

# Special meeting of ECOSOC on “International Cooperation in Tax Matters”



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## Base Erosion and Profit Shifting Issues for Developing Countries<sup>1</sup>

### Introduction

Over the last decade there has been increasing public scrutiny of the taxes paid by companies, especially Multinational Enterprises (MNEs). Evidence suggests that some companies pay little or no tax anywhere in the world. There is a wide range of cross-border tax planning techniques that are used to produce such results which are collectively referred to as “base erosion and profit shifting”.

Last year the OECD and G20 jointly established a Base Erosion and Profit Shifting project to address those global concerns. The acronym BEPS is often used to refer to this specific project. G20 countries that are not members of the OECD participate in BEPS as Associates, on an equal footing with Member Countries. However, it is widely recognized that many other countries need to be engaged in this work if it is to yield the greatest benefits for countries generally and reflect the concerns and aspirations of all countries, by reducing their vulnerability to base erosion and profit shifting and increasing their ability to respond to it cooperatively and effectively.

In response to these concerns and increasing international attention, the United Nations Committee of Experts on International Cooperation in Tax Matters established a Subcommittee on Base Erosion and Profit Shifting Issues for Developing Countries at its annual session in October 2013.

The Subcommittee is mandated to draw upon its own experience and engage with other relevant bodies,

particularly the OECD, with a view to monitoring developments on base erosion and profit shifting issues and communicating on such issues with officials in developing countries (especially the less developed) directly and through regional and inter-regional organisations. This communication is being done with a view to:

- helping inform developing countries on such issues;
- helping facilitate the input of developing country experiences and views into the on-going UN work, as appropriate; and
- helping facilitate the input of developing country experiences and views into the OECD/G20 Action Plan on BEPS.

### What are the Key Causes Of Base Erosion and Profit Shifting?

The global international tax framework reflected in countries’ domestic law and bilateral tax treaties assumes that MNEs will pay tax somewhere on their cross-border income. Generally speaking, it is envisaged that income will be taxable either in the country where the income is earned (the source state) or the state where the multinational is headquartered (the residence state) —depending on the nature of the cross-border activity undertaken by the MNE. A fundamental concern is that international tax standards, both in terms of domestic law and bilateral arrangements, have not kept pace with rapid advances in technology, transportation and communication and the resulting increase in the number of MNEs, highly mobile capital and global value chains. It is difficult for any country, acting alone, to fully address these issues. In fact, these concerns are a global problem that requires a global response, but one calibrated to the needs and situations of all countries, including developing countries.

<sup>1</sup> This Newsletter is largely based on the information note on the same issues written by the UN Subcommittee on Base Erosion and Profit Shifting Issues for Developing Countries and coordinated by Ms. Carmel Peters. It is available at the following webpage: [http://www.un.org/esa/ffd/tax/BEPS\\_note.pdf](http://www.un.org/esa/ffd/tax/BEPS_note.pdf)

It is important to note is that there is not one single cause of base erosion and profit shifting. In some cases it reflects gaps and inadequacies in the design of domestic laws. Countries' domestic rules for taxing multinationals on their world-wide profits ("controlled foreign company" (CFC) rules) may be inadequate. In other cases countries' rules for taxing investment into their country may be undermined by the use of related-party debt funding to strip out profits.

In some instances, certain transfer pricing practices (i.e. "mis-pricing") result in base erosion and profit shifting. These practices are particularly prevalent in relation to multinational profits generated by brands, intellectual property or digital services that are highly mobile and can be located anywhere in the world, but can also exist in relation to the pricing of extractive resource-related contracts, for example.

Another set of problems arise from complex interactions between different countries' tax rules. For example, one country may classify a local entity as a company. But the country where the investor in that entity is resident may treat the investor as the direct owner of the assets of the company. That is, that second country does not recognize the existence of a separate legal entity between the investor and the assets. These types of "hybrid entities" can be used to claim the same tax deduction in two countries and may result in unintended double non-taxation. Similar double non-taxation problems can arise from mismatches in the way different countries classify instruments as being either debt or equity.

To date, bilateral tax treaties which follow either the UN or OECD Model Tax Conventions have been focused on removing double taxation between the two countries which signed the treaty and preventing tax evasion and avoidance. Treaty abuses, including the practice of residents of third countries effectively gaining access to treaty benefits intended only for residents in the signatory states (i.e. "treaty shopping") also contribute to base erosion and profit shifting.

