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# The OECD's BEPS Project and Lower-Income Countries

by Michael C. Durst

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## The OECD's BEPS Project and Lower-Income Countries

by Michael C. Durst



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Durst is also the author of the forthcoming book *Taxing Multinational Business in Lower-Income Countries: A Problem of Economics, Politics and Ethical Norms*, which *Tax Notes International* is serializing in six installments. The book explores a topic that has been highly controversial in recent years: the use by multinational companies of "base erosion and profit-shifting" tax planning structures to reduce their tax liabilities in countries where they conduct business, including the world's lower-income developing countries. In this installment, which is Chapter 4, the author explores the OECD's BEPS initiative as it relates to lower-income countries. The most recent installment appeared in *Tax Notes Int'l*, Apr. 16, 2018, p. 449.

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### Why the OECD? Institutional Setting of the BEPS Studies

In reviewing the OECD's BEPS process as it relates to lower-income countries, it may be useful to begin with a question about global tax institutions: Why, as controversy arose over base erosion and profit shifting after the 2008 Financial Crisis, did the OECD assume leadership of the ensuing intergovernmental study of the topic, instead of a more inclusive international organization like the United Nations? The OECD's membership consists of 35 industrialized and relatively wealthy countries,<sup>1</sup> whereas the United Nations consists of 193 member states at all levels of wealth and economic development. Especially given that the fiscal consequences of BEPS-style tax planning, as discussed in Chapter 2, seem disproportionately severe for lower-income countries, why did the BEPS process originate under the auspices of an organization comprised of relatively wealthy countries?

Much of the reason is historical and has to do with events in the years immediately following World War II.<sup>2</sup> As discussed in Chapter 3, after the First World War, the League of Nations took leadership of a global effort to draft a Model Income Tax Treaty, a task that involved articulating a standard pattern for countries to use in enacting their international tax laws. After the Second World War, however, the League of Nations dissolved and its successor, the newly formed United Nations, was slow to assume the

<sup>1</sup> OECD members as of this writing include Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Latvia, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

<sup>2</sup> See generally Michael J. McIntyre, "Developing Countries and International Cooperation on Income Tax Matters: An Historical Review," unpublished manuscript (2005).

League's former work on model tax treaties. Instead, the Organization for European Economic Cooperation (OEEC), a group of sixteen Western European countries established to help administer post-War U.S. aid under the Marshall Plan, assumed the work of studying and reviewing the League's Model Treaties. In 1960, the OEEC was succeeded by the OECD, with a membership extending beyond Europe, and the new organization continued the OEEC's tax treaty work. In 1963, the OECD issued a new Model Income Tax Treaty, replacing the prior versions of the League, and since then the OECD, despite its relatively limited membership, has maintained the posture of primary global standards-setter in the design of international tax legislation.

In 1967, a group of developing countries, arguing that the international tax policy interests of capital-importing countries sometimes differ from those of capital-exporting countries like those in the OECD, initiated an effort at the United Nations to articulate a Model Income Tax Treaty parallel to the OECD's. The work on a model tax treaty at the United Nations, unlike that at the OECD, was not designated as a formal collaborative process among sovereign governments. Instead, the U.N. process was to be conducted by a committee of government officials and other tax experts from twenty countries, who were to act only in their individual capacities. Decisions of the U.N. committee therefore could be seen only as informal recommendations of experts, not resolutions agreed to among U.N. member governments.

In 1980, the U.N. Tax Committee issued its own Model Income Tax Treaty for use between developed and developing countries. In overall format, the new U.N. model treaty paralleled the OECD model, but departed from it in ways intended to give developing-country governments greater leverage in their tax dealings with investing multinationals. For example, in its rules regarding "permanent establishments" — that is, rules governing when an investing multinational has a sufficiently extensive presence in a country to become liable to local taxation<sup>3</sup> — the U.N. Model Treaty accorded

<sup>3</sup>See text at note 72 below.

countries greater power to tax investors than the OECD Model.<sup>4</sup> With respect to central concepts, however, including notably the "arm's-length principle" that governs rules for dividing a multinational group's income among countries, the U.N. model treaty was virtually identical to that of the OECD. Since 1980, both the OECD and the U.N. have been engaged in ongoing processes of reviewing and incrementally updating their model treaties. The two model treaties continue to differ in details relating to the ability of "source" countries to tax inbound investors, while remaining consistent with each other on broad principles like the applicability of arm's-length transfer pricing rules.<sup>5</sup>

The establishment of the U.N. Tax Committee, and the Committee's issuance of its own Model Treaty, did not as a practical matter dent the OECD's leading role in establishing global standards for international tax rules. The OECD has consistently maintained a much larger tax staff than the United Nations; it has extensive physical facilities based in Paris, for which the U.N. Tax Committee has no counterpart; and the OECD's formal status as an intergovernmental organization gives its pronouncements and publications greater apparent weight of legal authority than documents generated by the U.N. Tax Committee.

In addition, for many years, the OECD has worked closely with international business representatives through its Business and Industry Advisory Committee (BIAC).<sup>6</sup> Although BIAC has no formal decision-making role within the OECD, the OECD generally appears to try to reach a

<sup>4</sup>For a useful summary of differences between the OECD and U.N. model treaties, see Michael Lennard, "The UN Model Tax Convention as Compared With the OECD Model Tax Convention — Current Points of Difference and Recent Developments," *International Bureau of Fiscal Documentation Asia-Pacific Tax Bulletin* (Jan./Feb. 2009).

<sup>5</sup>The texts of the most recent versions of the OECD and U.N. Model Tax Conventions — extensive documents with lengthy official commentaries — are maintained on the websites of the two organizations.

In addition to the U.N. Model Treaty, an important U.N. Tax Committee document is the United Nations Practical Manual on Transfer Pricing for Developing Countries (2nd ed. 2017). The U.N. Manual contains detailed discussions of special administrative issues faced by developing countries in administering and enforcing transfer pricing rules, but does not challenge the primacy of the arm's-length principle, as interpreted in the OECD Transfer Pricing Guidelines.

<sup>6</sup>For a critical look at the OECD's historical relationship with business interests, see Jesse Drucker, "OECD Enables Companies to Avoid \$100 Billion in Taxes," *Bloomberg.com* (Mar. 18, 2013).

working accord with business interests when formulating its tax guidance. Therefore, the OECD's guidelines in different areas of taxation are perceived by many in the global tax community as reflecting the results of quasi-formal bargaining between global business interests and OECD member governments, a perception that affords the determinations of the OECD in tax matters additional international prestige.

As the controversy over corporate tax avoidance grew around the world following the 2008 Crisis, some nongovernmental organizations criticized the notion of according the OECD leadership over a tax-reform study that would affect the interests of many countries that were not OECD members.<sup>7</sup> These NGOs, supported by some developing-country governments, engaged in a global lobbying effort to upgrade the U.N. Tax Committee to an intergovernmental organization on a par with the OECD. This effort proved unsuccessful, but the argument that developing countries should be represented in the BEPS process was persuasive. Accordingly, from the outset of the BEPS effort, in late 2012, the OECD's leadership made efforts to invite developing-country governments to participate in its deliberations, in various ways.

During the initial stages of the BEPS analyses, in 2013 and 2014, the involvement of countries other than OECD members generally involved informal consultations among government officials from OECD member and nonmember countries, both at OECD headquarters in Paris and in regional conferences held around the world.<sup>8</sup> Later, as the BEPS process was concluding and focus was turning to the implementation

stage, the OECD invited all countries to participate formally in the BEPS process, on an equal footing with OECD members, in what the OECD named an "Inclusive Framework" for implementing BEPS, and about 100 countries have participated in meetings of the Framework.<sup>9</sup>

Developing-country governments generally have appeared eager to associate themselves with the OECD's tax reform efforts through the Inclusive Framework and other institutional means of cooperation with the OECD. In my view, this reflects at least in part that developing-country governments generally do not view themselves as engaged in zero-sum competition with either multinational companies or the governments of capital-exporting countries. It seems likely to me instead that most developing-country governments perceive themselves as engaged in a continuous negotiation with the world's multinationals, and with those companies' home-country governments, to achieve politically and economically viable levels of corporate taxation on cross-border investment. The OECD has, by longstanding practice, established itself as an experienced forum for conducting this kind of negotiation. As a practical matter, therefore, whatever doubts might be expressed as to the appropriateness of the OECD as arbiter of global standards in corporate taxation, it seems likely that the OECD will continue to serve as the world's primary locus of negotiation of those standards for the foreseeable future.

As will be discussed further in Chapter 6, this does not mean that the role of the U.N. Tax Committee, and especially its analytical resources, should not be enhanced. There are indeed ways in which the interests of OECD and U.N. member countries are likely systematically to differ, and forums should be provided to ensure that differing views are openly and thoroughly debated. No single institution should hold a monopoly over authoritative policy analysis in international taxation. But, especially if the Inclusive Framework proves to function effectively, the notion that the primary locus of negotiation in international tax matters should be

<sup>7</sup> For an account of NGOs' arguments to this effect, see, e.g., Margaret Burow, "Developing Countries' Options Limited in BEPS Discourse," *Tax Notes Int'l*, Aug. 4, 2014, p. 365; and Stephanie Soong Johnston, "U.N. Rejects Global Tax Body," *Tax Notes Int'l*, July 20, 2015, p. 195.

<sup>8</sup> The OECD describes its efforts to engage developing-country governments in the BEPS process in its on-line discussion of Frequently Asked Questions on the BEPS process. It should be recognized as well that the initial political impetus for the BEPS process came not only from the OECD, but from the G-20 Group of countries, a group that includes Brazil, China, and India. See G-20, G-20 Leaders' Declaration, St. Petersburg Summit (Sept. 6, 2013), paras. 50-52. From the initial stages of the BEPS process, Brazil, China, and India (as well as Mexico, which is an OECD member country) were included in negotiations as full participants, affording some degree of representation to countries that often are seen as "developing" (although their interests are likely to diverge from those of other developing countries with substantially lower per capita incomes).

<sup>9</sup> See Stephanie Soong Johnston, "OECD Inclusive Framework Moving on BEPS Implementation," *Tax Notes Int'l*, July 4, 2016, p. 32.

shifted from the OECD to the United Nations seems, at least at the current time, politically unrealistic and potentially distracting from more important substantive matters.

