing countries: for example, Brazil and Mexico have both recently revised their CFC rules.

[3] For a more detailed and technical discussion see S. Picciotto `Can the OECD Mend the International Tax System?'. *Tax Notes International* 71(2): 1105-1115 (September 16, 2013).

However, strong CFC rules would also indirectly benefit other countries, if they deter multinationals from eroding their source country taxable profits. CFC rules would be more effective if they were coordinated, and targeted against preferential tax regimes, but this may be difficult for the OECD to achieve, as several OECD countries offer such regimes.

Another Action point is indeed to **tackle such `harmful preferential tax practices'.** But the only method suggested for this is to revive the Forum on HTPs, which was suspended a decade ago when the previous HTP initiative was derailed by the US (as mentioned above). Without the stronger coercion that might come from concerted anti-CFC rules, all that remains is peer-pressure, which generally produces at best a gradual attrition of some measures, only to be replaced by others.

Finally in this group, proposals would be made for **limiting deductibility of interest and other payments to related entities**. The Plan proposes that in addition to developing `recommendations regarding best practices' for national rules, transfer pricing guidance will be formulated, and this work will be coordinated with that on CFCs and hybrids. Reconciling deduction limitation provisions via the transfer pricing arrangements will create further strains on that system, including the Mutual Agreement Procedure (MAP) for resolving conflicts. Limiting deductibility of payments such as royalties or interest to related parties could indeed help to reduce tax losses of host countries, and so is important for developing countries. However, many developing countries have been reluctant to introduce such measures, for fear of discouraging inward investment. Stronger coordination than best practice recommendations would be needed to overcome this problem, but there is no sign of the OECD providing such support or coordination.

Next, the Plan aims to restore the `full effects and benefits of international standards' by modifying tax rules `to more closely align the allocation of income with the economic activity that generates that income'. It proposes to attempt this not by changing any particular rules, but through **anti-abuse provisions**. Action 6 refers rather widely to developing model treaty provisions as well as recommendations for national rules. The Model treaty has for long been largely ineffective for preventing double non-taxation, not least because neither the text nor the commentary contain a clear statement that all income must be taxed somewhere, and national courts have been unwilling to use domestic anti-abuse rules to override (or even to help interpret) treaty rules.[4] This could be remedied if suitable anti-abuse provisions were included in the actual model treaty, or even better in the multilateral treaty envisaged by the Action Plan. However, business is likely to object that general anti-abuse provisions would create uncertainty. Presumably to forestall this, the Plan refers to `tight' treaty anti-abuse clauses. It remains to be seen whether, for example, a `subject to tax' provision is considered to be sufficiently `tight' to be put forward.

Also to be dealt with through an anti-abuse measure is the issue of **definition of and attribution of profits to a Permanent Establishment (PE)**. This suggests that the OECD does not intend to rethink this concept or revisit the changes made by the CFA in recent years, to introduce the so-called `authorized OECD approach', which treats a PE like a corporate subsidiary. Yet these changes have been rejected by most developing countries, and are controversial even for some in the OECD. Nevertheless, without such a rethink it is unlikely that adequate solutions could be found especially for the problems posed by the digital economy. There will be increasingly wide divergences therefore between the

[4] Notably, the Indian Supreme Court has refused to apply India's general anti-avoidance principle to invalidate the use of the India-Mauritius tax treaty, in its decisions in *Azadi Bachao Andolan* (2003) and *Vodafone* (2013).

`authorized OECD approach' on PEs, and the perspectives of developing countries and others which are mainly host states to TNCs.

