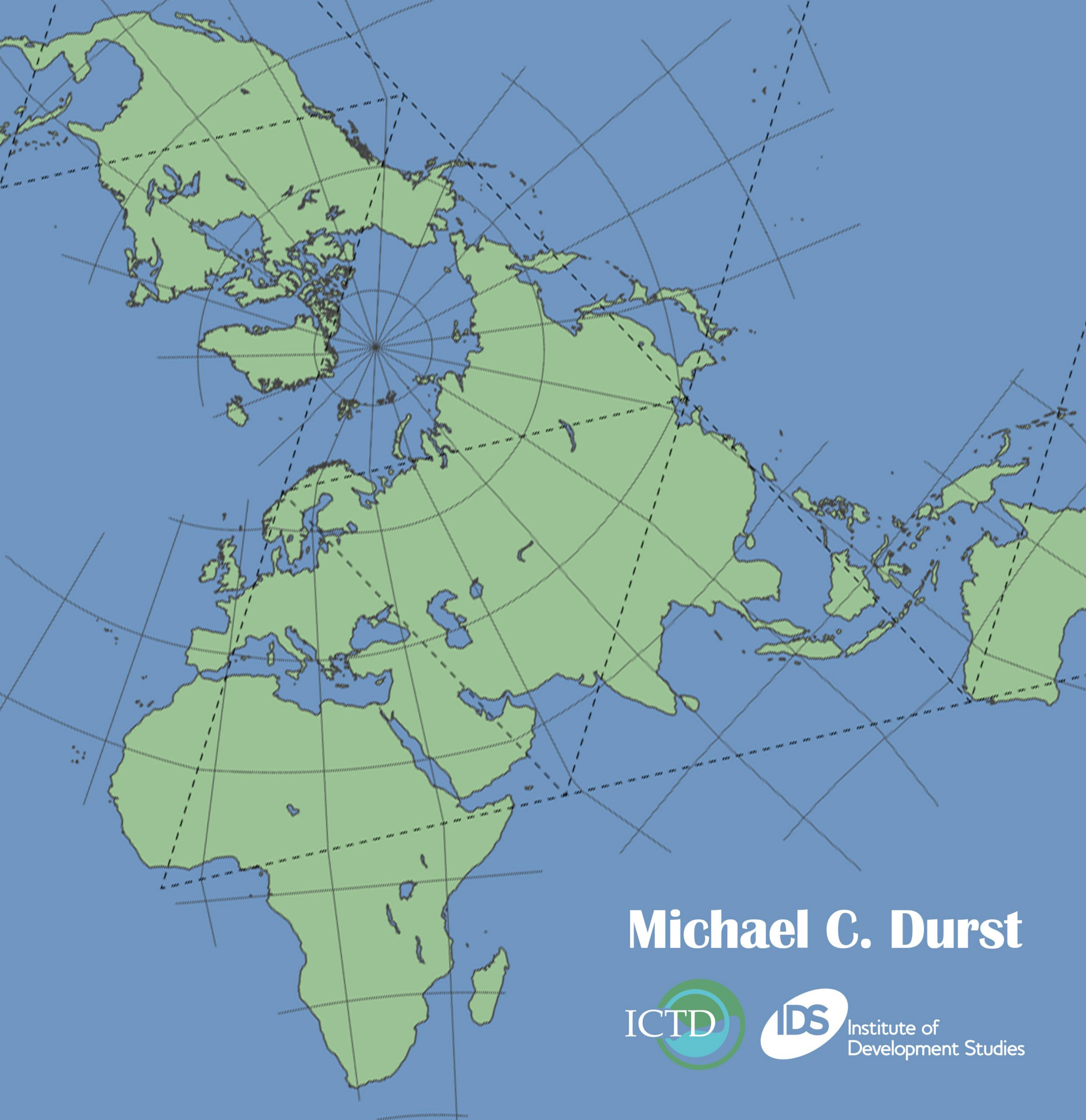
Taxing Multinational Business in Lower-Income Countries

Economics, Politics and Social Responsibility



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Taxing Multinational Business in Lower-Income Countries: Economics, Politics and Social Responsibility

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The world's lower-income countries face an urgent need for public revenue to build social and economic infrastructure. These countries, however, face a dilemma in seeking to tax the income of multinational companies operating within their borders. On the one hand, because lower-income countries face substantial limitations on their ability to raise revenue from broad-based taxes like personal income tax and value added tax, corporate taxes represent a large potential source of additional revenue. On the other hand, governments of lower-income countries often perceive international competition for investment as limiting their ability to levy taxes on multinationals.

