
# BEPS and developing countries

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# 1. BACKGROUND

# What does BEPS stand for?

- Base erosion and profit shifting (BEPS)
- Multinational enterprises (MNEs) redirect revenue to low-tax jurisdictions (LTJs)
- Weakness of tax systems
- Acts as a constraint on development finance
- G20-OECD Project begun in 2012 recognizes and addresses the problem
- 2013-15 Action Plan

# Weakness of tax systems (The core issues in BEPS)

*.. At the risk of over-simplifying*

- Transfer pricing (without a doubt)
- Activity transfers (depends)
  - Relocating an enterprise (probably not)

- even though the idea may be to seek better tax conditions and the base is eroded*

  - But investing in a foreign subsidiary (possibly yes)

    - A tax could be levied on global income
    - Active versus passive income
    - Credit against tax paid abroad

- And if passive income is derived from business with the parent company (certain)
- - Definition of tax powers (residence-source)

    - Withholding of source income/treaties

- Lack of transparency

* IOs: "Options for low income countries' effective and efficient use of tax incentives for investment"

# 2. ESTIMATING BEPS

# How serious is BEPS?

- Difficult to measure
- One of the areas being worked on in the BEPS project

  * Latest estimates US$100 - 160 billion (indirect - uncertain method)

  * NGOs have much larger estimates for developing countries (DCs), but methods used are highly questionable

- Broadly speaking, the signs are that it is serious
- For example, see the statistics on U.S. MNE activity – Table 1

# Table 1

| Share of LTJs in net profits of U.S. MNEs obtained outside the USA in 2005, 2010, 2013 | | | | | | |
|---|---|---|---|---|---|---|
| | 2005 | | 2010 | | 2013 | |
| | % profit | % employees | % profit | % employees | % profit | % employees |
| Holland | 13.0 | 2.1 | 14.6 | 1.9 | 13.4 | 1.8 |
| Luxembourg | 10.5 | 0.2 | 9.3 | 0.1 | 10.5 | 0.1 |
| Bermuda | 7.2 | * | 8.0 | 0.0 | 7.2 | 0.1 |
| Ireland | 7.0 | 1.0 | 9.3 | 0.9 | 9.9 | 0.9 |
| Switzerland | 6.7 | 0.8 | 5.4 | 0.8 | 6.0 | 0.7 |
| Hong Kong | 3.3 | 1.4 | 1.3 | 1.0 | 1.3 | 0.9 |
| Cayman Islands | 3.2 | 0.1 | 4.4 | 0.0 | 5.4 | 0.0 |
| Singapore | 3.0 | 1.3 | 3.3 | 1.3 | 3.6 | 1.4 |
| *Total* | 53.9 | 6.9 | 55.4 | 6.2 | 57.3 | 6.0 |

Source: K.B. Barefoot (2012), R. Mataloni (2007), US Bureau of Economic Analysis

*Less than 0.1 percent.

# Mismatch between MNE profits and activity

- The place where profits are recorded has little to do with the economic activity that appears to take place there.
- What would happen if profits were to be distributed according to the value added generated by the enterprises in each of the countries in which they operate? (Table 2)

Table 2

**Principal winners and losers of a redistribution of gross profits based on VA, Multinational Enterprises of the USA, 2010** (US$bn)

| Winners | | Losers | |
|---|---|---|---|
| USA | 485.5 | Holland | -184.5 |
| Germany | 37.7 | Luxembourg | -116.2 |
| France | 19.7 | Bermuda | -92.4 |
| Australia | 16.0 | Ireland | -69.5 |
| Japan | 14.4 | Cayman Islands | -46.9 |
| | | | |
| Own estimates based on | K.B. Barefoot (2012) | | |

# 3. ADVANCED ECONOMIES AND DEVELOPING COUNTRIES VIS-A-VIS BEPS

# BEPS in advanced countries (ACs)

- Most of the disputed revenue (by far) concerns the large economies and LTJs
- Even as a percentage of GDP, advanced countries have more revenue at risk, due to BEPS.
- Table 2; USA amount equivalent to almost 2.5% of GDP; for other countries, much less.

# Greatest harm in ACs

- Data in the OECD study point to similar outcome:

  - USA loses 20% of corporate income tax, double the percentage of the next country

- Profit transfer associated with intellectual property (IP)
- MNEs transfer capital to subsidiaries abroad, which in turn invest in R&D projects, defray the development costs and share the IP royalties
- Their earnings are disproportionate

# Planning

- Constituting a "cash-box" in a LTJ
- Avoiding characterization as passive income to get round Controlled Foreign Corporation (CFC) rules

  - Royalties taxed, but check-in-the-box loophole in USA
- Taking advantage of the special regime for intangibles in the country of registration (patent-box)
- Or a specific (confidential) resolution
- Taking advantage of treaties/zero withholding for remitting profits to a third country
- Or a transparent entity with foreign shareholders
- And adjusting transfer prices for buy-in fees.

