



Working Paper 71

Assisting Developing Countries in Taxation after the OECD's BEPS Reports: A Suggested Approach for the Donor Community

Michael C. Durst

November 2017

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ICTD Working Paper 71

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Assisting Developing Countries in Taxation after the OECD's BEPS Reports: A Suggested Approach for the International Donor Community

Michael C. Durst

Summary

This paper explores how the international donor community might most productively offer technical assistance to developing countries in the area of taxation, in light of the OECD's recently completed study of 'base erosion and profit shifting' (BEPS). The paper addresses both the political and the technical constraints facing developing country tax administrations. It recommends that donor agencies seek to build their technical assistance efforts through long-term collaborations with developing country governments, and observes that the most productive technical assistance efforts might extend beyond the boundaries of the particular international tax issues that the BEPS studies address. The paper also explores two particular BEPS-related measures on which productive technical assistance may be especially feasible, namely the implementation of limitations on corporate interest deductions, and the construction of 'transfer pricing safe harbours'.

Keywords: developing country taxation; base erosion and profit shifting; corporate taxation.

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Acronyms

| | |
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| AFD | Agence Française de Développement |
| BEPS | Base erosion and profit shifting |
| CFC | Controlled foreign corporation |
| CSO | Civil society organisation |
| EBITDA | Earnings before interest, taxes, depreciation and amortisation |
| ICTD | International Centre for Tax and Development |
| IMF | International Monetary Fund |
| MNE | Multinational enterprise |
| NGO | Non-governmental organisation |
| OECD | Organisation for Economic Co-operation and Development |
| PCT | Platform for Collaboration on Tax |
| TNMM | Transactional net margin method |
| VAT | Value-added tax |

Introduction and summary of conclusions

This paper responds to the request of Agence Française de Développement (AFD) for advice concerning how the international donor community might most constructively assist developing country governments in improving the performance of their tax systems in light of the recent recommendations of the Organisation for Economic Co-operation and Development (OECD), and other international organisations including the World Bank, the International Monetary Fund (IMF), and the United Nations, relating to the problem of ‘base erosion and profit shifting’ (BEPS). BEPS refers to a very common form of tax planning by multinational business groups that depends upon corporate subsidiaries located in tax havens.

Over recent decades, BEPS appears to have resulted in substantial avoidance of corporate income taxation in countries at all levels of economic development. As discussed below, however, revenue losses from BEPS can be seen as more damaging in developing than in wealthier countries, both because developing countries must as a practical matter depend relatively more heavily than wealthier countries on taxation from large businesses taxpayers, and because many developing countries face especially urgent needs for government revenues in order to invest in public infrastructure to alleviate persistent extreme poverty.

In responding to AFD’s request, this paper first seeks to provide a political and economic understanding of the BEPS phenomenon, with particular emphasis on the pressures of ‘tax competition’ – that is, the dilemma faced by countries in attempting to collect tax revenues from multinational companies, while at the same time encouraging the companies to maintain and increase their local investments. Second, this paper describes two particular recommendations that the OECD and other organisations have made for reducing revenue losses from BEPS: namely, that countries consider adopting (i) stricter limitations on deductions of interest expenses by multinational companies, and (ii) ‘safe harbours’ for use in simplifying the administration of ‘transfer pricing’ rules, which are complex rules by which tax authorities can attempt to limit various deductions of local corporate subsidiaries that are engaged in BEPS transactions. Third, this paper suggests processes by which AFD and other donors might assess opportunities in the area of tax technical assistance and begin to develop productive relationships for this purpose with governments that desire assistance. Throughout, this paper maintains a focus on the practical challenges that tax competition raises for the design and implementation of technical assistance in the tax area.

This paper concludes that promising opportunities exist for the donor community to contribute to the welfare of developing countries through technical assistance in taxation. However, the paper recommends that in beginning their engagement in technical assistance efforts, AFD and other donors should avoid prematurely advising countries to adopt particular anti-BEPS measures, as these measures might be unrealistic given the political and economic circumstances of the particular country. Instead, donors should seek to initiate long-term collaborations with selected countries that have indicated a strong interest in working with donors in the tax area, and, ideally, countries with which a particular donor already maintains close ties. Donors should, first, work closely with the tax and finance officials of those countries to identify forms of technical assistance that might be most suited to the countries’ political and economic circumstances. Depending on the outcome of this initial collaborative process, the technical assistance that is identified might relate to the kinds of international corporate tax issues raised by the BEPS phenomenon. Alternatively, the most promising technical assistance efforts might relate to problems in administering other types of taxes, like personal income and consumption taxes.

Many countries' needs for improvement in the administration of these types of taxes are large and pressing, and these taxes generally do not raise concerns regarding tax competition as intensively as the corporate income tax, perhaps raising a greater likelihood of successful implementation.

By engaging jointly with host country officials in identifying particular kinds of technical assistance to be provided, donors will maximise the likelihood of committed governmental support, which historically has been essential for any kind of tax technical assistance efforts to succeed. The final section of this paper will suggest procedural steps by which donors might initiate the envisioned long-term collaborative relationships with particular countries.

1 Explanation of base erosion and profit shifting (BEPS)

1.1 The fundamental dilemma of corporate taxation in developing countries

A first step in understanding the problem of BEPS for developing countries is to understand the basic dilemma that these countries face in designing their tax systems. The world's poorer developing countries require increased government revenues in order to build public infrastructure to address urgent requirements in health, education, and other basic human needs. Poorer countries, however, are more limited in their abilities to raise government revenues than the world's wealthier countries.

In wealthier countries, the bulk of government revenues come from broadly applied forms of personal taxation, including personal income tax, and consumption taxes like value-added tax (VAT). In poorer countries, however, low per capita earnings and levels of consumption in themselves limit the amount of revenue potentially available from personal income and consumption taxes. Moreover, in poorer countries, a large proportion of economic activity tends to be 'informal', in the sense that many business transactions are conducted in untraceable cash, and many employment arrangements are not formally documented. The combination of low per capita income and economic informality substantially limits the ability of many developing countries to raise revenue from 'workhorse' taxes like personal income tax and VAT; and as a result, total tax revenues, measured as a percentage of gross domestic product, tend to be much lower in the world's poorer developing countries than in wealthier countries.¹

Another form of taxation, corporate income tax, exists in virtually every country in the world. Over time, corporate income tax has fallen into political disfavour in many of the world's wealthy countries, largely based on a belief (which is common among economists but not universally shared) that taxes on corporate income unduly discourage business investment and therefore economic growth. Many countries have reduced the rates of their corporate income taxes substantially in recent decades,² and have provided corporations with tax benefits of various kinds to encourage investment. In recent decades, in the world's wealthier countries, the

¹ The IMF, using a four-category classification of countries by income level (low, lower middle, upper and high), has estimated that as of 2013, the ratio of tax revenue to GDP in high-income countries was approximately 25 per cent, whereas in low-income countries the ratio was less than 15 per cent. IMF, OECD, UN and World Bank Group 2016: 7.