Three action points concern the perennial problem of transfer pricing, and aim to continue and extend the revision of the Guidelines already under way since 2010, concerning the **attribution of income to intangibles**. This has become an intractable issue because the OECD approach has exacerbated the difficulties created by the separate entity/arm's length principle, by fetishizing the very concept of `intangibles'. The oligopolistic profits of TNCs are to a great extent due to their control of superior know-how, but a firm's knowledge or know-how is very much a result of synergy, and it is very hard to value the different contributions of different parts of the firm to that whole. This is so even when such knowledge can take the form of intellectual property, since this concept creates a misleading notion of the nature of innovation or creativity as individualized, episodic and discrete, instead of collective, continuous and cumulative.

The draft revised chapter of the OECD Guidelines on Intangibles issued a couple of weeks after the Action Plan does propose some long-overdue changes. It would move away from attribution of intangibles profits on the basis of ownership, or provision of finance. This has enabled firms such as Google to accumulate enormous profits in low-tax countries such as Bermuda, due to the foresight of its tax advisers in transferring at an early stage the rights in its search algorithm to an affiliate resident there. Instead, profits would be attributed according to each entity's contribution to `value creation' through its ` functions performed, assets used, and risks assumed'. The extent to which any of these functions, assets and risk factors affect value is stated to depend on the facts and circumstances, to be decided ad hoc in each case. The draft is full of equivocation on how this can be done, on the one hand stating that as far as possible the starting point should be `comparables', while also conceding that `the identification of reliable comparables in many cases involving intangibles may be difficult or impossible' (para.164).

This in practice reinforces the general trend towards the use of the `profit-split' method of transfer price adjustment. Yet there is still a marked absence of any attempt to flesh out this method, for example by developing agreed tax base definitions for the aggregation of the profits, although the OECD's own documents accept that financial accounts are unsuitable for this purpose. The Guidelines include some general discussion of possible `allocation keys' which may be used for profit-split, but fall far short of providing any clear and predictable system.

4. Investigating Alternatives

As this brief analysis shows, the Action Plan aims only to try to repair the current system, and cannot remedy its fundamental flaws, which result from the separate entity / arm's length principle in tax treaties. Indeed, the Plan (para. 14) explicitly rejects any move towards `formulary apportionment'. The main objection given is that, whatever its technical merits, it would be difficult or impossible to reach political agreement on such a system. Yet the attempt to strengthen the existing system in the Action Plan is also fraught with political difficulties, indeed in many respects it is a recipe for generating conflicts between states, as each tries to modify or interpret the rules to grab a larger share of the tax base. The difference is that the reform plan defers the political conflicts, and transfers them into the highly technicized context of the CFA. No doubt there are many who will hope that over time the political spotlight will move on, perhaps even the fiscal crises will dissipate, and the pressures for effective solutions will relax. Realistically, this will not happen.

Applying further patches to existing rules now seems futile. What clearly seems necessary is to reorient international tax rules and place them on a more realistic foundation, which can treat TNCs as single firms, instead of being based on the unrealistic fiction that they are a loose collection of separate and independent entities in each country. A number of proposals with this perspective have indeed been put forward. The most comprehensive is Unitary Taxation with formula apportionment (UT). This is widely accepted as a superior approach in principle,[5] and although not without its difficulties, in many ways a more practical and effective alternative.[6] More research and debate is now urgently needed. The International Centre for Tax and Development has funded a 12-month programme on Unitary Taxation of TNCs and its implications for developing countries, which will produce reports during 2014.[7] The IMF Tax Policy Division is also investigating the approach. Developing countries could now take a lead in opening up policy space for debates on such more radical reforms which are more likely to establish the international tax system on a fairer and sounder foundation.

January 2014.

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[5] For further details see S. Picciotto, `Is the International Tax System Fit for Purpose, especially for Developing Countries' (2013) *ICTD Working Paper* 13, available from http://www.ictd.ac/en/publications/international-tax-system-fit-purpose-especially-developing-countries .

[6] See articles by Michael Durst in *Tax Management International Journal* (2013-4), also available from http://www.ictd.ac/en/publications-unitary-taxation

[7] See http://www.ictd.ac/en/unitary-taxation-transnational-corporations-special-reference-developing-countries