### Content of the OECD's BEPS Studies: Overview

The OECD's BEPS studies address fifteen "Action" items, each of which involves a difficult technical topic in international tax law.<sup>10</sup> All fifteen Actions are important, in that they relate to areas of law that play some role in facilitating BEPS-style corporate tax avoidance around the world. Some of the items addressed in the BEPS studies, however, are more important than others to the tax systems of lower-income countries. One of the OECD's Action items, for example, involves sophisticated kinds of financial transactions ("hybrid mismatches") that are likely to be of greatest interest to the tax administrations of wealthier countries; whereas other items involve fundamental principles of international tax law, like those governing transfer pricing, which are likely to be of interest to tax authorities in countries at all levels of wealth and economic development.

This chapter seeks to address, in a non-technical manner, four topics covered by the BEPS report that are of special practical significance for lower-income countries. These include the OECD's treatments of (i) transfer pricing rules; (ii) controlled foreign corporation (CFC) rules; (iii) companies' deductions of interest on loans from related parties; and (iv) income tax "treaty shopping." Next, the chapter discusses some measures that relatively wealthy countries recently have taken, outside the boundaries of the BEPS recommendations, to protect their tax bases from erosion.

<sup>10</sup>The OECD organized 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 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.

## Transfer Pricing Rules Under the BEPS Studies

### The New 'Control of Risk' Test

As described in Chapters 2 and 3, BEPS-style tax avoidance typically involves claims that members of multinational groups located in zero- or low-tax jurisdictions are bearing business risks on behalf of the group, and therefore should be treated as earning large portions of the group's income, even though personnel of the zero- or low-tax affiliate may perform little or even no observable business activity. For example, zero- or low-tax affiliates that do nothing but contribute cash toward the development of a multinational group's intellectual property historically have been treated as entitled to large portions of the group's global income, typically by the receipt of royalties from other group members. Similarly, zero- or low-tax affiliates that simply receive cash from parent companies and re-lend that cash to other group members are treated as "really" bearing the risk of making the loans.

Even before the inception of the BEPS process, an OECD discussion draft on transfer pricing aspects of intangible property argued strongly that members of multinational groups should not be rewarded for supposedly bearing business risks associated with the ownership of intangibles if they performed no significant business functions other than contributing cash to the intangibles' development.<sup>11</sup> The discussion draft reported that the members of Working Party No. 6, the group of national tax and finance officials who are responsible for transfer pricing analysis at the OECD, were:

uniformly of the view that transfer pricing outcomes in cases involving intangibles should reflect the functions performed, assets used, and risks assumed by the parties. This suggests that neither legal ownership, nor the bearing of costs related to intangible development, taken separately or together, entitles an entity within an MNE group to retain the

<sup>11</sup>OECD, "Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions" (June 2012).

benefits or returns with respect to intangibles without more.<sup>12</sup>

A few months later, an early public release of the OECD BEPS process extended the principle that transfer pricing rules should enforce a geographic correlation between an entity's income and its value-creating functions, describing the BEPS process's goal as "better aligning [countries'] rights to tax with real economic activity."<sup>13</sup> Soon afterward, in the BEPS Action Plan, the OECD similarly endorsed the goal of ensuring "that transfer pricing outcomes are in line with value creation."<sup>14</sup>

Practitioners perceived the OECD's intention as a substantial departure from existing transfer pricing rules, which generally rejected, as an unacceptably formulaic departure from the arm's-length principle, the notion of apportioning income among affiliates in proportion to their levels of observable business activities. The language of the BEPS Action Plan indeed indicated possible willingness to depart from the arm's-length principle as historically understood, saying that although the OECD would try in its BEPS recommendations to remain consistent with the arm's-length principle, "special measures, either within or beyond the arm's length principle, may be required. . . ."<sup>15</sup> A few months later, the OECD Secretariat's top tax official, Pascal Saint-Amans, alarmed practitioners further when he described himself as "agnostic" with respect to the longstanding debate between the arm's-length

principle and formulaic approaches to the division of income among related companies.<sup>16</sup>

The BEPS final recommendations on transfer pricing, however, released late in 2015, do not contain "special measures," and disclaim any intention to depart from the arm's-length principle. Instead, the recommendations seek to solve the problem of excessive apportionment of income to zero- or low-tax affiliates by addressing how the transfer pricing rules determine which members of a multinational group should be treated as bearing the groups' business risks. In particular, the BEPS final report has revised the OECD Transfer Pricing Guidelines to provide that, regardless of the language of intragroup contracts seeking to assign risks to particular members, an affiliate can be treated for tax purpose as bearing particular business risks only if it in fact "controls" the bearing of those risks.<sup>17</sup>

The question whether a member of a group controls specified risks is based on a subjective, facts-and-circumstances test:

Control over risk involves . . . (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function. It is not necessary for a party to perform the day-to-day mitigation, as described in (iii) in order to have control of the risks. Such day-to-day mitigation may be outsourced . . . . However, where these day-to-day mitigation activities are outsourced, control of the risk would require capability to determine the objectives of the outsourced activities, to decide to hire the provider of the risk mitigation functions, to assess whether the objectives are being adequately met, and, where necessary, to decide to adapt or terminate

<sup>12</sup> *Id.* at 12.

<sup>13</sup> OECD, "Addressing Base Erosion and Profit Shifting" (Feb. 12, 2013), at 8.

<sup>14</sup> OECD, "Action Plan on Base Erosion and Profit Shifting" (July 19, 2013), at 20.

<sup>15</sup> OECD Action Plan at 20:

Alternative income allocation systems, including formula based systems, are sometimes suggested. However, the importance of concerted action and the practical difficulties associated with agreeing to and implementing the details of a new system consistently across all countries mean that, rather than seeking to replace the current transfer pricing system, the best course is to directly address the flaws in the current system, in particular with respect to returns related to intangible assets, risk and over-capitalisation. Nevertheless, special measures, either within or beyond the arm's length principle, may be required with respect to intangible assets, risk and over-capitalisation.

<sup>16</sup> PricewaterhouseCoopers, "An Interview with Pascal Saint-Amans" (Feb. 2014); see also Stephanie Soong Johnston, "Pascal Saint-Amans — The Face of BEPS," *Tax Notes Int'l*, Dec. 22, 2014, p. 1051.

<sup>17</sup> OECD Transfer Pricing Guidelines (2017), at paras. 1.61 ff.

the contract with that provider, together with the performance of such assessment and decision-making. In accordance with this definition of control, a party requires both capability and functional performance as described above in order to exercise control over a risk.<sup>18</sup>

This language is then followed in the newly revised Transfer Pricing Guidelines by five paragraphs detailing the various facts that a tax examiner is supposed to consider in determining whether personnel of a zero- or low-tax affiliate are exercising sufficient hands-on supervisory responsibility over a business activity to be seen as “controlling” the activity. The paragraphs avoid any language that could be seen as establishing a bright-line quantitative test for the level of supervisory activity that will suffice to constitute control.

The new control-of-risk test therefore makes inevitable difficult controversies between tax planners and tax authorities: how many people, at what levels of seniority, must a zero- or low-tax subsidiary employ to establish “control” over the subsidiary’s claimed business risks? This kind of controversy will not be new: for years tax practitioners, concerned with the “substance over form” doctrine or “general anti-avoidance” rules that, as described in Chapter 3, virtually all countries have long had in effect, have been reluctant to endorse tax plans in which a zero- or low-tax company has no employees or observable business activities at all. The standard of practice instead generally has been to require at least *some* observable quantum of personnel and activities; and given the difficulty faced by tax authorities in seeking adjustments based on subjective “substance” tests, minimal physical activity in zero- and low-tax jurisdictions often suffices, as a matter of practice, to sustain BEPS-style planning structures. Given its lack of a quantitative basis for determining whether control of risk has been achieved, it is difficult to see how the new test is likely to substantially change this result.

Further, even to the extent that the new control-of-risk test proves to demand a greater quantum of substance than was required of zero-

or low-tax affiliates under prior law, the new test is more likely to be of use for tax enforcement purposes by “residence” countries, in which multinationals are based, than in “source” countries like, generally, lower-income countries. The tax administration of a country in which a multinational group is based might argue that, for example, a low- or zero-tax intangibles holding company does not genuinely control the risks related to the intangibles it purports to earn, but that those risks are in reality borne by the parent company. The tax administration might therefore insist that royalty income that is paid to the holding company should instead be treated as paid to the parent company. The same argument might be made with respect to a zero- or low-tax financing company: the tax administration might argue that the parent rather than the financing company in reality controls the risks related to intragroup loans, so that interest income received by the financing company should be taxable instead to the parent company.

The new control-of-risk test, however, would seem to be of less potential use to the tax administrations of source countries, from which, for example, royalties are paid to a group’s zero- or low-tax intangibles holding company, or interest is paid to a group’s zero- or low-tax financing affiliate. In response to a transfer pricing challenge, the local companies paying royalties and interest can raise the defense that the amounts they are paying do not exceed arm’s-length levels; and that the fact that the payments are made to arguably insubstantial group affiliates, rather than to the group’s parent company or another member of the global affiliated group, should not affect the deductibility of the payments.<sup>19</sup> That is, from the perspective of the source country, the governing

<sup>18</sup> OECD Transfer Pricing Guidelines (2017), para. 1.65.

<sup>19</sup> Consider, for example, Parentco, located in a high-tax country, which establishes an intangibles holding company, Intangico, located in a zero-tax country. Intangico is granted ownership of a number of Parentco’s intangible assets, which Intangico on-licenses to manufacturing affiliates located in developing countries around the world, in return for royalties. Assume that the royalties represent arm’s-length consideration for use of the licensed intangibles, but that Intangico performs no activities in “control” of the risks associated with the intangibles. Under this scenario, if a group affiliate in a developing country pays arm’s-length royalties to Intangico, the tax administration in Parentco’s country might have a persuasive argument under the new control-of-risk test that the royalties should be taxed to Parentco rather than Intangico — but the tax administration in the country from which the royalties are paid is unlikely to be able to argue persuasively that the royalties should not be deductible in that country.



question with respect to the deductibility of outbound payments is whether they exceed arm's-length compensation for what the paying company is receiving in return from foreign members of its multinational group in the aggregate, not whether the compensation is paid to one particular group member instead of another.