² IMF 2014: 22.

percentage of total government revenue attributable to corporate income tax has declined dramatically.³

Because of the difficulties they face in raising revenue from personal income and consumption taxes, developing countries generally have not been able to reduce the relative importance of the corporate income tax in their fiscal systems. Income generated by corporations, particularly the local subsidiaries of foreign-owned multinational groups, tends to represent a large share of the total income generated each year in poorer countries, and corporate business tends to be documented by modern record-keeping systems. As a result, the relative share of total government revenues represented by corporate income tax has generally remained significantly higher in the poorer than in the wealthier countries.⁴

Despite their relative dependence on corporate tax revenues, however, developing countries, like wealthier countries, perceive strong pressures to minimise the tax burden on corporations in order to avoid discouraging inbound investment. This competition is often said to create a 'race to the bottom', under which countries compete to find various ways to exempt companies from taxation on income from their local investments. There are indications, moreover, that the economic pressures of tax competition, and the resulting tendency to offer inbound investors exemption from taxation, are especially important for developing countries.⁵

Many countries offer investing corporations explicit and formal exemptions from taxation. These take the forms of, for example, 'tax holidays' exempting companies from taxation for periods of, say, ten or fifteen years after commencing a new investment; and exemptions from taxation for companies willing to invest in designated 'economic development zones'. The practice of countries offering corporate tax holidays, and tax exemptions based on special economic zones, has been common for well over 60 years,⁶ and the practice has expanded substantially over recent decades.⁷

1.2 BEPS tax-avoidance structures

Formal tax exemptions, however, have not been the only means by which governments have offered companies tax reductions in order to compete for investment. Approximately 70 years ago, international tax practitioners developed informal techniques of tax avoidance using corporations established in tax havens (what we now call 'BEPS' transaction structures), which over the years have resulted in the extension of significant *de facto* tax exemptions to multinational companies without the need for formal legislation. From the start, these arrangements tended to conform to four patterns, which today are familiar to all international tax practitioners.⁸

1. *Loan-based income-shifting transactions:* A multinational group establishes a 'finance company' in, for example, the Cayman Islands, contributing a large amount of cash to this company. The finance company then extends a loan to a group member that

³ As of 2012, by IMF estimate, corporate income taxes accounted for less than 9 per cent of total government revenue in the world's high-income countries. IMF 2014: 7.

⁴ In 2012, by IMF estimate, low-income countries received about 16 per cent of their revenue from the corporate income tax. IMF 2014: 7.

⁵ See Crivelli, De Mooij and Keen 2015; IMF 2015; Cobham and Jansky 2017.

⁶ Lent 1967: 249 indicates that widespread use of tax incentives began shortly after the end of the Second World War.

⁷ IMF 2015: 8.

⁸ A useful summary of the various kinds of BEPS transactions can be found in OECD 2014a: 15-17. Extended descriptions can be found in Kleinbard 2011a and 2011b. A briefer treatment can be found in Durst 2012.

performs manufacturing operations in, for example, Kenya.⁹ The Kenyan operating company deducts interest paid on the loan, thereby reducing taxable income in Kenya, but no tax is imposed on receipt of the interest by the finance company in the Cayman Islands.

2. *Intangibles-based income-shifting transactions:* A group contributes valuable intellectual property, like the trademark to a popular brand of beer, to an ‘intangibles holding company’ established in the Cayman Islands. A member of the group in, for example, Togo, which distributes the group’s beer in that country, pays royalties to the Cayman Islands company for the use of the trademark. The royalty payments are deductible in Togo, thereby reducing the distribution company’s tax liability in that country, but no tax is imposed when the royalties are received in the Cayman Islands.
3. *Income-shifting transactions involving related-party transactions in services and tangible property:* Often, groups establish ‘hub’ or ‘principal’ companies in tax havens to engage in a variety of income-shifting transactions involving sales of services and of tangible property. For example, a multinational mining group with a parent company in Belgium might establish a ‘hub’ company in Bermuda. The Bermuda hub company might ‘purchase’ valuable mining supplies and equipment from a group member based, for example, in Belgium, and ‘resell’ the supplies and equipment, with a profit mark-up, to a mining subsidiary based, for example, in Tanzania. Alternatively, the hub company might contract for the performance of technical services by employees of the Belgian parent company and ‘resell’ the services, at a profit, to the Tanzanian company. Under both scenarios, inflated payments from Tanzania contribute to tax-sheltered profits in the hands of the Bermuda company.
4. *Income-shifting transactions involving outbound sales of products:* These kinds of income-shifting transactions are very common in the natural resources and agricultural sectors.¹⁰ As an example, a multinational group based in the Netherlands might be involved globally in the tyre business. The group might have a purchasing subsidiary in Laos, which buys raw rubber from farmers and ships it to the group’s tyre-making plants located around the world. Laos imposes corporate income tax at a 28 per cent rate. The group also might establish what it designates as a ‘marketing subsidiary’ in, say, Mauritius, which imposes a very low corporate income tax rate. The purchasing subsidiary might then enter into contracts to sell the rubber to the marketing company at 10 per cent below the world market price; and the marketing company might then contract with the group’s tyre-making subsidiaries around the world, to resell the rubber to them at 5 per cent above the market price.¹¹ In this manner, substantial profit can be shifted from the relatively high-tax Laotian subsidiary to very low-tax Mauritius.

By means of these four basic techniques and variants of them, it became possible over the years for multinational companies to conduct business in countries around the world with little if

⁹ All of these examples are for illustrative purposes only and are not intended to represent any particular transactions involving particular companies or countries.