This book seeks to explore this dilemma and to recommend policy measures that might enable lower-income countries to increase revenue from corporate tax in a world that is likely to remain characterised by tax competition. The book seeks to shed light on the complicated historical, economic and political roots of today's global corporate tax system – roots that have produced tax laws that all countries, but especially developing countries with resource-constrained tax administrations, have difficulty administering effectively. The book concludes by offering: (i) specific policy initiatives for governments to consider, and (ii) observations concerning the social responsibility faced by multinational companies, the governments of countries at all levels of economic development, and international organisations like the OECD and United Nations, in addressing the pressing revenue needs of lower-income countries.

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Acronyms

ACMT	Alternative corporate minimum tax
AMT	Alternative minimum tax
BALRM	Basic arm's-length return method
BEAT	Base erosion and anti-abuse tax
BEPS	Base erosion and profit shifting
BIAC	Business and Industry Advisory Committee
CbC	Country-by-country
CFC	Controlled foreign corporation
CPM	Comparable profits method
CSR	Corporate social responsibility
DPT	Diverted profits tax
EBITDA	Earnings before interest, taxes, depreciation and amortisation
FDI	Foreign direct investment
GAAR	General anti-avoidance rules
GDP	Gross domestic product
GILTI	Global intangible low-tax income
ICC	International Chamber of Commerce
ICTD	International Centre for Tax and Development
IMF	International Monetary Fund
IRS	Internal Revenue Service
MLI	Multilateral instrument
MP	Member of Parliament
NGO	Non-governmental organisation
OECD	Organisation for Economic Co-operation and Development
OEEC	Organisation for European Economic Co-operation
PCT	Platform for Collaboration on Tax
QIP	Qualified investment project
RRT	Resource rent tax
TIWB	Tax Inspectors Without Borders
TNMM	Transactional net margin method
VAT	Value added tax

Chapter 1

Taxing multinational business in lower-income countries

Motivation for this book

As the 2008 financial crisis sparked widespread public anger towards the world's large companies, investigative news reporters and non-governmental organisations (NGOs) revealed that the world's multinational business groups were routinely avoiding hundreds of billions of dollars of corporate income tax each year in the countries where they conduct business.[1] Multinationals were accomplishing this by shifting profits from countries where they earned their income to zero- and low-tax countries where the groups often appeared to conduct little if any business activity. The profit-shifting payments were not being made secretly – on the contrary, tax agencies around the world had been aware of them for many years. However, under the system of international tax laws that has been adopted by virtually every country in the world, and has been coordinated globally by the Organisation for Economic Co-operation and Development (OECD),[2] countries' revenue-protection agencies could not prevent the income shifting.

The reports by news media and NGOs tended to focus on the effects of tax avoidance in two different groups of countries. Media reports generally emphasised the effects of profit shifting on wealthier industrialised countries. The governments of many of these countries were experiencing fiscal shortfalls following the financial crisis. Some especially widely-noted news reports focused on well-known US companies, including Starbucks, Amazon and Google, which were earning large revenue from sales in the United Kingdom while paying little if any corporate tax there.[3]

The reports by NGOs, on the other hand, focused largely on the effects of profit shifting from the world's poorer developing countries. These countries typically face a chronic shortage of public infrastructure to meet people's most basic human needs, in areas like the supply of clean drinking water, health care and primary education. The NGOs argued that, by depriving

1 See, e.g., Christian Aid (2009); ActionAid (2010; updated 2012) (reports by NGOs); and Duhigg and Kalinowski (2012), Drucker (2013a) and Duncan and Cohen (2012) (news articles).

2 The OECD is a Paris-based organisation consisting mainly of the world's wealthiest governments. OECD member countries are Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Latvia, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, United Kingdom and United States.

3 See, e.g., Duncan and Cohen (2012) and BBC (2012).

countries of the financial means to build infrastructure in these and other areas, corporate tax avoidance was effectively perpetuating widespread personal suffering. One report, for example, suggested that if corporate tax avoidance were to be eliminated, the deaths of tens of thousands of children annually might be prevented.[4] The media and NGO reports typically acknowledged that the profit shifting they were describing was generally legal, in the sense that it was permissible under the tax laws of the countries that were involved. Nevertheless, the authors of the reports made no attempt to conceal their belief that the tax avoidance reflected moral failure on the part of a number of politically powerful actors – the multinational companies that engaged in the avoidance; the lawyers, accountants and other tax professionals who advised them; the OECD and other intergovernmental groups that had perpetuated ineffective tax laws; and national governments that seemed content to retain those laws on their statute books despite their apparent failure to contain revenue losses.