These problems can be difficult to identify as revenue authorities require information from multiple jurisdictions which may not be readily available. Even when information can be shared, the detail required to analyze an MNE's arrangements is seldom provided unless specifically requested, and not enough may be known to support such a request to a particular jurisdiction. The proliferation of different information disclosure standards and formats had also at times made it difficult to compare data sets between countries even when information has been exchanged.

## How does Base Erosion and Profit Shifting Affect Countries?

Base erosion and profit shifting is a global problem because the impact of the tax laws and policies of one country can adversely affect another country's ability to collect taxes that are due. This "spillover effect" can be unintended, but whether it is intended or not, it has the same budgetary effect on the country losing tax revenue. In turn, this can impede country development.

Historically, countries typically view the setting of domestic international tax laws as a matter for each sovereign state and in making these decisions too often little or no account is taken of either (i) the impact their laws have on other countries or (ii) the impact that the laws of other countries have on them. Practice has shown that this perspective, which many or even most sovereign states take, can give rise to base erosion and profit shifting concerns.

For instance, if some countries do not effectively tax their own multinationals, this may have a knock-on effect of giving these multinationals incentives to shift profits or minimize their taxable presence in other countries where they operate (and therefore pay no tax anywhere in the world).

In the same way, if countries do not tax businesses operating in their jurisdictions in an effective manner, when they should, the incentive on the multinational to escape taxation in the country where they are headquartered increases.

Another concern that base erosion and profit shifting raises for governments is that it may result in small and medium-sized local businesses that do not engage in cross-border economic activities (and therefore do not have the same possibilities for tax avoidance) being unable to effectively compete with MNEs.

Ultimately, base erosion and profit shifting have adverse implications for the important task of actual tax collection. Many income tax systems depend upon the voluntary compliance of taxpayers. Voluntary compliance is adversely impacted by perceptions of unfairness. If MNEs do not pay their share of tax this is perceived as unfair and that perception may undermine voluntary compliance by other taxpayers. A system that is seen as not bringing in the expected revenues from corporate income tax can be expected to result in less voluntary compliance (and greater costs of collection) in the areas of both corporate and personal income taxes.

## What has Happened so Far?

G20 countries and the OECD have jointly committed to addressing base erosion and profit shifting. In June 2012, the G20 leaders discussed the need to prevent base erosion and profit shifting at their meeting in Mexico. They asked the OECD to report to them on the issue. The report released by the OECD in February 2013 outlined the problems and promised an Action Plan by mid-2013. The OECD’s *Action Plan on Base Erosion and Profit Shifting* was then released in July 2013.

The OECD action plan makes specific reference to the interests of developing nations and the role the UN is expected to play: “Developing countries also face issues related to BEPS, though the issues may manifest differently given the specificities of their legal and administrative frameworks. The UN participates in the tax work of the OECD and will certainly provide useful insights regarding the particular concerns of developing countries.”<sup>2</sup>

## What does the OECD Action Plan on Base Erosion and Profit Shifting Cover?<sup>3</sup>

The Action Plan comprises some significant areas of work which are largely grouped under two themes:

### 1. *Establishing international coherence of corporate income taxation:*

- reviewing the impact of mismatches in domestic law which occur because countries have different tax rules for distinguishing between debt and equity or companies and partnerships;
- reviewing domestic rules for controlled foreign companies, which allow countries to tax their multinationals on passive/mobile income that they earn through foreign subsidiaries;
- reviewing domestic rules for limiting interest deductions (e.g. “thin-capitalisation” rules);
- evaluating countries’ domestic rules which offer preferential treatment on certain types of income in a way that is harmful to the international tax environment as a whole;

<sup>2</sup> <http://www.oecd.org/ctp/BEPSActionPlan.pdf>

<sup>3</sup> For a more detailed discussion on the OECD Action Plan on Base Erosion and Profit Shifting, please refer to the Annex to the paper of the Subcommittee on base erosion and profit shifting at: [http://www.un.org/esa/ffd/tax/BEPS\\_note.pdf](http://www.un.org/esa/ffd/tax/BEPS_note.pdf)

- restoring the full effects and benefits of international standards;
- preventing the misuse of tax treaties (e.g. by investors who should not qualify for tax relief under a tax treaty);
- improving the “permanent establishment” rules in treaties for determining when a business has a taxable presence in a foreign country; and
- improving transfer pricing rules (which ensure that a market price is paid on related-party transactions), by ensuring that transfer pricing rules are in line with the creation of value particularly in relation to debt, financial transactions, intellectual property, contractual bearing of risks, and management services.

