



## Working Paper 18

# Beyond BEPS: A Tax Policy Agenda for Developing Countries

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# Beyond BEPS: A Tax Policy Agenda for Developing Countries<sup>1</sup>

Michael C. Durst

## Summary

As the Organisation for Economic Co-operation and Development (OECD) moves to the final stages of its work on base erosion and profit shifting (BEPS), this paper reflects on the most promising directions for legislative changes and other action which developing countries might take to protect their corporate tax bases. The paper observes that the barriers facing developing countries generally do not arise from technical difficulties in designing and implementing legislative measures. Indeed, effective controls on base erosion are well-known among policy-makers, particularly limitations on outbound deductions and withholding taxes to discourage excessive outbound payments to affiliates. Instead, the most important impediment to effective control of base erosion is the pressure of tax competition – namely, the fear that effectively imposing income taxes on inbound investors will deter employment and economic growth. The paper does not seek to assess the objective validity of this fear, but observes that it is in fact pervasive, and that effective policy-making must recognise the practical political barriers this fear imposes. With the seriousness of tax competition borne in mind, the paper enumerates and briefly comments on the following topics, all of which should be developed in future research efforts: (i) the possible utility of simplified measures to discourage base erosion, notably the greater use of withholding taxes (a measure which the OECD's BEPS effort has not sought to address); (ii) the potential for both incremental changes to transfer pricing rules to facilitate enforcement and administration (for example, the use of Brazil-style standard margins and markups), as well as the longer-term possibility of unitary taxation; (iii) the importance of regional coordination of tax policies to mitigate tax competition; and (iv) the continuing role of international groups such as the International Monetary Fund (IMF) and non-government organisations in assisting developing countries to generate realistic assessments of the trade-off which may exist between effective corporate taxation and inbound investment.

**Keywords:** base erosion; profit shifting; tax competition; transfer pricing; unitary taxation; formulary apportionment.

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<sup>1</sup> This working paper is based on comments provided by the author to the IMF on 29 March 2014, in connection with the IMF's study of economic spillovers in taxation. The views expressed in this working paper are those of the author.

# Introduction

The recent and ongoing work of the OECD to review problems of BEPS, and the work which the IMF is now initiating to explore problems of 'economic spillovers' in taxation, provide an opportunity to identify elements which might be included in tax policies designed to enhance the fiscal performance of the world's developing countries. The discussion below is organised as a series of brief observations on selected topics which appear potentially to be especially important for future policy-making. In particular, the comments address: (i) the importance of recent work by the OECD and G20 in identifying a congruence between the locations in which a taxpayer performs value-generating activity, and the locations in which the taxpayer's income is subject to tax, as the central principle of a viable international tax system; (ii) the role of tax competition among countries throughout the world in creating the political environment which has facilitated the global proliferation of tax avoidance through BEPS; (iii) the special vulnerability of the world's developing countries to the problem of base erosion; (iv) the serious political challenges which are likely to limit the effectiveness of the OECD's attempt to curtail BEPS through a mixture of anti-avoidance measures, rather than through fundamental changes to existing patterns of international tax law and particularly to the rules for the international division of income for tax purposes; (v) the necessity for developing countries to devote resources to the improvement of domestic systems of income and consumption taxation, in view of the global political barriers to effective reform of international tax rules; and (vi) the desirability of a dual approach to international tax policy-making for developing countries, including the selective implementation of anti-avoidance measures as recommended by the OECD in order to provide interim, partial relief from revenue losses, while simultaneously conducting the technical work needed to design and implement, on a regional basis, a unitary and formulary system of international taxation for long-term use in the protection of developing countries' corporate tax bases.

## **1 The importance of the OECD's articulation of the goal of congruence between the locations of value-adding activities and the countries to which income is apportioned**

The OECD's recent work on BEPS, and the G20 pronouncements accompanying that work, identify the heart of base erosion as the ability of multinational groups, under current international tax laws as commonly interpreted, to assign to zero- and low-tax jurisdictions taxable income that arises from business activities which group members have performed in other jurisdictions. As a rule, these shifts of taxable income involve the use of contracts of various kinds made among members of the same multinational group, including licences of intangible property, loan agreements, and contracts assigning the bearing of specified group-wide business risks to particular group members. As a result of the OECD's BEPS analysis, the OECD and G20 conclude that multinational business groups should not be permitted, under a sound tax system, to use intragroup contracts to effectuate divergence between the countries in which income is generated through value-adding activities, and the country in which the income is treated as earned for tax purposes. The OECD's analysis is based on the recognition that a single legal entity, transacting with others at arm's length, could not succeed under prevailing international tax rules in achieving a separation between the locations in which income is generated and the locations in which income is taxed. Instead, this kind of separation can be achieved only through contractual arrangements between entities under common control and therefore is inconsistent with the arm's-length principle.