¹⁰ Problems in the taxation of natural resource producers are very important in resource-rich developing countries, and there is a substantial literature on income shifting in the natural resources sector. See generally Durst 2016b and sources cited therein. Providing technical assistance in the area of natural resource taxation requires access to specialised industry expertise.

¹¹ Typically, under a purchase-and-resale arrangement of this kind, the product that is sold is never actually shipped to the haven marketing company. Instead, the product is shipped from the producing country directly to the places around the world where the product will be used. The purchase and resale essentially amount to a contractual fiction, occurring on paper but having no effect on the physical handling and shipment of the product concerned.

any corporate income tax liability, regardless of whether the countries offered formal tax exemptions through, for example, tax holidays or special economic zones.

Occasionally over the decades, these tax avoidance structures have come under public scrutiny, with critics typically pointing to the artificiality of the tax haven companies that stand at the structures' centres.¹² In particular, from time to time, the home countries of multinational groups have enacted 'controlled foreign corporation' (CFC) rules that were designed to limit their multinationals from participating in the tax haven-based avoidance arrangements, but typically these proposals have been of limited coverage and relatively easily avoided.¹³ Overall, there has been little serious legislative effort in countries at all levels of economic development to interfere with the growth around the world of haven-based tax avoidance structures.

Indeed, over the decades, countries around the world have adopted systems of international tax law that have had the effect of protecting haven-based tax planning structures from legal challenge. For example, although a great many haven-based tax avoidance plans involve loans made between members of the same multinational group, many countries around the world have refrained from adopting laws that would have prevented companies from deducting even very high levels of interest payments made to related companies in tax havens.¹⁴ In addition, in part through negotiations held under the auspices of the OECD, almost all the world's countries have agreed to keep in effect difficult-to-administer arm's-length transfer pricing rules. These place a heavy procedural burden on tax administrations that might seek to argue that a company's royalties, management fees, or other payments to related parties were sufficiently excessive that deduction should be denied.¹⁵ In short, rather than seeking to eliminate haven-based tax planning arrangements, governments around the world in effect have tended to protect them through the maintenance of what has come to be called an 'international consensus' of accommodating legal rules.

1.3 Role of news media and civil society organisations after the 2007-8 financial crisis

The global financial crisis of 2007 and 2008 directed a great deal of critical public attention to the business practices of the world's multinational corporations, and also raised in many countries fears of serious reductions in public revenues. Investigative journalists around the world,¹⁶ as well as prominent civil society organisations (CSOs) that were concerned with problems of

¹² An important example occurred in 1961, when U.S. President John F. Kennedy criticised tax-avoidance corporate structures used by U.S. multinationals, in language that would be equally up-to-date in 2017 (Kennedy 1961).

Recently more and more enterprises organized abroad by American firms have arranged their corporate structures – aided by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and similar practices which maximize the accumulation of profits in a tax haven – so as to exploit the multiplicity of foreign tax systems and international agreements in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad.

CFC regimes, as they currently are in effect around the world, are discussed in OECD 2015a.

¹³ The United States adopted the world's first CFC rules, in Subpart F of the Internal Revenue Code, in 1962. The rules were gradually weakened over time, however, and since the release of the IRS's 'Check the Box' regulations in 1996, the rules of subpart F have been of little effect in constraining U.S. multinationals from engaging in haven-based tax avoidance. See generally Scott 2014. Many other countries maintain CFC rules in some form, although they have not been sufficiently strict to prevent haven-based tax avoidance from growing dramatically around the world. Apparently, governments around the world have been unable to maintain effective networks of CFC rules because of fear of reducing the competitiveness of their home-based multinationals. See generally Durst 2016a. In its BEPS report OECD 2015a, the OECD recommended that countries strengthen their CFC regimes, although politically there has been little if any movement among countries to do so.

¹⁴ See the discussion of this topic at pages 12-14 of this report below.

¹⁵ See the discussion of this topic at pages 14-18 of this report below.

¹⁶ Representative news reports include Drucker 2011, Duhigg and Kocieniewski 2012, and Duncan and Cohen 2012.

global poverty,¹⁷ described the world's global network of haven-based tax avoidance in terms understandable to the public. The media and CSO reports alleged that through these structures, the world's multinationals were avoiding paying billions of dollars in taxes per year in the countries where these multinationals conduct business.

Many news media reports focused on losses of tax revenues in some of the world's wealthier countries. The reports by CSOs, however, tended to focus on apparent revenue losses in the world's poorer developing countries. These reports pointed to the severe need in these countries for public infrastructure in the areas of health, education, and economic development, and alleged that revenue losses caused by haven-based tax avoidance structures were inflicting serious damage on vulnerable individuals. All of the reports, by media outlets and CSOs, generally acknowledged that the haven-based avoidance structures did not violate applicable legal rules, but many expressed the view that the widespread tax avoidance represented morally unacceptable behaviour on the part of the world's multinational businesses.

2 The OECD's recently completed BEPS analysis

2.1 In general

The reports by media outlets and CSOs generated unprecedented public interest in haven-based corporate tax avoidance in many countries in the world. In 2012, the G20 group of governments asked the OECD to commence an extensive study of the topic, which the OECD labelled 'base erosion and profit shifting', or BEPS.¹⁸ The OECD BEPS study was not directed primarily at problems faced by the poorer developing countries; indeed, much of the political protest that led to the BEPS study originated from apparent tax avoidance by multinationals operating in relatively wealthy countries, and the OECD itself is comprised of wealthy industrialised countries. The OECD nevertheless acknowledged the special vulnerability to BEPS of developing countries and consulted extensively during the BEPS study with representatives of developing as well as wealthy countries.¹⁹

The completed OECD studies are voluminous and cover a number of technical topics in international corporate tax law.²⁰ Some of the BEPS recommendations seek to remedy tax avoidance that occurs through highly complex kinds of financial transactions (including recommendations related to 'hybrid financial instruments'). These recommendations are likely to be of interest primarily to policymakers in wealthier countries, and may be of relatively little practical significance to developing countries. Other recommendations involve the topic of

¹⁷ Widely noted reports by CSOs included Christian Aid 2009 and ActionAid 2010.

¹⁸ The OECD formally initiated its BEPS study by publishing an Action Plan in 2013. OECD 2013.