This does not mean that the control-of-risk test might not offer some base-protection advantages to lower-income countries. To the extent capital-exporting countries choose to enforce the new test rigorously, they will reduce the attractiveness of BEPS-style tax planning to their home-based multinationals, thereby perhaps reducing the levels of tax deductions taken in lower-income countries. It is unclear, however, (i) whether as a political matter capital-exporting countries will in fact desire to enforce the new control-of-risk test rigorously, or (ii) given the subjective nature of the new test, whether courts in capital-exporting countries will support tax adjustments that might be made under it. In sum, therefore, while the new control-of-risk test might reduce overall global demand for profit shifting from lower-income countries, the extent if any to which that effect will materialize remains to be seen.

### The BEPS Reports and the TNMM

The BEPS reports do not directly address problems of the Transactional Net Margin Method (TNMM) which, as discussed in Chapter 3, is the transfer pricing method that lower-income countries typically apply in attempting to ensure that local subsidiaries of multinational groups report reasonable levels of taxable income. In the aftermath of the BEPS project, however, the OECD, along with the IMF, the United Nations, and the World Bank, have established a "Platform for Collaboration on Tax (PCT)" to provide technical assistance in transfer pricing administration to developing countries. The PCT has produced a detailed study (labeled a "Toolkit") of the administrative challenges posed by different OECD transfer pricing methods, including the TNMM.<sup>20</sup> The Toolkit can fairly be

<sup>20</sup>Platform for Collaboration on Tax, "A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses" (2017).

seen as the functional equivalent of a BEPS report on TNMM as it is applied in developing countries, and it offers some important observations.

The Toolkit reports that tax administrations in developing countries often have been unable to identify sufficient numbers of "uncontrolled comparables," from commercially available financial databases or other sources, to apply the TNMM effectively.<sup>21</sup> In the absence of sufficient data on comparables, it can be impossible to argue with reasonable persuasiveness (the kind of persuasiveness that might support a finding in court) that the income of a taxpayer is lower than the taxpayer would have earned at arm's length. The Toolkit offers various means by which tax administrations might try to expand the pool of available comparables, for example by accepting comparables from other areas of the world, or perhaps by using comparables information derived from tax returns in the tax administration's files, as well as from commercially available financial databases.

The Toolkit acknowledges, however, that these measures will not suffice, in many circumstances, to generate a persuasive case that a local subsidiary should be earning income of at least a specified level:

This reality means that all parties need to be realistic about the use of comparability data and avoid the misperception that comparability analyses always result in a well-defined and definitive answer. It is often necessary to recognise that a

<sup>21</sup>The Toolkit says at page 12: A common concern of developing economies in the implementation of transfer pricing regimes relates to difficulties in accessing information on "comparables": data on transactions between independent parties used in the application of the arm's length principle. . . .

Available statistics and academic research on the availability of information on comparables corroborate the difficulties reported by many developing countries. Often, the information relevant to a jurisdiction can only be accessed through the purchase of a licence from database providers. However, even putting aside the financial cost of acquiring access to such databases, challenges for developing country tax administrations often remain, particularly in cases where little relevant information relating to a specific jurisdiction or even region exists. Where the information does exist, it may exhibit differences compared to the transactions under review. Typically, in such cases, transfer pricing practitioners need to consider using imperfect data, including the use of data from foreign markets. However, the effectiveness of such approaches has not been studied sufficiently to enable definitive conclusions to be drawn about when they are reliable or how any adjustments to account for such differences should be applied.

comparability analysis provides only an approximate answer and that some flexibility is needed to determine a principled answer in many cases.<sup>22</sup>

The Toolkit suggests that even if available comparables are insufficient to permit a definitive answer in a transfer pricing examination, the available data might provide a tax authority with a basis for negotiation of a resolution with the taxpayer.<sup>23</sup> A transfer pricing method that provides only a starting point for negotiation with taxpayers, however, is not appropriate for principled and transparent tax administration. The TNMM, therefore, remains an unsolved problem for tax administrations: although TNMM is the only OECD-endorsed transfer pricing method that is, as a practical matter, available to lower-income country tax administrations in many cases to try to control base erosion and profit shifting, the method remains too flawed to serve this purpose effectively.<sup>24</sup>

The Toolkit mentions several possible routes toward improving the performance of TNMM. First, the Toolkit describes (but does not endorse) the approach to transfer pricing that is used by Brazil.<sup>25</sup> Brazil employs a transfer pricing method that is similar to TNMM, but which does not rely on searches for comparables; instead, the tax authority publishes required minimum margins for companies performing different kinds of

activities in the country.<sup>26</sup> The Brazilian fixed-margin approach, however, is inconsistent with the political settlement within the OECD that gave rise to the TNMM in 1995 — particularly the insistence on case-by-case, factually intensive examinations of each taxpayer, with individualized searches for comparables.<sup>27</sup> Even today, in light of growing recognition of the difficulties of applying TNMM, it is unlikely that many OECD members would consider favorably an approach like Brazil's, which dispenses with case-by-case identification of comparables.<sup>28</sup> Therefore, at least in the short term, it seems unlikely that widespread adoption of a Brazilian-style fixed margin approach will solve the difficulties faced by low-income country tax administrations in attempting to apply TNMM.

The Toolkit also considers an approach to simplifying administration of TNMM that is in some ways similar to but not as prescriptive as the Brazilian fixed-margin approach, namely the statement by a tax administration of “safe harbor” net margins for specified categories of local subsidiaries of multinational groups.<sup>29</sup> For example, minimum safe-harbor profit margins might be prescribed for subsidiaries engaged in distribution, in manufacturing, and in the provision of various kinds of services. Taxpayers would be assured that if their operating margins were at least as high as the safe-harbor levels, the tax authority would not subject them to further transfer pricing examination. The safe-harbor margin levels would not be binding on taxpayers — that is, if a taxpayer believes that the applicable safe harbor margin is too high, the taxpayer would remain free to state a lower margin on its

<sup>22</sup> *Id.* at 66.

<sup>23</sup> *Id.* at 67:

Some countries, particularly those that are more experienced in transfer pricing seek to mitigate this issue by negotiating with taxpayers to arrive at a sensible, arm's length result, however others, particularly many developing countries, prefer to avoid settlement of cases in this manner. Further, many developing countries report that they do not have the capacity to negotiate in this way. However, where tax administrations do negotiate with taxpayers, the available data will inform the negotiations.

<sup>24</sup> The Toolkit observes that TNMM is not the only transfer pricing method potentially available to tax authorities, and that in some cases, especially where the activities of a local subsidiary seem to generate locally valuable intangibles, a profit-split method might be most appropriate. See, e.g., PCT Toolkit, note 20 above, at 28-29. The profit split method, however, requires tax administrators to analyze not only a multinational group's local operations, but also the operations of other group affiliates located around the world. In practice, convincing profit split analyses can surpass the technical capacity of even the best-resourced revenue administrations, and transfer pricing enforcement in lower-income countries generally is likely to remain limited, as a practical matter, largely to attempts to apply the TNMM.

<sup>25</sup> *Id.* at 76.

<sup>26</sup> The Brazilian transfer pricing rules are described in detail in Chapter D.1 of the U.N. Practical Transfer Pricing Manual for Developing Countries, note 5 above. In the PCT Toolkit, note 20 above, the Brazilian approach is described at pages 75-76. (As a technical point, it should be noted that the “margins” specified under the Brazilian approach are gross margins, rather than the net margins prescribed for use under TNMM. It should be possible, however, also to apply the Brazilian approach in the context of a transfer pricing method based on net instead of gross margins.)

<sup>27</sup> See the discussion of the origins of the TNMM in Chapter 3.

<sup>28</sup> In connection with Brazil's proposed membership in the OECD, the Brazilian government and the OECD are, at this writing, exploring means of harmonizing the current Brazilian approach to transfer pricing with the OECD Guidelines. See Stephanie Soong Johnston and Ryan M. Finley, “OECD and Brazil to Explore Convergence on Transfer Pricing,” *Tax Notes Int'l*, Mar. 5, 2018, p. 959.

<sup>29</sup> PCT Toolkit, note 20 above, at 75, 82-84.

tax return. The overall success of the safe harbor depends, however, on the hope that many taxpayers would choose to comply with the safe harbor to avoid the costs and uncertainties of undergoing intensive transfer pricing examination.<sup>30</sup>

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 harbors.<sup>31</sup> In 2013, however, the OECD revised the Guidelines and endorsed the use by countries of safe harbors as an aid to transfer pricing administration.<sup>32</sup> Therefore, at least in theory, transfer pricing safe harbors fall within the OECD's "international consensus" of acceptable tax administration mechanisms.

Nevertheless, in practice, countries have made relatively little use of transfer pricing safe harbors as a means of simplifying the application of TNMM. India appears to be the only country to have attempted the use of transfer pricing safe harbors on a large scale.<sup>33</sup> Practitioners, however, appear to have perceived the Indian safe harbor margins as unrealistically high, and few taxpayers reportedly have followed them. The difficulties seen in the Indian safe-harbor regime reflect a problem inherent in safe harbors under TNMM. If the tax authority sets the required safe harbor margins too low, they will be seen as permitting taxpayers to report income below the proper arm's-length level; but if the tax authority sets the safe harbor margins too high, taxpayers will report income below the safe-harbor levels and risk examination.

Another problem in designing safe harbors is determining the extent, if any, to which taxpayers

who report incomes below safe-harbor levels should be subjected to heightened scrutiny by tax authorities. The most common-sense approach arguably would be to subject these taxpayers to both an enhanced likelihood of selection for audit and a strong burden of persuasion in supporting margins below safe-harbor levels. A safe harbor with this kind of relatively strong presumptive effect, however, arguably would be difficult to distinguish in practice from the politically problematic Brazilian approach. Moreover, even if a country attempts to subject taxpayers with margins below safe-harbor levels to strong adverse presumptions in tax audits, the only transfer pricing method by which the tax administration can attempt to enforce the presumption is likely as a practical matter to be the TNMM, which remains largely ineffective in application because of the absence of comparables.