The central principle of the OECD's BEPS analysis is articulated in the Tax Annex to the G20's recent St. Petersburg declaration, which calls for changes to international tax laws in order 'to ensure that profits are taxed where economic activities occur and value is created', and 'to put

an end to the divorce between the location of profits and the location of real activities'. The OECD's BEPS analysis advocates retention of the arm's-length principle as the conceptual basis for rules governing the division of income for tax purposes, and the BEPS analysis accordingly would rule out the adoption of explicit rules for formulary apportionment. Nevertheless, the G20 declaration's call for congruence between the locations at which value-adding activities and to which income is subject to tax articulates not only a criterion for acceptable results under an arm's-length apportionment regime, but also the principle that governs formulary apportionment. Thus, the BEPS analysis can help to dispel what has been, historically, an erroneous perception – that the arm's length and formulary approaches to taxation are in principle incompatible. To the contrary, the two approaches to the division of income can be seen as different technical approaches to achieving reasonable conformity between the locations of a taxpayer group's income-producing activities and the international apportionment of the group's income for tax purposes. Recognising that arm's-length transfer pricing and formulary apportionment constitute different technical means to the same goal may prove helpful in clarifying the analysis of tax spillovers, and particularly in focusing on instrumental objectives rather than historically overdrawn debates over terminology.

## **2 The OECD's recommendation to address base erosion through a mixture of anti-avoidance measures is technically sound but may be politically unrealistic**

The OECD recommends against addressing base erosion through a shift to an explicitly formulary system for dividing income, and recommends instead that countries adopt a variety of anti-avoidance measures. Prominent among the measures proposed by the OECD are: (i) the strengthening of controlled foreign corporation (CFC) regimes by countries in which multinational groups are based; and (ii) restrictions on the deduction of interest and certain other payments to related parties which typically are used to facilitate base erosion. If an additional kind of measure

of potential use especially to developing countries – namely, a reinvigorated system of withholding taxes – were added to this list, the list would describe a set of measures which, if implemented by many countries around the world, could significantly limit the incidence of profit shifting to group affiliates in zero- or low-tax jurisdictions.

Historical experience, however, counsels caution in attempting to rely on anti-avoidance measures, including CFC rules, deduction limitations and withholding taxes, as means of curtailing BEPS. All of these measures have been well-known around the world for many years, but political considerations – primarily pressure generated by tax competition – generally have prevented countries from applying these kinds of measures with sufficient rigour to curtail the worldwide proliferation of base erosion. For example, those countries which are home to multinational groups have often perceived CFC rules as placing their own multinational groups at a competitive disadvantage with respect to groups based in other countries. The results of this kind of competitive concern have included, in the United States, the near nullification of CFC rules as a result of the ‘check the box’ regulations issued in 1997; and in the United Kingdom recent legislation which has limited the reach of the UK CFC rules. Similarly, many countries around the world have often been averse to maintaining other kinds of anti-avoidance measures, such as limitations on deductions for interest and other intragroup payments, and withholding taxes on deductible payments, for fear of losing capital investment to other countries which do not seek to limit tax avoidance through these kinds of rules. There is no reason to expect that the perceived pressures of tax competition, which to date have prevented effective use of CFC rules, deduction limitations and withholding taxes, will dissipate in the near future. Therefore, there is a strong possibility that a successful international effort to curtail BEPS will need to include initiatives which are more fundamental than the encouragement of greater use of CFC rules, deduction limitations and other familiar anti-avoidance measures.

### **3 The special vulnerability to base erosion and profit shifting of the poorer developing countries**

The widespread prevalence of BEPS has resulted, in effect, in the substantial nullification of corporate income taxation in countries around the world, especially on income that is connected with companies' international operations. Although views will differ, some might reasonably argue from an economic perspective that the widespread curtailment of corporate income taxation generally can be seen as desirable. Corporate income taxation arguably constrains investment and economic growth more than many alternative forms of taxation; in addition, as the phenomenon of BEPS itself shows, attempting to enforce corporate taxation in an open global economy can be unduly expensive, if it is feasible at all. Therefore, it is perhaps understandable, if not universally seen as desirable, that many countries around the world have essentially acquiesced in the partial nullification of their corporate tax rules through BEPS.