¹⁹ In the course of the BEPS study, several important reports were issued pointing to the special vulnerability of developing countries to revenue losses from BEPS. See International Monetary Fund 2014, and two reports by the OECD to the G20 group of governments, OECD 2014a and 2014b.

²⁰ The OECD organised its BEPS study around 15 'actions': Action 1: address the tax challenges of the digital economy; Action 2: neutralise the effects of hybrid mismatch arrangements; Action 3: strengthen CFC rules; Action 4: limit base erosion via interest deductions and other financial payments; Action 5: counter harmful tax practices more effectively, taking into account transparency and substance; Action 6: prevent treaty abuse; Action 7: prevent the artificial avoidance of PE [permanent establishment] status; Actions 8, 9 and 10: assure that transfer pricing outcomes are in line with value creation; Action 11: establish methodologies to collect and analyse 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; Action 14: make dispute resolution mechanisms more effective; and Action 15: develop a multilateral instrument.

income tax treaties. These recommendations are of potential significance to developing countries but, because changes in countries' tax treaty policies are likely to occur, if at all, only over extended periods of time, the BEPS recommendations related to income tax treaties offer relatively little potential for short-term revenue gains in developing countries.

Two of the recommendations of the BEPS studies, however, might offer a realistic possibility of revenue benefits to developing countries, even in the short to medium term, through technical assistance efforts.²¹ These include (i) the recommendation of the BEPS Action 4 report (OECD 2015b) that countries adopt more stringent limitations on interest deductions, and (ii) the OECD's treatment of transfer pricing rules, which on one hand declines to recommend departure from the historical subjective and fact-intensive principle of 'arm's-length' transfer pricing enforcement, but on the other hand appears to leave open the possibility that countries might adopt somewhat more simplified transfer pricing rules, perhaps incorporating some forms of safe harbours, which could result in more effective constraints on income shifting to related parties in tax havens.²²

2.2 Limitations on interest deductions

The OECD concludes in its report on BEPS Action 4²³ that as a theoretical matter, each subsidiary within a multinational group should be permitted to deduct a reasonably determined, allocable share of the group's total indebtedness to unrelated lenders. For example, if a multinational group as a whole holds indebtedness to unrelated lenders totalling €100,000,000, each member of the group should be entitled to deduct a portion of that amount, in proportion, for example, to the member's share of the group's net income before interest. Thus, as a theoretical ideal, the Action 4 report advocates what might reasonably be seen as a formulary approach to the apportionment of interest expense, which the OECD refers to as a 'group ratio rule'. This approach would substantially curtail income shifting through the use of related-party loans, because group finance companies established in tax havens could not 'manufacture' debt to affiliates in excess of the group's actual total indebtedness to outside parties.

Despite the theoretical appeal of the group ratio approach, however, the Action 4 report acknowledges that the approach could pose administrative problems, and might be considered overly restrictive by some countries. As an alternative, the OECD has recommended that countries adopt 'bright-line' limitations on interest deductions, which generally would limit companies' deductions to 30 per cent of their earnings before interest, taxes, depreciation and amortisation (EBITDA).²⁴ The OECD also recommends various exceptions and technical refinements to EBITDA-based rules, notably an exemption for financial businesses like banks

²¹ Participants in meetings organised by AFD in Paris in March 2017, involving personnel from the OECD and World Bank, generally expressed agreement that technical assistance in these areas has the potential for generating positive results. See also note 42 below.

²² The OECD's overall recommendations regarding transfer pricing are contained in its report on BEPS Actions 8-10, OECD 2015c. Other suggestions for developing countries are contained in Platform for Collaboration on Tax 2017.

²³ In October 2015, the OECD released its final report on 'Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments (OECD 2015b), along with its final reports on other BEPS actions. Later, in July 2016, the OECD released two follow-up studies of technical issues related to limitations on taxpayers' interest deductions: 'Public Discussion Draft: BEPS Action 4 – Elements of the Design and Operation of the Group Ratio Rule' (OECD 2016a) and 'Public Discussion Draft: BEPS Action 4 – Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors' (OECD 2016b). For an analysis of the policy issues that the OECD has addressed in connection with Action 4, see Durst 2015.

²⁴ The OECD's Action 4 report envisions that countries will use EBITDA-based limitations to replace or supplement existing 'thin-capitalisation' rules which are common around the world. Thin capitalisation rules deny interest deductions if a taxpayer's ratio of debt to equity exceeds a specified level (for example, 3 to 1). The OECD points out that multinationals can relatively easily avoid application of thin-capitalisation rules, in the context of BEPS, by injecting additional equity into their subsidiaries.

and insurance companies, which typically have very high interest expenses and for which an EBITDA limitation would not be suitable.

The OECD has based its EBITDA recommendation on the actions of a number of countries around the world that already have adopted 30 per cent limitations, including Germany, Italy, Spain, Norway, Japan, Finland, and, as of April 1, 2017, the United Kingdom.²⁵ It is notable as well that under France's interest deduction limitations, which set forth several alternative limitations on deductions, interest deductions can in some circumstances be limited to approximately 25 per cent of a taxpayer's EBITDA.²⁶ In addition, in 2013, South Africa enacted limitations, which became effective in 2015, based generally on 40 per cent of EBITDA, although the limitation can vary based on market interest rates in the economy.²⁷ In general, the rules that have been adopted around the world provide for special treatment of banking and other financial businesses, as recommended in the OECD Action 4 report.

Politically, it is an open question in any particular instance whether a country will wish to adopt a 30 per cent-of-EBITDA limitation, in light of continuing perceived pressures of tax competition. Indeed, Germany initiated the practice of EBITDA-based limitations on interest deductions almost ten years ago, well before the OECD's BEPS analysis, and to date it appears that only one country in the developing world, South Africa, has adopted limitations based on the model. Nevertheless, the convergence around interest deduction limitations at or around 30 per cent of EBITDA suggests that an international consensus may be solidifying around that level. Accordingly, limitations of this kind might be a realistic means of reducing base erosion for developing countries with the appropriate political motivation.