In sum, transfer pricing safe harbors at least in theory offer potential administrative advantages for lower-income countries, by inducing some taxpayers to avail themselves of the safe harbor margins and thereby reduce pressure on the transfer pricing audit process. Some key problems in the design of safe harbors, however, remain unresolved. Perhaps the most important of these unsolved problems are (i) the levels at which safe harbor margins should be set and (ii) the degree of presumptiveness that should be afforded to the published safe-harbor margins. Progress in resolving these problems is likely to occur only incrementally, as additional countries seek to implement safe harbors.

As an additional approach to improving transfer pricing enforcement in developing countries, the PCT Toolkit envisions technical assistance to help tax administrators broaden the criteria for identifying acceptable comparables under TNMM.<sup>34</sup> For example, the Toolkit

<sup>30</sup> The discussion in the following paragraphs is based in large part on the analysis of transfer pricing safe harbors in Michael C. Durst, "Assisting Developing Countries in Taxation After the OECD's BEPS Reports: A Suggested Approach for the Donor Community," ICTD Working Paper No. 71 (2017).

<sup>31</sup> See OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995), chapter 4(E) (text subsequently replaced as described below).

<sup>32</sup> OECD, "Revised Section E on Safe Harbours in Chapter IV of the Transfer Pricing Guidelines" (May 2013).

<sup>33</sup> See generally Patricia G. Lewis, "Where Have All the Safe Harbors Gone? A Plea for Reinvigoration," *Bloomberg BNA Transfer Pricing Report* (Feb. 23, 2017). See also Richard S. Collier and Joseph L. Andrus, *Transfer Pricing and the Arm's Length Principle After BEPS* (2017), at 269-270 (noting the historical lack of use of transfer pricing safe harbors and encouraging countries to give safe harbors closer consideration).

<sup>34</sup> The PCT Toolkit, note 20 above, summarizes these elements of the PCT's technical assistance plans at page 84:

*Undertake further research and spread available good practices on measures that may be taken to use existing data more effectively.* Such guidance might include the challenges, and options for using data from foreign markets, the use of data drawn from widened search criteria, and the use of comparability adjustments. There is limited evidence on the impact of geographic differences on profitability. This is an area which could benefit from further research, and the suggested mechanism for increasing the pool of data, described at point 1 above, may provide data to support such research.

envisions providing assistance in adjusting the results of comparables found in databases covering different geographic regions, and in supplementing data from commercial databases with data culled from taxpayers' returns (with safeguards to prevent disclosure of information that might be associated with particular taxpayers). If successful, these kinds of assistance could help tax administrators to assemble larger numbers of comparables for use in a transfer pricing examination, and thereby to make a more persuasive case for adjustment when taxpayers have reported apparently low levels of income.

The Toolkit envisions continuation of current efforts under the auspices of the OECD and other international organizations, to provide training to transfer pricing examiners in developing countries. The still-unsolved nature of the problem of comparables under TNMM raises the question whether this training is likely to be cost effective. Even the best-trained of tax examiners are unlikely to be able, in the course of a tax audit, to generate sufficiently large numbers of comparables to support a scientifically defensible TNMM analysis. Therefore, there is a danger that technical assistance could serve mainly to provide a veneer of progress that might tend to obscure the continuing dysfunction of the current transfer pricing rules.

Against this, however, as the Toolkit points out, in practice transfer pricing examinations sometimes are resolved based not upon scientifically conclusive analyses of comparables, but instead upon *de facto* negotiation between taxpayers and examiners.<sup>35</sup> In this connection, enhanced training of examiners in TNMM could be helpful for two reasons: (i) the training could increase examiners' skills in pointing out vulnerabilities to taxpayers with respect to their reported return positions, thereby enhancing the kinds of resolutions that auditors are able to negotiate; and (ii) the training could increase the pool of available transfer pricing auditors, thereby increasing the number of instances in which revenue recoveries are obtained through negotiation. Revenue recoveries through increased transfer pricing audit coverage are

<sup>35</sup> Note 23 above.

especially likely if audit coverage in a jurisdiction has historically been limited. Therefore, despite the defects of current transfer pricing methods, incremental revenue recoveries from training efforts, especially in the initial years following the training, could be substantial.

Tax Inspectors Without Borders (TIWB), a collaboration of the OECD and the United Nations, has been providing on-the-job training to transfer pricing examiners for several years, and revenue recoveries reportedly have been significant.<sup>36</sup> It seems sensible to continue and even expand these efforts, so long as the revenue benefits appear significantly to outweigh the costs.

It is important, however, that training and other forms of technical assistance not be permitted to mask the need for transfer pricing methods that can be applied more persuasively than is possible today. In particular, the persistence of a regime in which results can only be negotiated, rather than determined with reasonable certainty, is unacceptable in the long or even medium terms, given the obvious dangers presented with respect to the integrity as well as the effectiveness of revenue administration.

### Transfer Pricing Documentation under BEPS

BEPS Action 13 addressed the topic of "Transfer Pricing Documentation and Country-by-Country Reporting."<sup>37</sup> The requirement that taxpayers maintain transfer pricing "documentation" originated in the United States during the early 1990s, and it has now spread to dozens of countries around the world at all levels of economic development.<sup>38</sup> The idea has been that by maintaining, and making available to tax authorities on request, a comprehensive explanation of the policies under which they determine transfer prices, taxpayers will enable

<sup>36</sup> See the reports of recent TIWB activities at [tiwb.org](http://tiwb.org).

<sup>37</sup> The OECD's recommendations under Article 13 are contained in two documents, "Guidance on Transfer Pricing Documentation and Country-by-Country Reporting" (Sept. 2014) and a brief "Final Report on Action 13" (Oct. 2015).

<sup>38</sup> For historical background, see Michael C. Durst and Robert E. Culbertson, "Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today," *57 Tax Law Review* 37, 96-98 (2003).

tax inspectors to perform more effective transfer pricing audits.

In practice, it has been my impression that in many instances, transfer pricing documentation proves to be of surprisingly limited value to tax examiners. During the 1990s, as first the United States and then dozens of other countries began requiring documentation, its drafting quickly became a routinized function of accounting firms and other consultants around the world. In part through the movement of personnel among accounting and other firms, transfer pricing documentation quickly took on a standardized format. In the documentation, much of the factual description of the taxpayer's business has tended to be copied from annual reports or similar documents prepared under securities laws; this material is publicly available and would be readily available to tax inspectors even in the absence of the documentation. The documentation also contains the results of taxpayers' computerized comparable searches; however, in most instances the analyses are performed under TNMM, and because of the difficulties of statistical analysis under that method, the "arm's-length ranges" reported in the documentation generally are, as discussed in Chapter 3, too wide to be very useful in tax enforcement.

After a few years of operating with transfer pricing documentation in the United States, it became clear that in practice, many examiners were not reviewing the documentation.<sup>39</sup> Examiners in the United States are now required to memorialize in their files that they have read the taxpayer's transfer pricing documentation, but it is not clear whether this requirement has led to enhanced revenue recoveries.

Under BEPS Action 13, the OECD has prescribed a standard format to be used internationally for transfer pricing documentation. Information on the multinational group's global activities (the "master file") is to be combined with information on local activities in each country (the "local file"). The OECD

recommendations also contain standard templates for the presentation of information, designed to make the documentation more useful to tax examiners. Tax administrations around the world are adopting the OECD's recommendations, and they are likely to be used widely by tax administrations.

The Action 13 report also recommends that countries require large multinational groups (those with consolidated global sales greater than €750 million) to prepare, and make available to the tax authorities, a "country-by-country (CbC) report" that compares the distribution of the group's taxable income, among the countries where it operates, to the distribution of the group's active business activities among those countries, as measured by the group's sales, the value of its tangible assets, and its number of employees in each country. The country-by-country report therefore shows tax authorities how the apportionment of a group's income among countries differs from the apportionment that might have resulted from a three-factor formulary system. Governments generally have reacted favorably to the OECD's recommendation with respect to country-by-country reports, and many member as well as non-member countries are implementing the new requirement.<sup>40</sup>

The OECD promotes country-by-country reporting as a potentially valuable risk assessment tool for tax administrations in conducting transfer pricing examinations: presumably, the country-by-country breakdown will assist examiners in identifying situations where income is being shifted from their jurisdictions to zero- or low-tax affiliates. The country-by-country proposal, however, originated not with the OECD or national tax administrations but instead with NGOs, which had in mind for it a broader function.<sup>41</sup> The NGOs advocated that multinational groups' country-by-country reports be made available not only to tax authorities, but also to the public. The apparent hope was that public dissemination of the CbC

<sup>39</sup> See Memorandum from IRS chief corporate enforcement official Larry Langdon to IRS Executives, Managers, and Agents (Jan. 22, 2003) (reminding of the need for examiners to request transfer pricing documentation).

<sup>40</sup> See OECD, "BEPS Action 13: OECD Releases CbC Reporting Implementation Status and Exchange Relationships Between Tax Administrations" (Oct. 11, 2017).

<sup>41</sup> See generally Richard Murphy of Tax Justice Network, "Country-by-Country Reporting" (2012).

reports would generate continuing political pressures for change to international tax rules, particularly in the direction of formulary apportionment. The proposal for public disclosure, however, departed from a longstanding global tradition of treating companies' tax filings as confidential, and the OECD did not adopt it. To the contrary, the OECD's report on Action 13 recommends strongly that tax authorities protect country-by-country reports from public disclosure. In addition, the OECD emphasizes that although it expects the country-by-country reports to be useful to tax authorities for risk assessment, the requirement does not reflect an intention to establish formulary apportionment as a substantive rule — and in particular, countries are not to use the country-by-country reports as the basis for tax adjustments made on formulary principles.

It is important, I believe, to be cautious in expectations that the new documentation rules, including the CbC rules, will fundamentally enhance the capacities of tax examiners in practice. In my experience, a barrier to effective transfer pricing examinations often is not that tax inspectors lack necessary information, but instead that they are expected in theory, under the OECD Transfer Pricing Guidelines and similar bodies of national regulation, to consult a broader range of information about a taxpayer than can be organized and digested in a real-life tax audit.<sup>42</sup> Presenting the same or a higher volume of information, but in an internationally standardized format, may have only limited effects on the quality of transfer pricing examinations that can be performed under applicable rules.