Developing countries, however, typically cannot afford to indulge in the partial nullification of their corporate tax rules. Countries with highly developed economies often place limited reliance on revenue raised from corporate taxation because other sources of revenue, such as individual income taxes and consumption taxes, are arguably sufficient to meet national needs. In many developing countries, however, much domestic economic activity occurs informally, with few if any books and records maintained, so the government's ability to raise revenue from individual income taxes and consumption taxes is severely limited. For these countries, corporate taxation, and especially taxation of income from cross-border operations, represents a substantial portion of the potentially available revenue base. These countries cannot afford to sacrifice a large proportion of their corporate tax bases, and the perpetuation of BEPS therefore poses a significant national hardship. Current international efforts to find ways to curtail base erosion

therefore can be seen as directed particularly at improving the well-being of countries which are still in the process of economic development.

The nature of the difficulties faced by many developing countries, coupled with historical impediments to the enactment and retention of effective measures to prevent international base erosion, also strongly suggest that a high priority continue to be given to efforts, in which developing countries and international assistance groups are already involved, to assist developing countries in raising revenue more effectively from their domestic tax bases. Given the current conditions of internal markets for goods and services in many developing countries, this is necessarily a long-term effort. Nevertheless, historical experience suggests that, even with effective efforts to improve revenue-raising from cross-border investors, public finance in developing countries will be more secure if it is possible to rely relatively less on international and more on domestic sources of government revenue.

#### **4 How much improvement can be obtained through incremental changes to existing transfer pricing rules?**

Much of the current problem of BEPS can be attributed to the manner in which current arm's-length transfer pricing rules have been interpreted as giving deference to contractual agreements for the shifting of income among different members of commonly controlled groups. In addition, some other technical aspects of current transfer pricing rules have exacerbated countries' vulnerability to income-shifting through contractual arrangements, including: (i) one-sided transfer pricing methods such as the comparable profits method (CPM) and the transactional net margin method (TNMM), which have facilitated limiting the incomes of various kinds of entities to 'risk-stripped' or 'routine' returns; and (ii) profit split methods as currently applied, which have been interpreted as permitting the apportionment of income to a taxpayer

based on mere cash contributions to a group's activities or the legal ownership of intangible assets used in other countries, rather than the actual performance of activities by the taxpayer in the jurisdiction where the taxpayer is subject to taxation.

Meaningful improvements can and should be made to existing, arm's-length transfer pricing rules. In particular, under one-sided transfer pricing methods, greater use of safe harbours, with presumptive effects (despite the controversy which presumptive rules may elicit), can help mitigate the often-discussed problems faced by countries in identifying satisfactory data with respect to uncontrolled comparables, and therefore can help deter the use of unrealistically low margins and markups under CPM, TNMM and other one-sided transfer pricing methods. In addition, changes to rules governing profit split methods, to permit income to be apportioned only with respect to a taxpayer's expenses for activities actually performed in the country in which the taxpayer is subject to taxation, could meaningfully reduce the ability of taxpayers to use profit split methods to justify the shifting of income to low- and zero-tax countries.

Nevertheless, while these and other improvements to current transfer pricing rules could improve the rules' performance to a worthwhile extent, it is unlikely that transfer pricing rules following current arm's-length patterns, even improved as suggested, are capable of controlling BEPS to an adequate extent, particularly from the standpoint of developing countries which must rely relatively heavily on corporate tax revenue. Even with improved means of determining adequate margins and markups, one-sided transfer pricing methods, by reason of their structure, will continue to facilitate the shifting of much of a group's income to zero- and low-tax jurisdictions with only a 'routine' apportionment to countries in which business is actually conducted. Moreover, one-sided transfer pricing methods have proven unstable in periods of global economic slowdown, in which taxpayers may perceive themselves as required to impute

taxable income in certain countries even when their global operations are operating at a loss or at very low levels of profitability.