An important early step in evaluating possible limitations on interest deductions in a country should be a quantitative evaluation, based on information derived from previously filed tax returns, of the current ratios of interest deductions to EBITDA that local subsidiaries of multinational enterprises (MNEs) are currently reporting. This process is necessary in order to be able to estimate the additional tax revenues that might be generated by EBITDA-based limitations on deductions. This process of revenue estimation may help the local tax administration identify areas in which its practices for extracting data from filed corporate income tax returns, and maintaining that data in useful form, might be improved. Also, government officials' willingness to facilitate the revenue estimates may provide a good indication of whether political support exists for adoption of the deduction limitation.

It is important that the drafting of an interest limitation statute be a collaborative process involving senior finance and revenue personnel from the host country. It will be necessary to conform the statute to the terminology and format, as well as the substantive provisions, of the country's pre-existing revenue statutes.²⁸ Also, under the leadership of appropriate government officials, consultations on the proposed statute should be conducted with potentially affected taxpayers (that is, with MNEs operating within the country). This process could be contentious, and may evoke claims by companies that the proposed legislation would discourage inbound

²⁵ See generally Sheppard 2014 and PwC 2017. On July 12, 2016, the Council of the European Union issued a directive establishing the maintenance of limitations on interest deductions, generally conforming to the OECD BEPS recommendations, as standard practice for EU countries. European Union 2016, Article 4.

²⁶ See <http://taxsummaries.pwc.com/ID/France-Corporate-Group-taxation>
²⁷ Republic of South Africa, Income Tax Act (revised), Section 23M.

²⁸ Although a statute limiting interest deductions is not unusually complicated according to the standards of tax legislation, drafting an interest limitation statute does pose technical challenges, especially with respect to coverage of special industries, like banks and insurance companies, for which the statute's generally applicable EBITDA-based limitation will not be appropriate. Of course, there exists today a body of statutory language from those countries that have to date adopted EBITDA-based limitations. In addition, detailed technical discussion on the drafting of interest limitation statutes can be found in several sources, including the three OECD BEPS reports on the topic, (see note 23 above), and in United Nations 2017.

investment. Despite the possible controversy, however, consultation with potentially affected taxpayers is essential. It is necessary that taxpayers and the government maintain a reasonably cooperative relationship, and taxpayers should perceive that any limitations on interest deductions that are enacted resulted from a process of open and public negotiation, rather than being imposed entirely by governmental fiat.

Following consultation, the next step, if feasible, would be enactment of the interest limitation statute according to the country's regular legislative processes. Technical assistance might continue after enactment, and could include consultation with the tax administration in the examination of corporate returns for the first taxable years affected by the new statute.

2.3 Transfer pricing safe harbours

Under the classic BEPS tax avoidance structure, the multinational group typically tries to reduce its operating subsidiaries' incomes to low levels. Under the OECD's Transfer Pricing Guidelines, the tax authorities of the country in which the operating subsidiary is located is generally entitled to test the adequacy of the income left in the subsidiary by applying one of five specified transfer pricing methods. The most frequently used is the 'transactional net margin method' (TNMM).²⁹

In theory, the TNMM is simple and straightforward. For example, in the case of an operating subsidiary of a multinational group engaged in the distribution of a high-margin, branded beverage, the tax authority is to locate data, from publicly available information, on the profitability of comparable distributors of high-margin beverages that are independent, in the sense that they are not owned within multinational groups. Based on this information, tax administrations are supposed to use statistical techniques to determine an 'arm's-length range' of minimum operating income, which the subsidiary is supposed to maintain. If the subsidiary's operating income falls below the bottom of the arm's-length range, the tax authority is permitted to increase the taxpayer's income by means of a transfer pricing adjustment.³⁰

In practice, however, TNMM has often proven ineffective in enforcing reasonable minimum levels of operating income in subsidiaries of multinational groups.³¹ The central problem is that in

²⁹ Rules governing the TNMM are contained in Paragraphs 2.64 to 2.113 of the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The OECD originally adopted the Guidelines in 1995, and has revised them on several occasions since. The OECD Guidelines offer taxpayers and tax administrations a variety of transfer pricing methods from which to choose, depending on the facts and circumstances. In practice, taxpayers and tax administrations typically use TNMM for the purposes of attempting to evaluate the profit levels of distribution, manufacturing and service-provider subsidiaries.

³⁰ It is important to recognise that transfer pricing methods like TNMM generally are intended to require taxpayers to earn minimum levels of *operating income* within a particular country. Operating income is a measure of income *before* deduction of interest. Therefore, transfer pricing rules generally do not place restrictions on the levels of interest that taxpayers must deduct. This is why, in order to control base erosion, a country needs to adopt *both* effective transfer pricing methods, and separate rules for limiting interest deductions.

³¹ The conceptual challenges facing successful implementation of TNMM (and its equivalent under the U.S. transfer pricing regulations, the comparable profits method (CPM)), are discussed in detail in Durst and Culbertson 2003: 105-114. In July 2014, the OECD issued a report that describes the difficulties faced by developing countries in locating data for application of the TNMM, and suggests several possible approaches to improving operation of TNMM in developing countries, including development of transfer pricing safe harbours (OECD 2015c). The problems of applying TNMM in developing countries are also discussed in Platform for Collaboration in Tax 2017.

Many have argued that the shortcomings of the OECD Guidelines extend well beyond TNMM, and derive instead from a general misunderstanding of the likelihood of finding 'uncontrolled comparables' for the activities that are engaged in among members of multinational groups. Some who point to this problem recommend that the OECD's approach to transfer pricing, with its reliance on comparables, be replaced by a 'formulary' or 'unitary' system under which a group's total, global income would be divided among group members based on their relative levels of actual business activity, like their sales to unrelated parties. For a recent collection of essays on this possibility, see Picciotto 2017. The OECD rejected a move toward global formulary apportionment in its BEPS recommendations; the IMF similarly advises against full adoption of formulary systems but notes that some elements of a unitary approach might be useful in transfer pricing rules for developing countries (IMF 2014: 31-35).

practice, few if any independent companies can be found that are reasonably 'comparable' to the subsidiaries that are established by MNEs. For example, in many different industries, ranging from automobiles, pharmaceuticals and medical devices, to high-profit branded foods and beverages, all or almost all of the distributors in a country are likely to be members of multinational groups. In these industries, it is typically impossible to locate data on more than a few, if any, reasonably close comparables to use for the purposes of a TNMM analysis, and it is therefore impossible for tax authorities to use TNMM to compute a reliable arm's-length range of results. The practical result is that taxpayers can make BEPS-style deductible payments to tax-haven affiliates essentially without limitation. Indeed, it seems likely that in many cases, the amount of income that multinationals leave in their operating subsidiaries, after deduction of BEPS-style payments to tax havens, is limited more by a political desire of multinational companies to pay some level of tax in the countries where they operate, rather than by the compulsion of TNMM or another potentially applicable transfer pricing method.