Given the attention that has been paid them, it is especially important to be realistic about the practical effects on tax audits of the new CbC reports. Even without the reports, it should be apparent to tax examiners in a country whether taxpayers are making large deductible payments to affiliates; the additional flood of information presented in the CbC reports may complicate as

<sup>42</sup> A sample "functional analysis" questionnaire, to be used by examiners in transfer pricing examinations, is attached to the PCT Toolkit, note 20 above, as Appendix 1. It should be apparent from a reading of this document that detailed "functional analysis" conforming with OECD standards occurs more frequently in theory than in practice.

much as enhance enforcement efforts.<sup>43</sup> Further, even if the new reports do provide tax administrators with additional knowledge concerning disparities between where income is earned and where economic activity takes place, the tax administrators may have no legal means, under the still-applicable arm's-length transfer pricing rules, of translating the knowledge into additional revenue recoveries. The significance of the new CbC requirement, in sum, may be more symbolic and less substantive than has been hoped.

## The BEPS Project and CFC Rules

### The OECD's Action 3 Report

Action 3 of the OECD's BEPS effort addressed the task of "Designing Effective Controlled Foreign Company Rules." CFC rules, it will be recalled from Chapter 3, are laws, following a pattern originated by the United States in 1962, by which many countries have sought to limit the benefits to their home-based multinationals from shifting income from countries where they operate to affiliates in zero- or low-tax countries. Essentially, under a CFC rule, any amounts accumulated in zero- or low-tax affiliates are treated as "CFC income" and become taxable by the home country.

If all countries subjected their home-based multinationals to strict CFC rules, the incidence of BEPS around the world would be substantially reduced if not eliminated. Thus, lower-income and other countries would enjoy substantial protections of their corporate tax bases. As

<sup>43</sup> The Canada Revenue Agency has prepared for the OECD a risk-assessment manual for use with CbC reports. Although the manual suggests numerous ways in which tax examiners might employ CbC reports to identify taxpayers for transfer pricing examination, the manual also contains the following warning:

One of the most basic challenges faced by tax authorities will be the sheer volume of information provided. CbC Reports are prepared by the largest MNE groups, many of which include hundreds or even thousands of entities, across a large number of jurisdictions. In addition, jurisdictions will vary in terms of the number of CbC Reports they will receive, but some large jurisdictions are expecting to receive several thousand reports (including those received from foreign tax authorities). This quantity of information will pose a particular problem for tax authorities that rely on manual processes, but even those which currently use automated systems may find it challenging to determine information relevant to their jurisdiction, to apply risk assessment tools and to identify risk flags among such a large volume of data.

OECD, BEPS Action 13 Country-by-Country Reporting: Handbook on Effective Tax Risk Assessment (2017), at 46.

described in Chapter 3, however, capital-exporting countries have allowed their CFC rules to become relatively toothless over time. The problem has basically been political: when a country imposes CFC rules, it precludes its own multinationals from benefiting from profit-shifting opportunities that might remain available to other countries' multinationals.

The OECD's Action 3 report acknowledges the political difficulties that have led to the maintenance of weak CFC rules, referring somewhat delicately to the need to "strik[e] a balance between taxing foreign income and maintaining competitiveness."<sup>44</sup> The report also notes the possibility that capital-exporting countries might, at least in theory, mitigate concerns regarding competitiveness through multilateral coordination of their CFC rules.<sup>45</sup> The report, however, perhaps bowing to political reality, makes no move toward advocacy of a global network of strict CFC rules as a primary goal of the BEPS project.

Instead, the bulk of the Action 3 report consists of an exhaustive and, in tone, academic discussion of the various technical choices that legislatures and tax authorities must make in drafting CFC statutes and regulations.<sup>46</sup> Apparently, lack of consensus among governments during the BEPS process prevented the OECD from taking a more prescriptive approach to the topic of CFC rules, notwithstanding the rules' potential for eliminating BEPS around the world through collective action by capital-exporting countries.

The Action 3 report notes that some countries' CFC rules attempt to tax only income that is shifted from the multinational's home country (that is, from the country that has enacted the CFC

rules), rather than from other countries.<sup>47</sup> The approach of protecting only the tax base of the home country removes the protection that CFC rules might otherwise afford to the tax bases of other countries, including lower-income countries.<sup>48</sup> Rules incorporating this approach arguably should not be considered CFC rules at all, but rather should be seen as a different species of self-protective base protection measure that countries might implement.<sup>49</sup>

### CFC Rules and the EU Anti-Tax Avoidance Directive

In July 2016, as a follow-up to the OECD's final BEPS reports, the Council of the European Union issued an "Anti-Tax Avoidance Directive" prescribing minimum standards for anti-tax avoidance legislation which EU member states were to enact by the end of 2018.<sup>50</sup> It is not clear whether the Directive will permit member states to adopt CFC rules that apply only to income shifted from the enacting country itself, or whether countries will be required to maintain CFC rules that also protect the tax bases of other countries.

Even if the Directive is interpreted to require members to adopt rules that protect the tax bases of other countries, however, the effect on the global extent of base erosion and profit shifting may not prove very large. The Directive permits member countries to exempt from coverage by

<sup>47</sup>This topic is discussed in the OECD Action 3 report at 15-16. An example is provided by the CFC rules currently maintained by the United Kingdom; see the U.K. government explanation of the rules at U.K. Government, "Controlled Foreign Companies: An Overview" (Apr. 13, 2013).

<sup>48</sup>The OECD's Action 3 report criticizes this characteristic of CFC rules that protect the tax base only of the parent country: CFC rules that focus only on parent jurisdiction stripping may not be as effective against BEPS arrangements for two reasons. First, it may not be possible to determine which country's base has been stripped (for example, in the case of stateless income). Second, even if it were possible to determine which country's base was stripped, the BEPS Action Plan aims to prevent erosion of all tax bases, including those of third countries. This issue may be of particular relevance for developing countries because there may be more of an incentive to structure through low-tax jurisdictions in the absence of CFC rules that focus on foreign-to-foreign stripping.

Action 3 report at 16 (footnote omitted).

<sup>49</sup>Cf. the related discussion of the U.K. and Australian Diverted Profits Tax rules, and the U.S. Base Erosion and Anti-Abuse Tax (BEAT), below at notes 76-77 and accompanying text.

<sup>50</sup>Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

<sup>44</sup>OECD BEPS Action 3 Report at 15.

<sup>45</sup>*Id.* at 16:

[A] way to maintain competitiveness would be to ensure that more countries implement similar CFC rules. This is therefore a space where countries working collectively and adopting similar rules could reduce the competitiveness concerns that individual countries may have when considering whether to implement CFC rules.

<sup>46</sup>One practitioner's critique of an intermediate draft of the Action 3 report was entitled, "How Not to Engage with CFC Rules." Kimberly Blanchard, *Bloomberg BNA International Tax Monitor* (Sept. 15, 2015).

CFC rules income transferred to a zero- or low-tax company that “carries on a substantive economic activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstances.” This is a vague test, similar in form to the “minimum substance” tests contained in many general anti-avoidance rules (GAARs) around the world. Depending on how member countries choose to interpret the test, CFC practice in the European Union might quickly devolve into gamesmanship, with companies seeking to satisfy the test through the assignment to zero- or low-tax affiliates of only token numbers of employees, and minimal levels of physical business activity. If EU governments accept this interpretation, the effect of European CFC rules on demand for BEPS planning could be quite limited.

In fairness, it should not be assumed that EU countries will interpret the requirement for CFC rules in so permissive a manner. EU governments may instead require that subsidiaries in zero- or low-tax jurisdictions demonstrate a high quantum of observable, profit-motivated business activities to be exempted from CFC rules. An interpretation of this kind might make it difficult for EU-based multinationals to continue to engage in BEPS-style tax planning, thus affording significant protections to lower-income countries around the world. Moreover, the maintenance by EU countries of effective CFC rules could establish a normative standard for capital-exporting countries outside the European Union, resulting in further reductions in profit-shifting globally.

### The ‘GILTI’ Tax: Revival of CFC Concept in 2017 U.S. Tax Reform

In its tax reform legislation of December 2017, the United States enacted a special tax on the “Global Intangible Low-Taxed Income (GILTI)” of U.S.-owned multinational groups. The GILTI tax is complex in its structure:<sup>51</sup> somewhat simplified, it generally imposes a U.S. tax, at a rate of 10.5 percent (half the regular U.S. corporate rate of 21 percent), on that portion of a U.S.-owned group’s

foreign income that exceeds a 10-percent return on the value of the group’s foreign tangible assets, except to the extent that the income has already been subject to foreign tax. Thus, roughly speaking (as the actual computations are complex and depend upon the availability to the U.S. taxpayer of foreign tax credits), the GILTI tax subjects the non-U.S. income of U.S.-based multinational groups, above a “routine” level (defined as a return of 10 percent on the group’s foreign tangible assets), to a minimum tax of 10.5 percent.

The GILTI tax would appear to remove some of the financial benefit to U.S.-owned multinationals from engaging in BEPS planning around the world, and therefore may reduce some of the competitive pressure on lower-income countries to tolerate the erosion of their tax bases. In practice, however, because of the way that the GILTI minimum tax is structured, the degree of protection afforded lower-income countries may be limited.

During the Obama Administration, the president had proposed a minimum tax roughly similar in structure to the GILTI tax, except that application of the minimum tax would be determined on a “per country” basis.<sup>52</sup> That is, the minimum tax would have applied to the extent the U.S.-owned group’s effective tax rate *in any single country* fell below the stated threshold amount, even if the group was subject to higher effective tax rates in other countries. Under the “overall” approach of the GILTI tax, however, a U.S.-owned group becomes subject to the minimum tax only if the average effective non-U.S. tax rate on *all* the group’s non-U.S. income falls below a threshold level, generally of 13.125 percent. Thus, under the GILTI tax, a taxpayer facing a high tax rate in some countries can continue to benefit from shifting profits from other countries, even down to an effective tax rate of zero in that country, so long as the taxpayer’s average foreign tax rate doesn’t fall below the threshold. An overall minimum tax like the GILTI

<sup>51</sup>The GILTI tax is contained in Section 951A of the U.S. Internal Revenue Code. It is described in detail at pages 622-627 of H.R. Conf. Report No. 466, Tax Cuts and Jobs Act, 115th Cong., 1st Sess. (2017).