Profit split methods can and should be improved by requiring that apportionment keys attribute income to different countries based only on indicators of actual business activity conducted within the countries, rather than on amounts expended by a group member in a zero- or low-tax country to support business activities that are in fact conducted elsewhere. This should substantially improve the performance of the profit split method and should be of material practical assistance to countries in countering base erosion. In the long term, however, it is not clear that even an improved profit split method can lead to an adequately functioning system for income apportionment under the current arm's-length model. The current requirement that profit split methods be crafted individually for each of a taxpayer's different operations imposes a large burden of complexity on tax administrations, which is likely to be especially prohibitive for developing countries with limited administrative resources. Moreover, unless profit split methods cover all a taxpayer's income and expenses in a country – including interest and similar expenses – profit split methods will continue to allow for the leakage of deductible payments to zero- and low-tax countries, resulting in continued problems of base erosion.<sup>2</sup> In order for profit split methods to be effective, they should, therefore, cover all a taxpayer's income and deductions in a country, and they should also provide uniform apportionment keys in order to reduce administrative complexity. In sum, while improvements to current profit split methods may provide worthwhile benefits over the short term, a stable system for income apportionment over the long term may need to take on an explicitly formulary configuration.

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<sup>2</sup> In the United States, the general rule (which is required under US constitutional principles) that formulary apportionment for state tax purposes cover only 'business' income and expenses, but not investment income and expenses, has led to serious problems of base erosion in state corporate taxation over the years.

## **5 To what extent might formulary apportionment have a practical role in efforts to address base erosion, particularly for developing countries?**

A formulary system of income apportionment could operate with respect to base erosion as what economists sometimes call a 'constitutional rule'. That is, the rules of a formulary system would be based explicitly on the principle that income apportionment should coincide with the locations of value-adding activities, so that departures from this result should be fairly readily discernible by tax authorities, facilitating efficient enforcement. Similarly, legislative or regulatory proposals to create exceptions to the generally applicable formula, in order to facilitate one or another kind of income-shifting transaction, should be readily recognisable as departures from the normative model of correspondence between the locations where business activities are performed and the countries to which income is apportioned. It therefore should be less likely that legal measures which would facilitate base erosion could pass through the legislative or regulatory process relatively invisibly than under the international tax rules commonly in place around the world today. In sum, the adoption by a country of a formulary approach to income apportionment would appear to offer a more reliable means of curtailing base erosion, particularly over the long term, than attempting to apply a mixture of politically vulnerable, and often only partially effective, anti-avoidance measures.

Despite the potential promise of formulary apportionment in controlling BEPS, however, countries will need to address a number of important and as yet unresolved technical challenges if formulary apportionment is to be applied effectively in the international sphere.<sup>3</sup> Some of the most important of these challenges relate to the need, under a system of formulary

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<sup>3</sup> With research assistance from ICTD, I have recently completed a book-length study of the technical challenges of designing a formulary system, which I hope will prove useful to persons considering the possible application of a formulary approach by developing countries. The study has been published in instalments over the past year in the Bloomberg BNA Transfer Pricing Report, and it is anticipated that it will be revised and re-released in book form.

apportionment, for countries to rely on a taxpayer group's global financial statements as the basis for apportionment according to the formula adopted by the particular country. The need to convert the group's global financial statement income into taxable income under each country's separate rules for tax accounting, and the need for individual countries to have practical means of verifying the validity of the group's global financial accounts, raise technical and administrative challenges which will require effort and time to resolve if a formulary system is to work effectively. Quite probably, the resolution of these challenges will require cooperation among countries, including cooperation in achieving greater convergence between book and tax accounting in order to ease problems in the translation of accounts, and also cooperation in examination and enforcement. In particular it would seem sensible for countries to pool their resources in reasonably verifying (perhaps with the assistance of private sector accountants) taxpayers' global consolidated financial statements, which will be used simultaneously as the basis for formulary apportionment in a number of different countries. Achieving satisfactory resolution of these and other important practical challenges to formulary apportionment will require at least several years of dedicated work by experienced tax administrators, practitioners, and other professionals, before countries can prudently seek to implement national systems of formulary apportionment.

## **6 Conclusion: International policy-makers should consider a multi-faceted approach to the protection of developing countries' revenues, with attention to both shorter- and longer-term objectives**

Although formulary apportionment would appear to offer the most effective and durable means of controlling BEPS, the time and resources needed to implement formulary apportionment will require reliance on other anti-avoidance measures at least on an interim basis. In particular,

international advisory groups might urge and assist developing countries to adopt more comprehensive systems of limitations on deductions for payments to related parties, and strengthened systems of withholding taxes on deductible payments, as well as robust systems of presumptive transfer pricing safe harbours to limit revenue losses through the use of risk-limited subsidiaries. A significant impediment to the adoption of these measures is likely to be fear of tax competition; accordingly, international groups should encourage governments of developing countries to seek to adopt the necessary anti-avoidance measures on a concerted basis through the intermediation of regional intergovernmental organisations.