This situation might be remedied if tax administrations were not required to rely only on comparables data in seeking to establish arm's-length ranges under TNMM, but instead were given authority to prescribe minimum operating income levels based on overall economic data in their countries. Indeed, one country, Brazil, has for a number of years taken this approach of prescribing required margins for local subsidiaries by administrative action, rather than attempting to analyse comparables on a case-by-case basis.³² The Brazilian approach, however, is inconsistent with the longstanding insistence of the OECD Transfer Pricing Guidelines that tax authorities base their transfer pricing determinations only on detailed study of the unique facts of the company under examination, and that the determinations be based on reference to uncontrolled comparables. The OECD and its member countries remain insistent that the Brazilian fixed-margin approach violates the international consensus regarding permissible transfer pricing laws as set forth in the OECD Guidelines.

An alternative approach, which is not as prescriptive as the Brazilian fixed-margin method, consists of the statement of 'safe harbour' operating margins for specified categories of limited-risk subsidiaries engaged in distribution, manufacturing, and the provision of various kinds of services. Taxpayers would be assured that if their operating margins were at least as high as the safe-harbour levels, the tax authority would not subject them to transfer pricing examination. The safe-harbour margin levels would not be binding on taxpayers – that is, a taxpayer that believes the safe harbour margin level is too high would remain free to state a lower margin on its tax return – but at least in theory, taxpayers would face incentives to comply with the safe harbour in order to avoid the costs and uncertainties of undergoing transfer pricing examination.

The 1995 OECD Transfer Pricing Guidelines, reflecting their overall aversion to any departure from the use of comparables in transfer pricing enforcement, expressed disapproval of transfer pricing safe harbours.³³ In 2013, however, the OECD revised the Guidelines and endorsed the use by countries of safe harbours as an aid to transfer pricing administration.³⁴ The OECD's acceptance of transfer pricing safe harbours chronologically preceded the release of the OECD's BEPS reports and therefore, strictly speaking, is not a BEPS recommendation. The BEPS recommendations do not, however, conflict with the use of safe harbours, and it is clear that the OECD considers safe harbours to be within the range of measures that are permissible under OECD transfer pricing policies. The Platform for Collaboration on Tax, a consortium

³² The Brazilian transfer pricing system is described in United Nations 2013, chapter 10.2.

³³ See OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (version as of 2010), chapter IV(E) (text subsequently replaced as described below).

³⁴ OECD, 'Revised Section E on Safe Harbours in Chapter IV of the Transfer Pricing Guidelines', May 2013, <http://www.oecd.org/ctp/transfer-pricing/Revised-Section-E-Safe-Harbours-TP-Guidelines.pdf>

including the OECD, United Nations, IMF and World Bank, has issued a toolkit on technical assistance in the area of transfer pricing, which prominently addresses the possibility of transfer pricing safe harbours.³⁵

India appears to be the only country to have attempted the use of safe harbours, on a large scale, for limited-risk subsidiaries operating in the country.³⁶ The margins stated in the Indian safe harbour, however, appear to be perceived as unreasonably high, and reportedly few taxpayers have followed them.³⁷

Despite the limited experience with them around the world, safe harbours may be the only means realistically available to developing countries, under current political circumstances and in view of the tax laws already in force in developing countries, to enforce reasonable profit margins for risk-limited subsidiaries of MNEs. More prescriptive approaches like Brazilian-style fixed margins, or even safe harbour margins that are given the power of formal presumptions in tax examinations, are likely to receive intense criticism as violating the 'international consensus' in favour of case-by-case, comparables-based transfer pricing analysis that is still reflected in the OECD Transfer Pricing Guidelines. In view of the continuing importance of risk-limited subsidiaries in BEPS tax-avoidance structures, it would seem desirable for developing countries to consider the extent to which, even within the inevitable constraints on their political feasibility, carefully-designed safe harbours might result in significantly higher reported operating margins. Currently, international organisations engaged in technical tax assistance in developing countries, including the Platform for Collaboration on Tax (PCT) comprising the OECD, World Bank, IMF and UN, are actively exploring whether it might be possible to assist in the development of transfer pricing safe harbour regimes.³⁸

Notwithstanding the potential promise of transfer pricing safe harbours in controlling BEPS in developing countries, however, they raise many as-yet unsolved technical and political problems. First, there is the question of how, in the absence of reliable data on comparables, tax administrations are to compute safe-harbour ranges of required income for subsidiaries operating in their countries. Attempts to rely on approximation, rather than on reference to comparables, are likely to raise objections that tax administrations are departing from the central principles of the OECD Transfer Pricing Guidelines. This basic dilemma in designing safe harbours has not yet been resolved in practice.

Another unresolved question is how much presumptive weight safe harbours should have in tax examinations. One possibility is that safe harbour ranges of required income under TNMM should establish strong presumptions in favour of the tax administration, and that taxpayers seeking to support income levels below the safe harbour levels would need to make a strong factual showing that the lower income levels are justified. Some might argue, however, that giving this amount of presumptive force to safe harbours would tip the burden of proof in transfer pricing examinations excessively in favour of tax administrations, in contradiction to the general principle evident in the OECD Guidelines that the tax administration's authority to adjust taxpayers' income levels should be subject to substantial procedural limits.

³⁵ Platform for Collaboration on Tax 2017.

³⁶ The United States and Mexico have, since the mid-1990s, provided taxpayers with a safe harbour with respect to the income of a confined class of manufacturing companies operating in Mexico, *maquiladoras*. See U.S. Internal Revenue Service, 'IRS Announces Position on Unilateral APA Applications Involving Maquiladoras', IR-2016-133, October 14, 2016, https://www.irs.gov/pub/irs-news/ir-16-133.pdf?_ga=1.134315953.1959233956.1449872249

³⁷ See Lewis 2016.

³⁸ See Platform for Collaboration on Tax 2017: 69-77.