<sup>52</sup>For discussion of the Obama Administration proposal, see Mindy Herzfeld, “News Analysis: The Cases for and Against a Minimum Tax,” *Tax Notes Int’l*, Mar. 7, 2016, p. 807. For formal statement of the proposal, see U.S. Treasury Department, “General Explanations of the Administration’s Fiscal Year 2017 Revenue Proposals” (Feb. 2016), at 9-12.



tax therefore discourages BEPS-style tax planning less strongly than does a similar tax imposed on a per-country basis.<sup>53</sup>

Given the large role played by the United States in the global economy, it is possible that even given its overall rather than per-country structure, the GILTI tax will reduce overall demand for BEPS-style profit-shifting to an extent that will meaningfully lessen the pressures of tax competition on lower-income countries. If that is the case, the GILTI tax might serve as a promising model for CFC-like reforms in other countries. If, however, the effects of the GILTI tax on demand for BEPS-style planning prove very limited, then the per-country approach of the Obama Administration might be necessary for a GILTI-style minimum-tax structure to afford adequate protection to the tax bases of lower-income countries. Careful monitoring of the performance of the GILTI tax over time, particularly the extent to which the tax planning behavior of U.S. multinational groups in lower-income countries appears to be affected, may provide valuable information for policy-making in the future.

### BEPS and Limitations on Interest Deductions

As discussed in Chapters 2 and 3, the payment of interest on intragroup loans extended from zero- and low-tax financing companies has for many years comprised a large component of BEPS-style tax planning around the world. The BEPS Action 4 report<sup>54</sup> focuses on this topic and

offers policy recommendations that seem well-suited to the situation of lower-income countries.

The Action 4 report proceeds from the principle that a member of a multinational group should be permitted to deduct, for local corporate income tax purposes, only its fair share of the group's total indebtedness to unrelated lenders. Under this principle, the Action 4 report argues that if a multinational group as a whole holds indebtedness to unrelated lenders totaling, say, €100 million, each member of the group should be entitled to deduct interest on a part of that amount, in proportion, say, to the member's share of the group's total income. Thus, as a conceptual ideal, the Action 4 report advocates a formulary approach to the apportionment of interest expense, which the report refers to as a "group ratio rule." A group ratio rule would substantially curtail income-shifting through related-party loans, because group finance companies could not "manufacture" debt to affiliates in excess of the group's actual total indebtedness to outside parties.<sup>55</sup>

Despite the theoretical appeal of the group ratio approach, however, the Action 4 report concludes 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 "fixed ratio" limitations on interest deductions, which generally would limit each group member's net interest deductions (that is, the excess of interest deductions over interest income) to a fixed percentage set at a point in the range of 10 to 30 percent of their earnings before interest, taxes, depreciation, and amortization

<sup>53</sup> As a simplified example, consider a GILTI-style minimum tax that subjects to home country taxation all foreign income that a group earns which is not subject to a local tax of at least 12 percent. Assume that a multinational conducts operations in two foreign countries, Countries A and B, earning \$100 million in each country. Assume that Country A imposes corporate tax at a rate of 30 percent, and Country B imposes corporate tax at a rate of 5 percent. Under an "overall" GILTI-style minimum tax, the taxpayer is considered to pay tax at an average rate of 17.5 percent on all its foreign income, which is above the 12-percent threshold, so no minimum tax is imposed. Under a per-country approach, however, whereas the taxpayer owes no minimum tax based on its operations in Country A, its effective rate in Country B is below the 12-percent threshold so that minimum tax is imposed on income earned in that country.

<sup>54</sup> In October 2015, the OECD released its final report on Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments," along with its final reports on other BEPS actions. Later, in 2017, the OECD released a follow-up study of two technical topics: (i) the details of the design of a "group ratio rule, as will be explained in the text below; and (ii) the application of interest deduction limitations to banks and insurance companies. OECD, "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments: Action 4 — 2016 Update" (2017).

<sup>55</sup> Consider for example a multinational group comprised of a parent company in Country A, which owns operating subsidiaries in Countries B and C, and a group finance company in zero- or low-tax Country F. Assume the group as a whole is subject to indebtedness from unrelated parties (for example, bondholders and banks) of \$100 million, and that the group as a whole pays \$8 million annually in interest on this debt. The group finance company extends indebtedness to each of the group affiliates in Countries A, B, and C of \$250 million each, with stated interest of \$20 million per year. During the taxable year, the parent in Country A earns \$300 million, and the affiliates in Countries B and C each earn \$150 million, in EBITDA prior to payment of taxes and interest. Under a group ratio approach, since the parent in Country A earns 50 percent of the group's income before interest and taxes, the parent would be permitted to deduct half the group's interest expense paid to unrelated lenders, or \$4 million; and the affiliates in Countries B and C, which each account for 25 percent of the group's income before interest and taxes, would be permitted to deduct \$2 million each. No deduction would be allowed to any group member for the interest paid to the Country H finance company.

(EBITDA). The report also recommends that countries consider allowing companies to use a group ratio approach as an elective alternative.

The Action 4 report envisions that countries will use the recommended EBITDA-based limitations to replace or supplement existing “thin-capitalization” rules which, as described in Chapter 3, countries historically have used to attempt to limit revenue losses from companies’ excessive deductions of interest payments. As discussed in Chapter 3, thin capitalization 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 in its Action 4 report that multinationals can relatively easily avoid application of thin-capitalization rules by injecting additional equity into its subsidiaries.<sup>56</sup>

The OECD based its EBITDA recommendation on the actions of a number of countries around the world that already had adopted 30-percent of EBITDA limitations, including Germany and Italy, as well as Spain, and Finland and Norway, which have 25-percent limitations.<sup>57</sup> Since the BEPS reports, the United Kingdom has implemented a 30-percent of EBITDA rule effective April 1, 2017,<sup>58</sup> and the United States has done so effective January 1, 2018.<sup>59</sup> 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 percent of a taxpayer’s EBITDA.<sup>60</sup> In addition, the European Union now prescribes EBITDA-based limitations as best practice for tax administrations among member countries, essentially requiring member countries

to amend their limitations as necessary to conform to the new OECD standard.<sup>61</sup> In 2013, South Africa enacted limitations, which became effective in 2015, based generally on 40 percent of EBITDA, although the limitation can be higher or lower based on fluctuations of market interest rates.<sup>62</sup> In addition, as of early 2018, the OECD has reported that Argentina, India, South Korea, and Vietnam have enacted 30-percent-of-EBITDA-rules, and Norway, Japan, Malaysia, and Turkey are taking legislative steps to align their rules with the OECD Action 4 recommendations.<sup>63</sup>

The OECD’s report on BEPS Action 4 cites data indicating that the interest expenses of most multinational groups on unrelated-party debt are substantially below 30 percent of the group’s EBITDA, suggesting that a 30-percent limitation will continue to allow substantial scope for loan-centered, BEPS-style tax planning.<sup>64</sup> Nevertheless, it seems likely based on the OECD data that a 30-percent limitation has the potential to reduce loan-based, BEPS-style tax avoidance to substantially below current levels in many countries.<sup>65</sup> Moreover, although some elements of EBITDA-based deduction limitations, like any significant corporate tax rules, raise administrative complexity,<sup>66</sup> the rules are relatively simple compared to other kinds of corporate tax anti-avoidance measures, and should be administrable even by revenue agencies of constrained resources. In sum, EBITDA-style limitations on interest deductions would appear suitable for use by many lower-income countries.

<sup>56</sup> Action 4 report at 21: “[A]n equity test allows entities with higher levels of equity capital to deduct more interest expense, which makes it relatively easy for a group to manipulate the outcome of a test by increasing the level of equity in a particular entity.”

<sup>57</sup> See Lee A. Sheppard, “News Analysis: Countries Implement BEPS on Their Own,” *Tax Notes Int’l*, May 26, 2014, p. 692.

<sup>58</sup> PricewaterhouseCoopers, “UK Introduces New Corporation Tax Limitation on Interest Deductibility” (Mar. 2, 2017).

Although the OECD’s Action 4 report recommends that countries limit interest deductions to anywhere from 10 to 30 percent of EBITDA, because a number of countries have in practice enacted 30-percent limitations, the OECD recommendation often is perceived as a 30-percent limitation.

<sup>59</sup> See pp. 385-392 of H.R. Conf. Report No. 466, note 51 above.

<sup>60</sup> See PwC, “France – Corporate Group Taxation.”

<sup>61</sup> European Union, Council Directive (EU) 2016/1164 (establishing rules against tax avoidance) (July 12, 2016).

<sup>62</sup> Republic of South Africa, Income Tax Act (revised) section 23M. See generally Alexandra Readhead, “Preventing Base Erosion: South Africa’s Interest Limitation Rules,” Natural Resource Governance Institute (2017).

<sup>63</sup> OECD, “Tax Challenges Arising from Digitalisation – Interim Report 2018” (Mar. 16, 2018), at 117.

<sup>64</sup> Action 4 report at 49.

<sup>65</sup> A 2017 study concludes that the introduction of a limitation in Finland, based in part on approximately 25 percent of EBITDA, has been effective in raising revenues. Jarkko Harju, Ilpo Kauppinen, and Olli Ropponen, “Firm Responses to an Interest Barrier: Empirical Evidence,” Working Paper, VATT Institute for Economic Research (2017).

<sup>66</sup> For discussion of this topic, see Peter A. Barnes, “Limiting Interest Deductions,” in *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries* (2d ed. 2017), at 179 ff.

In view of continuing pressures of tax competition, however, it remains an open question whether many lower-income country governments will choose to adopt EBITDA-based limitations on interest deductions. To date, the only countries in the developing world to have adopted EBITDA-based limitation conforming to the new model have been countries that offer relatively strong attraction to investors. It also is not clear whether, and if so to what extent, the effect of the new interest limitations will be offset by tax holidays or other tax exemptions. Nevertheless, the growing global acceptance of EBITDA-based limitations, their relative simplicity of administration, and their limited but still significant effects on the volume of base erosion all suggest that at least some lower-income countries might find the limitations both politically feasible and capable of raising worthwhile amounts of additional revenue. Chapter 5 of this book will consider how lower-income countries might incorporate EBITDA-based interest deduction limitations into a broad approach to the control of base erosion and profit shifting.