### 2. *Ensuring transparency while promoting increased certainty and predictability:*

- developing methods and identifying sources of information which will allow countries to assess the impact of base erosion and profit shifting, and monitor the effect of any solutions;
- designing best practice rules which would require taxpayers to disclose aggressive tax arrangements or transactions;
- improving transfer pricing documentation and introducing country-by-country reporting requiring multinationals to disclose which countries they pay tax in, derive income from, and conduct activities in; and
- making dispute resolution procedures in treaties more effective, efficient and accessible.

Lastly, the two themes are supported by two projects which span the breadth of the OECD’s Action Plan:

- considering whether special tax rules are needed to tax digital goods and services that are provided over the Internet; and
- developing a multilateral instrument so that solutions can be implemented swiftly without needing to separately renegotiate individual treaties.

Finally, it is important to note that the Action Plan states that while “a number of countries have expressed a concern about how international standards [...] allocate taxing rights between source and residence States” it is not directed at addressing these broader concerns. It goes on to note that the Action Plan will “restore both source and residence taxation in a number of cases where cross-border income would otherwise go untaxed or would be

taxed at very low rates” but that the Action plan is “not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income”.<sup>4</sup> ■

The following questions were posed to tax administrations of developing countries. Please refer to the Financing for Development website for the responses that were received.<sup>a</sup>

1. How does base erosion and profit shifting affect your country?
2. If you are affected by base erosion and profit shifting, what are the most common practices or structures used in your country or region, and the responses to them?
3. When you consider an MNE’s activity in your country, how do you judge whether the MNE has reported an appropriate amount of profit in your jurisdiction?
4. What main obstacles have you encountered in assessing whether the appropriate amount of profit is reported in your jurisdiction and in ensuring that tax is paid on such profit?

The Subcommittee has identified a number of actions in the Action Plan that impact on taxation in the country where the income is earned (the source country), as opposed to taxation in the country in which the MNE is headquartered (the residence country), or seek to improve transparency between MNEs and revenue authorities as being particularly important to many developing countries (while recognizing that there will be particular differences between such countries).

These are:

- Action 4—Limit base erosion via interest deductions and other financial payments
- Action 6—Prevent treaty abuse
- Action 8—Assure that transfer pricing outcomes are in line with value creation: intangibles
- Action 9—Assure that transfer pricing outcomes are in line with value creation: risks and capital
- Action 10—Assure that transfer pricing outcomes are in line with value creation with reference to other high risk

transactions (in particular management fees)

- Action 11—Establish methodologies to collect and analyze data on BEPS and the actions to address it
  - Action 12—Require taxpayers to disclose their aggressive tax planning arrangements
  - Action 13—Re-examine transfer pricing documentation
5. Do you agree that these are particularly important priorities for developing countries?
  6. Which of these OECD’s Action Points do you see as being most important for your country, and do you see that priority changing over time?
  7. Are there other Action Points currently in the Action Plan but not listed above that you would include as being most important for developing countries?
  8. Having considered the issues outlined in the Action Plan and the proposed approaches to addressing them (including domestic legislation, bilateral treaties and a possible multilateral treaty) do you believe there are other approaches to addressing that practices that might be more effective at the policy or practical levels instead of, or alongside such actions, for your country?
  9. Having considered the issues outlined in the Action Plan, are there are **other** base erosion and profit shifting issues in the broad sense that you consider may deserve consideration by international organisations such as the UN and OECD?
  10. Do you want to be kept informed by email on the Subcommittee’s work on Base Erosion and Profit Shifting Issues for Developing Countries and related work of the UN Committee of Experts on International Cooperation in Tax Matters?
  11. Do you have any other comments you wish to share with the Subcommittee about base erosion and profit shifting, including your experience of obstacles to assessing and then addressing the issues, as well as lessons learned that may be of wider benefit?

<sup>a</sup> Please refer to the following website: <http://www.un.org/esa/ffd/tax/Beps/index.htm>

### For further information

Please refer to the Financing for Development website at [www.un.org/esa/ffd/](http://www.un.org/esa/ffd/)

Link to Base Erosion and Profit Shifting: <http://www.un.org/esa/ffd/tax/Beps/index.htm>

<sup>4</sup> <http://www.oecd.org/ctp/BEPSActionPlan.pdf>, page 11.