An alternative would be to give safe harbours only limited presumptive force, by providing that taxpayers reporting income levels within the safe harbour range would be immune from challenge by tax authorities, but that taxpayers could, if they desired, report lower income levels and remain subject to transfer pricing examination. Given the difficulties historically faced by tax administrations in conducting transfer pricing examinations under TNMM, however, this kind of limited-force safe harbour might not offer taxpayers sufficient incentive to report income levels within the safe harbour range. Overall, the question of how much prescriptive weight to assign safe harbour margins represents a central question in the design of transfer pricing safe harbours that has not yet been resolved.

As in the design of interest deduction limitations as discussed above, an early step in evaluating the potential benefit of safe harbours in a country should be to analyse existing corporate tax return information in cooperation with host country officials. The analysis would seek to determine the operating margins that risk-limited subsidiaries are currently reporting in the country, and therefore the scope for increased revenues from safe harbours.³⁹

If the analysis of data collected from tax returns proves promising, work might begin on designing safe harbours for the three categories of subsidiaries to which TNMM analysis is most commonly applied: distribution, manufacturing, and service-provider subsidiaries. It is very important that safe harbour margins do not exceed levels that are consistent with taxpayer expectations under the arm's-length standard; otherwise, taxpayers will likely decline to apply the margins, preferring to risk examination by and controversy with the tax authorities. As a practical matter, tax administrations might want to establish safe harbour margins at levels slightly lower than perceived 'arm's-length' levels, in order to encourage taxpayers to use the safe harbours. Given the great difficulties faced by tax authorities in enforcing the TNMM method through examinations, safe harbours even at relatively low levels may generate more revenue than could be raised in their absence.

Overall, the prospects for successful application of transfer pricing safe harbours in developing countries are sufficiently encouraging to justify efforts to assist countries in considering them. However, the design of safe harbours will require resolution of questions that are as political in nature as they are technical. Especially given the limited experience with safe harbours around the world to date, donors should recognise the difficulty and uncertainty involved in efforts to design and implement successful safe harbours. Efforts to develop and implement safe harbours, while offering realistic prospects for benefit to developing countries, should, as discussed further immediately below, constitute only a portion of technical assistance efforts.

3 Further observations on potential work

3.1 The need for long-term, collaborative relationships with host countries

A recent report on technical assistance to developing countries authored by the PCT⁴⁰ confirms that technical assistance involves not only technical challenges of tax design and administration,

³⁹ See in this connection note 46 below, relating to one significant aspect of the revenue estimation process in developing countries.

⁴⁰ Platform for Collaboration on Tax 2016. The PCT's report contains substantial information about the history of technical assistance efforts by international organisations, as well as possible avenues of future work, and should serve as a useful point of reference for AFD. In addition, of course, as evidenced by AFD's March 2017 meetings in Paris on technical

but also, typically, difficult political challenges. Pressures of tax competition, of the kind described earlier in this report, are likely to cause political ambivalence in many countries concerning the desirability of tax measures that would reduce revenue losses to BEPS, and thereby result in effective tax increases on corporations with investments in the country. Sometimes, this ambivalence can involve active disagreement between officials in different governmental departments with, for example, finance and tax officials favouring measures to increase tax collection from multinationals, whereas officials charged with encouraging investment in the same country might strongly oppose these measures. In light of this kind of political ambivalence, which probably is present to at least some extent in every country of the world, it is not surprising that the recent PCT report warns, as part of its main findings: 'An indispensable prerequisite to improving tax capacity is enthusiastic country commitment.'⁴¹

An essential part of successful technical assistance, therefore, consists of obtaining sincere support for the assistance efforts from both senior levels of government, as well as the personnel within the tax administration who will need to implement any measures that might arise from the assistance.⁴² The situation of each country, moreover, is likely to be unique, with countries varying significantly in the extent of their perceptions of being exposed to tax competition, and also in the current level of training and technological capacity of their tax administrations. There is always a danger that those beginning efforts to provide technical assistance to a country will approach their tasks excessively influenced by preconceptions concerning the particular kind of assistance that might be most useful. Host country personnel might easily perceive the suggested approach to assistance as being unrealistically naive, in view of local political or other realities. This kind of situation can easily lead to the failure of a technical assistance mission – and indeed, to the mission never really getting started.

In entering into engagements to provide tax technical assistance, donors should avoid prematurely formulating specific proposals for legal changes or other reforms in the host countries in which it will be working. Instead, a donor should be careful to initiate a process in which host government and donor personnel, jointly, first conduct research on the various elements of the country's revenue and tax administration system and then, together, identify particular projects that appear to offer the best prospect of being productive.

Therefore, a donor's first task should be to establish ongoing consulting relationships with the tax administrations and finance ministries of several (perhaps, initially, two or three) different developing countries, and to establish ongoing dialogues with officials concerning the kinds of technical assistance that are likely to be most beneficial to the particular country. A donor like AFD, for example, might identify the countries from among those with which the agency has maintained close relationships outside the tax field. In addition, international organisations like the OECD, World Bank or IMF might serve as intermediaries in placing AFD and other donors in contact with countries that might be interested in collaboration in the tax area.

In short, the most promising way to approach technical assistance is to treat it as an ongoing process involving continuing, joint research and learning with host country personnel.

assistance, members of the organisations that comprise the PCT appear willing to collaborate with AFD in planning and conducting technical assistance efforts, and AFD should maintain close contact with these organisations.

⁴¹ Platform for Collaboration on Tax 2016: 3.

⁴² The recent PCT report on technical assistance observes in this connection:

Successful strengthening of tax capacity can only be country-driven, requiring continued energy, enthusiasm and commitment from the highest levels. External support can provide critical help. ... But ultimately it is the country itself that will determine success or failure.

Recommendations for particular assistance efforts should be made only after an appropriate process of joint consideration. It is only in this way that the appropriate support can be built for those initiatives that appear to offer the most promise for successful implementation.

3.2 The need to consider opportunities for domestic as well as international technical assistance projects

Donors should remain open, depending on how their collaborations with host countries proceed, to offering assistance in the areas of domestic as well as international taxation. There may well be opportunities to engage productively in technical assistance relating to international taxation, particularly with respect to interest limitations and transfer pricing safe harbours. As discussed above, however, both of those suggested initiatives are likely to face political opposition as well as technical challenges. Given the political and economic pressures of corporate tax competition, it may be more realistic to envision developing countries improving their fiscal positions by improving domestic tax administration than by the taxation of cross-border investors.