## Income Tax Treaties and Withholding Taxes

### Introduction

Chapter 3 offered an overview of the development of the now-global institution of bilateral income tax treaties, under the auspices first of the League of Nations after World War I, and then of both the OECD and the United Nations since World War II. Income tax treaties address a very wide range of tax issues that arise when individuals or companies conduct cross-border activities. Thus, virtually all the BEPS Action Items have some connection with the topic of income tax treaties.<sup>67</sup>

### Procedural Aspects of Tax Treaties

For example, income tax treaties typically provide for exchanges of taxpayer information between countries' tax administrations for

enforcement purposes, and they also establish procedures by which the tax authorities of different countries can consult with one another to protect companies from double taxation arising from inconsistent claims by revenue agencies, for example in transfer pricing examinations. The BEPS reports contain numerous suggestions for improving these and other procedural rules in bilateral tax treaties.<sup>68</sup>

### 'Permanent Establishment' Provisions

Other important provisions found in tax treaties set forth the circumstances under which a country that is party to a treaty is permitted to assert taxing jurisdiction over an individual or corporate resident of the other party. For example, a multinational based in Country A might maintain an office in Country B to coordinate the local sales of the multinational's products. If Countries A and B have entered into an income tax treaty, the treaty will typically contain provisions determining whether the local office is substantial enough (in terms of, for example, whether local personnel have authority to bind the parent company contractually) to permit Country B to tax income attributable to the office's activities.

A local presence of a foreign taxpayer that is substantial enough to subject the taxpayer to local income taxation is called, in tax treaties, a "permanent establishment." It has become widely acknowledged in recent years that, in part because it has become easier to conduct business operations remotely by selling products and services online, the permanent establishment provisions in many bilateral income tax treaties can deprive a host country of tax jurisdiction even over a foreign multinational that transacts substantial local business. The BEPS Action 7 report recommends that countries revise their tax treaties to expand, somewhat, the circumstances under which the local operations of a foreign company will constitute a permanent establishment — for example, by expanding the

<sup>67</sup> For a comprehensive discussion of the many connections between the BEPS Action Items and questions related to international tax treaties, see Yariv Brauner, "Treaties in the Aftermath of BEPS," 41 *Brooklyn Journal of International Law* 973 (2016).

<sup>68</sup> Discussion of the procedural aspects of income tax treaties is found especially in the Final Reports on BEPS Action 15, "Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS," and BEPS Action 14, "Making Dispute Resolution Mechanisms More Effective."

circumstances in which the solicitation of sales orders within a country can give rise to a permanent establishment. In addition, a more extensive expansion of the permanent establishment concept, under which on-line sales into a country could create a permanent establishment even without a local physical presence, is currently under discussion within both the OECD and the European Union, and has already been adopted by a few countries.<sup>69</sup> Numerous technical and political barriers remain before global rules with respect to permanent establishments are likely to be fundamentally restructured. Over time, however, rules expanding the definition of permanent establishment, if adopted by lower-income countries, might generate meaningful revenue increases.

### 'Treaty Shopping' and 'Withholding Taxes'

One element of the BEPS project's analysis of income tax treaties, dealing with the interrelated topics of "treaty shopping" and "withholding taxes," has special importance for lower-income countries. Countries around the world have, for many decades, imposed taxes on the gross amounts of interest, royalties, dividends, and sometimes management or other service fees, paid by local taxpayers to recipients in other countries. These withholding taxes reflect a longstanding and widespread view that international tax laws tend to assign insufficient taxing rights to capital-importing (source) countries, and excessive taxing rights to capital-exporting (residence) countries in which investing multinational groups are based. For example, under the "mercantilist" paradigm that was described in Chapter 3 and still pervades international tax laws, the local distribution, manufacturing, and service-provider subsidiaries of multinational groups, especially in developing countries, often end up with low taxable incomes after the subsidiaries have deducted payments to other group members for management fees, interest, and royalties. Withholding taxes are

intended to move the balance of taxing rights to some extent back in the direction of source countries.

Withholding taxes are simple in their operation, and their potential for mitigating profit-shifting from source countries is easy to see. Assume, for example, that a country's tax statutes impose a corporate income tax at a rate of 25 percent and also impose a withholding tax of 20 percent on outbound payments of interest.<sup>70</sup> If a local member of a multinational group makes a payment of \$1,000 to a lender (which might be a related party located in a zero- or low-tax jurisdiction), deducting the interest for income tax purposes will result in a tax reduction of \$250. The withholding tax will, however, impose a corresponding tax cost of \$200. The overall loss of government revenue from the lending arrangement, therefore, will be substantially reduced.

If source countries in fact applied withholding taxes at substantial rates, they would significantly reduce the amount of their revenue losses from base erosion and profit shifting. Bilateral income tax treaties, however, typically provide for the reduction of withholding taxes on different kinds of payments to levels much lower than those prescribed by countries' tax statutes. For example, whereas two countries might under their domestic tax statutes both impose withholding taxes on interest, royalties, and dividends at, say, a 25-percent statutory rate, they might agree in their income tax treaty to reduce that rate to 10 or 5 percent, or even zero.

The treaty-based reduction or elimination of withholding taxes by a country may be appropriate if the treaty is not being used by companies to facilitate BEPS-style avoidance. In that case, the amounts of interest, royalties, and service fees that taxpayers are paying generally will be limited to economically sensible levels, and there should be no need for a withholding tax to compensate for the taking of excessive deductions. Where BEPS is present, however, the deductions taken by taxpayers tend to be at higher than economically justifiable levels. For

<sup>69</sup> This topic is discussed in OECD, "Tax Challenges Arising from Digitalisation — Interim Report 2018"; and European Commission, "Proposal for a Council directive laying down rules relating to the corporate taxation of a significant digital presence" (Mar. 21, 2018).

<sup>70</sup> A summary of the withholding taxes levied by countries around the world can be found at Deloitte, "Global corporate tax and withholding tax rates" (2018).

example, interest deductions might simply be manufactured through related-party debt, and related-party service fees might be inflated. In those circumstances, the imposition of withholding taxes at relatively high levels seems necessary if substantial losses of tax revenue are to be prevented.

Often, however, the pressures of tax competition induce countries, particularly in the developing world, to agree to tax treaties that reduce or eliminate withholding taxes, even when the countries are plainly affected by high levels of base erosion and profit shifting.<sup>71</sup> Thus, over the years, developing countries have entered into many tax treaties that reduce or eliminate withholding taxes, even when the financial cost of doing so, in terms of revenues lost to BEPS-style tax planning, probably has been high. In light of this history, lower-income countries should exercise considerable caution in deciding whether to enter into tax treaties, especially those that would involve substantial reduction or elimination of withholding taxes.<sup>72</sup>

The damage from treaties that reduce or eliminate withholding taxes has been magnified over the years by the phenomenon of “treaty shopping.” Consider, for example, Investco, a multinational group headquartered in Country A, that wishes to open a manufacturing operation in Country B, a lower-income country. Because Investco desires to engage in BEPS-style tax avoidance in Country B, the company does not make its desired investment directly in Country B. Instead, Investco establishes a subsidiary in a zero-tax country, Country H, which happens to have a tax treaty with Country B eliminating withholding taxes; and the Country H subsidiary serves as the parent for the new manufacturing subsidiary in Country B.

Under the envisioned planning structure, substantial payments of interest and royalties are to be made from Investco’s new subsidiary in

Country B to the holding company in Country H. Country B, under its generally applicable tax statute, imposes a 25-percent withholding tax on outbound payments of interest and royalties, which could substantially offset Country B’s revenue losses from Investco’s BEPS-style tax planning. The income tax treaty that is in effect between Countries B and H, however, exempts the payments made from Country B to Country H from withholding taxes. A situation like this is said to involve “treaty shopping” because the real beneficiary of the withholding exemption, Investco, is a resident of Country A, which is not a party to the treaty between Countries B and H. Treaty shopping in order to reduce or eliminate withholding taxes is common in tax planning around the world.<sup>73</sup>

The OECD’s BEPS reports identify treaty shopping as a substantial contributor to base erosion and profit shifting, and the OECD has initiated an ambitious plan to introduce a new Multilateral Instrument (MLI) which would, in effect, substitute for the thousands of bilateral tax treaties now in effect around the world. The centerpiece of the MLI consists of an anti-treaty shopping rule, which would permit countries to deny treaty benefits, including exemptions from withholding tax, to taxpayers that are engaged in triangular treaty-shopping efforts with a “principal purpose” of avoiding taxes.<sup>74</sup>

More than 100 countries, at all levels of economic development, have signed the MLI, expressing at least symbolic support for its

<sup>73</sup> The frequency of treaty shopping reflects, in part, that the zero- and low-tax jurisdictions that are involved in BEPS planning structures are not limited only to tiny island nations scattered around the world. In some instances, substantial economic powers like the Netherlands, Belgium, and Switzerland historically have been willing to allow multinationals to use their jurisdictions as zero- or low-tax jurisdictions in BEPS-style planning, especially for transactions involving royalties and interest payments, and these countries have substantial tax treaty networks extending around the world. See, e.g., Mark P. Keightley, “An Analysis of Where American Companies Report Profits: Indications of Profit Shifting,” U.S. Congressional Research Service (2013) (examining apparently large volumes of profit shifting by members of U.S.-owned multinational groups to affiliates in Bermuda, Ireland, Luxembourg, the Netherlands, and Switzerland).

<sup>74</sup> The text of the MLI, and various discussion documents pertaining to it, are available online. The MLI offers countries the option of adopting language more stringent than the mere “principal purpose” test to control treaty shopping, including a detailed “limitation of benefits” test modeled after language that the United States has used in a number of its treaties. See generally Brauner, note 67 above, at 1004-1006. Relatively few countries, however, are likely to adopt the U.S.-style language.

<sup>71</sup> A quantitative study of treaty-negotiation outcomes involving lower-income countries is provided by Martin Hearson, “Measuring Tax Treaty Negotiation Outcomes: The ActionAid Tax Treaties Dataset,” ICTD Working Paper No. 47 (2016).