## What is at stake for developing couontries?

- For DCs, corporate income tax constitutes a larger share of tax revenue*
- It is derived from a relatively small modern sector
- With a high concentration of MNEs
- Natural resources – nontax revenue
- Particular vulnerability to BEPS
- Key to mobilizing domestic resources

* IMF (2014), *Spillovers in international corporate taxation*

# Differing perspectives?

- Different manifestations of the same problem, which are solved in the same way?
- Applying the same general principles?
- Is it a matter of coming up with guidelines on applying principles to specific cases?
- Or ad hoc solutions, which solve some problems but not others? Or even worse?
- Or all of the above?

# Building technical capacity

- Consensus: the system is complex
  - (with anti-BEPS measures it will probably be more complex)
- DCs lack technical capacity
- Severe disadvantage vis-à-vis MNEs and ACs
- That has been DCs' main complaint
  - (outrageous cases of  abuses in DCs denounced by NGOs)
- Important →training and transition
- Yet, this throws little light on the core issues

# 3. ACTIONS FOR CURBING BEPS

# The 15 actions

1. Address the tax challenges of the digital economy
2. Neutralize the effects of hybrid mismatch arrangements
3. Strengthen corporate income tax rules for Controlled Foreign Corporations
4. Limits to indebtedness
5. Counter harmful tax practices more effectively, taking into account transparency and substance
6. Prevent treaty abuse
7. Prevent the artificial avoidance of permanent establishment status

8-10. Assure that transfer pricing outcomes are in line with value creation

- Risk assignment
- *Commodities*
- Intangibles
- Services (HQ)

11. Measure BEPS
12. Require taxpayers to disclose their aggressive tax planning arrangements
13. Re-examine country-by-country transfer pricing documentation
14. Make dispute resolution mechanisms more effective (swifter)
15. Develop a multilateral instrument (arbitration)

# Positive and relevant outcomes

**4:** Limits to <u>indebtedness</u>: a common and stricter approach to thin capitalization; more so than what most DCs currently have and relatively simple.

**6:** A minimum standard for preventing treaty abuse, options, that the beneficiary actually be a resident in the signatory country.

**7:** Precision in the rules to ensure that there is a permanent establishment for domestic sales; restrictions on planning through "commissionaire arrangements."

# Of less universal interest

***CFCs***

**3:** Recommendations for best practices with regard to CFC rules

**5:** Substance requirement for patent-box regimes

***Transparency***

***12:*** Recommendations for best practices

***13:*** Transfer pricing master file

# Possibly more controversial aspects

- **Hybrid instruments (2)**
- Financial instruments that in one country qualify as debt and in another as capital (numerous variants)
- Deductible interest – nontaxable dividend (e.g. territorial)
- Lack of coordination -- problem is not one of different tax policies, but different tax treatment
- Recommendation is not to unify policies, but rather to eliminate the benefit from mis-characterization.

# Hybrid instruments/entities

- Hybrid entities achieve similar fiscal mismatches (deduction – non-inclusion in income)
- E.g., the interest paid by a subsidiary to its parent company is not accruable for the latter, but if the subsidiary consolidates its net earnings with other subsidiaries in the host country, it obtains a deduction.
- Or double deductions: a subsidiary borrows from a third party and the interest is deductible for the parent company, but also for the subsidiary with which net earnings are consolidated in the host country.
- It is not clear which country's tax base is eroded, but altogether the countries clearly collect less tax revenue.

# Hybrid instruments/entities

- The agreement: domestic laws impose taxes when the payment is deductible in the other jurisdiction
- Defensive measures: if a country does not tax, deduction is not allowed.
- The rationale behind the tax changes; it is the differential treatment abroad, irrespective of domestic treatment of others that are the same for domestic law purposes.
- The analysis does not take withholdings into account
- Possible double taxation – special pressure is put on DCs, which depend more on withholding taxes / fewer treaties

# Transfer pricing

- Transfer pricing (8-10) Emphasis on:
    - Valuation of intangibles
    - Contractual assignment of risks
    - Profits from cash-boxes
    - Commercially rational test

➢ Financial estimation of value, with flexibility in contingent contracts: important in DCs (trademarks)

➢ Assumption of contractual risks and determination of profit: difficult to ascertain, need for rules, but

- A decisive factor in new rules: capacity to confront and manage risk, associated with decision-making
- Works well for precluding the cash boxes that finance R&D
- Does it work as well with subsidiaries typically found in DCs?
- Does it favor HQ?

# Conclusions

- Taking note of deficient capacity to implement a complex system is fair enough, but it is no reason for eluding discussion of the core issues
- The agreements of the BEPS project will have barely begun to be implemented... It is up to DCs to examine them carefully to determine how beneficial or relevant they are for them.
- Listen to the experience of DCs.