Thus, dialogue with host country personnel might identify as promising subjects for technical assistance domestic measures like improving tax examinations of high-net-worth individuals,⁴³ or improving compliance in the ‘informal’ economy (which includes high-income taxpayers operating cash-based businesses, as well as low-income taxpayers).⁴⁴ The ultimate outcome of consultation with host country personnel might end up consisting of a programme of assistance that includes both domestic and international tax initiatives.

3.3 The importance of generating necessary data on the local tax system

An important aspect of the initial phase of long-term collaboration with a host country should be the assembly of revenue data needed to assess the relative strengths and weaknesses of different components of the tax rules within a country, as well as the particular needs of the country in different areas of tax administration. High-quality tax information is also necessary to develop revenue estimates for particular proposals.⁴⁵ Countries vary markedly in the extent to which they maintain revenue data, and data on tax administration, and in many instances lack of available data will pose a significant challenge in determining the highest priorities for technical assistance.⁴⁶ The earliest phases of a long-term technical assistance relationship might include concentrated work on data collection and maintenance processes within a country.

3.4 Capacity-building aspects of technical assistance

It also should be borne in mind that technical assistance in taxation can take two basic forms. First, some technical assistance is directed toward the enactment of particular legal and regulatory initiatives, like limitations on interest deductions and transfer pricing safe harbours.

⁴³ See Kangave, Nakato, Waisla and Lumal Zzimbe 2016.

⁴⁴ See generally Joshi, Prichard and Heady 2015.

⁴⁵ In evaluating potential revenue gains from safe harbours, interest deductions and other proposals in the corporate tax area, it is important to note that many developing countries have adopted ‘alternative minimum taxes’ for corporations, which typically are designed to prevent taxable incomes from falling below a specified percentage (say, 0.5 per cent) of the corporation’s gross receipts. See Best, Brockmeyer, Jacobsen Kleven, Spinnewijn and Waseem 2015. In providing technical assistance to a country in the area of corporate taxation, it is important to determine whether the country has adopted an alternative minimum tax and, if so, to understand the effects of the minimum tax on corporate tax revenues.

⁴⁶ See African Tax Administration Forum 2016. The maintenance of high-quality revenue and tax administration data within a country is crucial to the maintenance of transparency in tax policy and tax administration. It is likely that work to improve data collection and maintenance within a particular country will raise political considerations of various kinds, which can pose substantial challenges in determining the highest priorities for technical assistance.

Second, a large number of technical assistance projects historically have focused on building administrative capacity in developing countries. These include such diverse initiatives as (i) establishing mentoring and ‘job shadowing’ programmes for tax inspectors and other tax and finance officials, through which experienced personnel can share skills and techniques; (ii) developing better information technology systems for use both in direct tax administration and in maintaining accurate governmental financial and tax statistics to promote transparency; and (iii) assistance in the organisation of revenue and finance departments, including the design of employee retention programmes and internal audit capacities.⁴⁷

4 Possible sequence of steps for a donor

Based on the analysis above, a donor might approach its decision making and planning with respect to tax technical assistance efforts according to the following sequence.

1. *Determine whether the donor agency has access to personnel resources needed for long-term technical assistance collaborations:* The necessary resources need not, of course, come only from within the particular agency, but also could come from other government agencies, as well as from non-governmental sources. It needs to be recognised, though, that a successful technical assistance programme will require a long-term commitment from the personnel involved. In order to maintain an ongoing relationship with a particular host country, a core team of at least two or three experts will need to devote substantial portions of their professional time to the technical assistance effort over an extended time period.
2. *Identify particular countries with which to initiate technical assistance efforts:* This process might begin through conversations with tax and finance officials in countries with which the donor already has ongoing relationships outside the area of taxation. In addition, contacts at the World Bank, OECD and other international organisations can provide referrals to countries that might benefit from a technical assistance relationship. A particular donor might wish to begin its technical assistance efforts by establishing ongoing relationships with, perhaps, two countries. Working with two countries simultaneously should accelerate the donor’s progress along its learning curve in the tax area, especially by providing indications of how different countries’ political and economic circumstances might affect the choice of highest-priority areas for technical assistance.
3. *Begin relationships with a substantial period of data gathering and joint learning:* In order to identify the highest priority areas for technical assistance, donor and host country personnel will need to develop a comprehensive understanding of the country’s various revenue sources, and of the relative strengths and weaknesses of its tax administration. As mentioned above, countries vary widely in their practices of data gathering and maintenance, and the gathering of necessary data may pose an early challenge in beginning technical assistance efforts. In general, a donor and the governments with which it is working should, over the course of a series of intensive on-site meetings, perhaps over a period of a year, jointly develop as full an understanding as possible of the strengths and weaknesses of the local tax system and tax administration, as well as local political and economic conditions, in order to identify the most promising areas for assistance efforts.⁴⁸

⁴⁷ Platform for Collaboration on Tax 2016 describes various technical assistance initiatives that have addressed administrative needs.

⁴⁸ In gaining an understanding of a particular country’s tax administration, it would be useful to seek advice from officials involved in the Tax Administration Data Assessment Tool (TADAT) project, which is administered by a consortium that includes the IMF, the World Bank, and a number of other donor agencies. See www.tadat.org. TADAT has, in recent years,

4. *Initiate particular technical assistance projects:* The identification of particular technical assistance projects should follow naturally from the initial joint consultations with host country personnel. It may be the case that some projects are of sufficiently obvious value that they could commence even before the end of the initial consultation period. For example, if a country already has a strong political commitment to limiting companies' interest deductions, work might begin relatively early on a project of legislative drafting of an EBITDA-based statute that would be appropriate for that country's situation. In addition, if capacity building in the form of mentoring seems promising, those efforts could begin relatively early in the consultation period, and could provide valuable insights for use in identifying additional technical assistance projects through the collaborative learning process.

accumulated significant experience in attempts to systematically analyse different national tax administrations in a technical assistance setting. Nevertheless, even if TADAT has already accumulated substantial useful information concerning a particular country's tax administration, it very likely will be necessary to generate additional information, at a high level of detail, in order to be able to conduct a technical assistance project effectively.

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