<sup>72</sup> A policy paper of the IMF staff in 2014 advised that “countries should not enter treaties lightly – all too often this has been done largely as a political gesture – but with close and well-advised attention to the risks that may be created.” IMF Policy Paper, “Spillovers in International Corporate Taxation” (2014), at 28.

provisions. Before the MLI comes into effect, however, pairs of countries must formally indicate their desire to be bound by its terms; and participating countries also must ratify the instrument through legislative action. Despite the large number of countries that have indicated initial approval of the MLI by signing it, it remains uncertain whether the procedural steps needed to bind a large number of country pairs to the MLI will be taken.<sup>75</sup>

Moreover, the “principal purpose” test that in most cases will control treaty shopping under the MLI is factually vague, and tax administrations may encounter substantial practical difficulties in attempting to apply it. Overall, it is unclear whether the BEPS recommendations will, in practice, lead to substantial reductions in the frequency of treaty shopping.

### Base Protection Measures That Countries Have Taken Outside the Scope of the BEPS Reports

#### Diverted Profits Taxes

Some relatively wealthy countries have, in recent years, enacted new protections to protect their own corporate tax bases from erosion, which fall outside the recommendations of the BEPS reports. For example, both the United Kingdom and Australia have enacted “diverted profits taxes” (DPTs) which essentially disallow deductions taken from the enacting countries in connection with BEPS-style planning strategies.<sup>76</sup> The U.K. and Australian DPTs have attracted a good deal of attention among tax practitioners. However, in determining whether profits have been inappropriately diverted, both the U.K. and Australian DPTs rely heavily on the application of a subjective “substance over form” test; therefore, the DPTs incorporate at least some of the weakness of traditional general anti-avoidance rules, which tax administrations typically have had difficulty applying. It remains to be seen whether the U.K. and Australian DPTs will prove substantially effective in controlling BEPS, and

whether the DPTs offer a legislative model that may be useful for lower-income countries.

### The U.S. Base Erosion and Anti-Abuse Tax (BEAT)

In late 2017, as part of comprehensive tax reform legislation, the United States enacted a new “Base Erosion and Anti-Abuse Tax” (BEAT) in an effort to curtail profit shifting from the United States through the making of deductible payments to foreign related parties.<sup>77</sup> The BEAT requires a United States taxpayer to add back into its taxable income most deductible payments, including interest expenses, royalties, some service-fee payments, and others, made to related foreign persons. A 10-percent tax<sup>78</sup> is then computed on the expanded taxable income, and if that amount exceeds the taxpayer’s regular tax liability the 10-percent tax is imposed instead of the regular tax. The BEAT therefore operates as a form of minimum tax on companies engaged in cross-border business in the United States.

The apparent intent of the BEAT is to limit the extent to which multinational groups can benefit from the use of “stripped risk” entities in the United States. The BEAT can therefore be seen as a protective overlay placed atop the transfer pricing rules and interest limitations. Even if the deduction of certain amounts is permitted under the transfer pricing rules and the interest limitations, the BEAT can nevertheless deny some of the tax benefit from taking the deductions. Enactment of the BEAT can be seen as an acknowledgement by the U.S. Congress that transfer pricing rules and limitations on interest deductions are not in themselves sufficient to limit base erosion from the United States to acceptable levels, but that an additional back-up is needed to strengthen those rules.

As an economic matter, the United States was able to enact the BEAT because of the strong market power that the country enjoys as a destination for investment. Lower-income countries, which are likely to be much more beholden than the United States to pressures of

<sup>75</sup> See Lee A. Sheppard, “Latin America and the MLI,” *Tax Notes Int’l*, July 3, 2017, p. 7 (“Signing the MLI is like a dating service — a lot of work, a lot of dashed expectations, and no joy”).

<sup>76</sup> See generally Shinasa Wasimi, Jai Nario, and Kathryn Bertram, “Diverted Profits Tax: U.K, Australian, and New Zealand Approaches,” *Tax Notes Int’l*, July 24, 2017, p. 349.

<sup>77</sup> The Base Erosion Minimum Tax is contained in a new Section 59A of the Internal Revenue Code, and is described in H.R. Conf. Report No. 466, note 51 above, at 653-660.

<sup>78</sup> The tax is phased in, with a 5-percent rate applying in 2018. The rate is scheduled to rise to 12.5 percent in 2025.

tax competition, may be hesitant to follow the U.S. example for fear of suppressing inbound investment. Moreover, the U.S. BEAT is administratively demanding, counseling against its application in lower-income countries without substantial modification. Nevertheless, the new tax is intriguing; and Chapter 5 will offer discussion of how a minimum-tax overlay that is administratively simpler than the U.S. BEAT might be applied effectively in the lower-income country setting.

### The Overall Legacy of the BEPS Studies for Lower-Income Countries

#### Incrementalism vs. Systemic Transformation

The BEPS process arose from substantial public anger toward corporate tax avoidance in the aftermath of the Financial Crisis. In response to these political pressures, statements of the OECD and G-20 early in the BEPS process promised a thorough revisiting of the existing structure of international tax rules, aimed at sharply curtailing profit-shifting by multinationals to corporate affiliates in low- and zero-tax jurisdictions.<sup>79</sup> In particular, in emphasizing the goal of aligning the division of income among a group's members with their relative contributions to value creation, the early OECD and G-20 statements hinted at willingness to re-examine the basic tenets of arm's-length transfer pricing rules, under which groups are able to steer income toward affiliates in zero- and

low-tax countries through intragroup contracts, even when the affiliates perform little if any physical business activity.<sup>80</sup> If the BEPS process had in fact resulted in fundamentally revised transfer pricing rules, which firmly established the principle of proportionality between a company's business activities and the income that can be attributed to it, BEPS-style tax planning would have been dealt a serious and perhaps even fatal blow.

Fundamental systemic change, however, was never realistically on the table during the BEPS process.<sup>81</sup> Popular political pressures required the G-20 and OECD to use ambitious language in the BEPS process's early stages; but BEPS-style tax planning was and remains deeply embedded in the structuring of virtually all multinational business activity around the world. Base erosion and profit shifting have long stood at the center of a global political equilibrium under which companies' effective tax rates are constrained, in practice, at levels far below the rates stated in countries' tax statutes.

Even in view of the political pressures that arose from the 2008 Crisis, upsetting this equilibrium in favor of markedly higher effective rates would have been politically unacceptable to governments of both capital-exporting and capital-importing countries. Highly effective constraints on BEPS would in effect have forced capital-exporting countries to tax their home-based multinationals at levels that many would have seen as unduly discouraging outbound investment, and similarly would have compelled capital-importing countries to tax inbound investment at levels that many in those countries would consider as excessive.

Rather than recommendations for fundamental systemic change, therefore, the BEPS process has suggested incremental measures that governments might adopt to protect their tax bases from erosion, generally to modest extents. The decisions whether to adopt these measures, and how vigorously to enforce them, are left to each country. To date, it appears that the world's wealthier countries, which

<sup>79</sup> The OECD's 2013 Action Plan, note 14 above at 14, declared that "Fundamental changes [to international tax rules] are needed to effectively prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it." In a similar vein, the 2013 St. Petersburg Declaration of the G-20, note 8 above at paragraph 50, said:

In a context of severe fiscal consolidation and social hardship, in many countries ensuring that all taxpayers pay their fair share of taxes is more than ever a priority. Tax avoidance, harmful practices and aggressive tax planning have to be tackled. The growth of the digital economy also poses challenges for international taxation. We fully endorse the ambitious and comprehensive Action Plan — originated in the OECD — aimed at addressing base erosion and profit shifting with mechanism to enrich the Plan as appropriate. We welcome the establishment of the G20/OECD BEPS project and we encourage all interested countries to participate. Profits should be taxed where economic activities deriving the profits are performed and where value is created. In order to minimize BEPS, we call on member countries to examine how our own domestic laws contribute to BEPS and to ensure that international and our own tax rules do not allow or encourage multinational enterprises to reduce overall taxes paid by artificially shifting profits to low-tax jurisdictions.

<sup>80</sup> Notes 11-17 above and accompanying text.

<sup>81</sup> Cf. generally Thomas Rixen, "From Double Tax Avoidance to Tax Competition," 2010 *Review of International Political Economy* 1.

perceive themselves as relatively insulated from pressures of tax competition, and where local political sentiment opposing corporate profit-shifting remains substantial, are more likely to adopt the BEPS recommendations, or other base-protection measures, than are the world's lower-income countries.

Some of the measures taken by relatively wealthy countries in the aftermath of the BEPS reports — including, as discussed above, the strengthened CFC rules envisioned under the EU's Anti-Tax Avoidance Directive, and the U.S. GILTI tax — might have the spillover effect of mitigating the pressures of base erosion on lower-income countries. Similarly, revised transfer pricing rules around the world, modeled on the OECD's new "control of risk" test, might reduce global demand for BEPS-style tax planning, thereby reducing base-erosion pressures on lower-income countries. Efforts by the European Union to discourage the use of EU countries as zero- or low-tax jurisdictions also could reduce demand for BEPS-style planning.

The quantitative extent of any spillover effects of these kinds, however, is unknown, and is likely to remain so for some time. Overall, it seems likely that whatever mitigating effects they might have, measures like enhanced CFC rules, the U.S. GILTI tax, and revised transfer pricing rules

incorporating the control-of-risk test will fall far short of eliminating the attractiveness of BEPS-style planning among the world's multinationals. Therefore, if lower-income countries are to raise corporate tax revenues to or near desirable levels, they will need to do more than rely on spillover effects from actions taken by other countries; they will instead need to adopt base protection measures of their own, suitable to their political and economic circumstances.

The next chapter of this book, Chapter 5, will suggest particular base-protection measures that lower-income countries might adopt in the aftermath of the BEPS process. These include some of the BEPS recommendations in the areas of interest deduction limitations and the improvement of administrative practices under transfer pricing rules. In addition, extending beyond the boundaries of the BEPS recommendations, Chapter 5 will recommend that lower-income countries give serious consideration to the adoption of corporate minimum taxes of a kind conceptually similar to, but administratively much simpler than, the U.S. BEAT. Corporate minimum taxes of this kind already are in effect in a number of developing countries, and their expanded use might provide meaningful revenue enhancements under countries' existing corporate income tax systems. ■