In addition, international groups with a special focus on the needs of developing countries should consider initiating a serious and comprehensive exploration of both the promise and technical challenges of implementing systems of unitary taxation based on formulary apportionment. This work might focus particularly on the prospect of adoption of a formulary approach by regional groups of developing countries which see a particularly strong need to protect their corporate tax bases for the foreseeable future.<sup>4</sup> Implementation of formulary apportionment by a number of countries on a regional basis may help mitigate competitive concerns which might otherwise discourage individual countries from adopting reforms. The

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<sup>4</sup> In order to achieve effective control of BEPS, regional groups of developing countries will need to adopt formulary apportionment governing not only the division of taxable income among themselves, as is currently envisioned under the European Union proposal for a Common Consolidated Corporate Tax Base, but also the division of income between members of the regional group and other countries around the world.

The prospect of one or more regions adopting a system of formulary apportionment with respect to their relations with other countries, while other countries may continue to use arm's-length transfer pricing rules, might raise concern about excessive double taxation. The adoption of formulary apportionment rules, however, even by only a few countries or groups of countries, should reduce rather than exacerbate existing problems arising from double taxation. Under today's relatively subjective arm's-length transfer pricing rules, perceived problems of double taxation arise because taxpayers – including potential investors in cross-border ventures – are unable to predict with confidence how the tax authorities of the different countries involved in international transactions will apply transfer pricing rules. The possibility therefore exists that conflicting after-the-fact interpretations of different countries might subject the taxpayer to an unanticipatedly high total tax burden; this uncertainty could well inhibit taxpayers from engaging in cross-border investments, and therefore may have the effect of constraining economic activity and growth. To the extent that even a few countries in the world adopt more predictable formulary rules for the division of income, the overall uncertainty as to the total taxation to be faced by the taxpayer will be reduced, and this reduction of uncertainty should be conducive to international trade and investment. The key is to recognise that the kind of double taxation that inhibits trade and growth is *unpredictable* double taxation, and the problem of unpredictable double taxation will be mitigated even if only some countries in the world choose to adopt formulary apportionment. See Michael C. Durst, 'Transfer Pricing and Double Tax: Rethinking Conventional Wisdom', *Tax Notes*, 29 October 2012.

same mitigation of competitive concerns through regional cooperation, moreover, might help countries avoid the temptation of adopting single factor, sales-based formulas, which could unduly restrict the available tax bases of developing countries in which inbound investors manufacture products and perform services for export.<sup>5</sup> Historical experience suggests a substantial likelihood that measures short of formulary apportionment will fail to curtail base erosion effectively over time. Those charged with devising and recommending effective tax policies, especially for developing countries, should therefore carefully consider the possibility that a formulary approach can provide protection to fiscal systems which cannot be achieved by other available means. Building on insights that have already been developed through recent analyses of base erosion by the OECD and others, it is suggested that the international economic community, including those with special responsibility for economic development, devote the resources necessary to conduct a comprehensive expert review of the potential that explicitly formulary rules might have for a sound system of international taxation, especially for the benefit of developing countries which must continue to rely relatively heavily on revenue from corporate taxation.

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<sup>5</sup> Under the system of formulary apportionment that governs the division of income for tax purposes among US states, the perceived pressures of tax competition have induced about half the states to adopt single-factor apportionment formulas based on the destinations of a taxpayer's sales. Sales-only apportionment of this kind is seen as encouraging inbound investment to a state, since increases by a taxpayer in productive activities within a state, for example by increasing payroll in that state, will not increase the amount of the taxpayer's income which is apportioned to the state. For many developing countries, however, a sales-only formula would effectively remove from the corporate tax base income derived from the production of goods and services for export, since that kind of economic activity would not generate local sales. It should nevertheless be recognised that even sales-only apportionment, while not optimal for developing countries, might yield developing countries more revenue than current arm's-length transfer pricing rules. Sales-only apportionment should be effective in countering base-erosion transactions, which currently appear to be taking a large toll on developing country tax revenue, so that even for export-oriented countries sales-only apportionment might yield better revenue results than current arm's-length rules.



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