The media and NGO reports generated a strong public reaction, especially in the economically developed world. Parliamentarians in some countries conducted inquiries at which legislators were highly critical of the world's most prominent multinational corporations. In one widely reported instance, for example, a senior UK Member of Parliament (MP) criticised US multinationals Starbucks, Amazon, and Google as having fallen short of basic ethical standards in engaging in tax-avoidance practices, notwithstanding that the avoidance appeared legally permissible. 'We're not accusing you of being illegal', the MP declared, 'we're accusing you of being immoral' (BBC 2012).

In response to these developments, in 2012 the finance ministers of the G20 group of countries directed the OECD to conduct a multi-year inquiry into the phenomenon of what the OECD labelled base erosion and profit shifting, or BEPS.[5] Senior officials of both the G20 and the OECD expressed the view that BEPS-style tax planning around the world was eroding public confidence in national and global economic institutions, and should no longer be tolerated. The OECD began its study of base erosion and profit shifting in 2013, promising a thorough reassessment of the body of international tax laws that the OECD had historically been responsible for articulating and maintaining.

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4 Christian Aid (2008: 2). The report claims that if tax revenue lost in developing countries to two forms of corporate behaviour could be recovered – 'legal' avoidance of the kind addressed in this book, and certain criminal tax avoidance consisting of the falsification of trade documents – 'then the lives of *350,000 children under the age of five* would be saved every year – including 250,000 babies' (emphasis in original). The quantitative analysis of the Christian Aid study has been criticised, and the report may substantially overstate the revenue losses that countries experience from corporate tax avoidance - see Fuest and Riedel (2009); and M. Forstater (2015). Moreover, it must be remembered that increased corporate tax revenue alone will not necessarily improve social well-being in a country. It is also necessary that the revenue be used to meet unmet social needs, rather than being misappropriated through corruption and inefficiency. See, e.g., Besley and Persson (2014: 113). It is, of course, important to recognise that effective tax policy represents only one among many requirements for the alleviation of poverty in the world's poorest countries.

5 The G20 countries are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom and the United States.

Although it draws much of its membership from the world's wealthiest countries, the OECD acknowledged that revenue losses from base erosion and profit shifting were affecting developing countries especially acutely. The OECD therefore invited governments of developing countries to participate in the BEPS studies. In addition, intergovernmental organisations active in the field of international development, including the International Monetary Fund (IMF), World Bank and United Nations, collaborated with the OECD and produced several extensive analyses that focused particularly on the situation of developing countries with respect to corporate profit shifting.

The OECD issued final reports from its BEPS studies in late 2015, recommending a number of legislative and administrative measures that governments might take to curtail the shifting of income by multinational groups. In addition, a consortium of intergovernmental organisations, including the OECD, World Bank, IMF and United Nations, pledged to join in a sustained programme of technical assistance to help the world's developing countries implement the BEPS recommendations and otherwise improve the performance of their tax systems.

This book seeks to provide a critical, and in some ways novel, assessment of base erosion and profit shifting as it affects the world's lower-income countries,[6] and of the current efforts of the OECD and other international organisations to curtail the phenomenon. I write this book in the belief that the advocacy of NGOs and others, described above, performed a valuable service in bringing the tax situation of lower-income countries to greater public attention. I also believe, however, that the problems of corporate taxation in lower-income countries reflect a longstanding complex and stubborn mix of political and economic influences, and that the post-2008 public exposure represented only the beginning of a still incomplete process of understanding the roots of the problems that have been identified. As discussed below, progress has been made towards improving the performance of corporate income tax in lower-income countries, largely through the OECD's BEPS process – but the process of reform has only begun. The BEPS process has to date been unable to address some of the most central difficulties faced by lower-income countries, and some of the fundamental political and economic causes of those difficulties have not yet been sufficiently aired and confronted.

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[6] A note is in order about the use by this book of the term lower-income countries. It might be possible instead to use the term developing countries, but that is used popularly to describe countries at many different levels of per capita income, some of which are relatively wealthy by global standards. The World Bank uses the terms low-income (per capita income of $1,005 or less for fiscal year 2017/18); lower-middle-income (per capita income of $1,006 to $3,955), upper-middle-income (per capita income of $3,956 to $12,235) and high-income (per capita income of at least $12,236). I use lower-income to denote countries falling roughly within the low- and lower-middle-income groups. (For the World Bank classification, see World Bank, 'World Bank Country and Lending Groups'.) It should be recognised that each World Bank category includes countries of widely varying levels of per capita income and social conditions, and my use of the term lower-income inevitably encompasses countries that differ from one another in many important ways.

The book’s fundamental argument

This book addresses three fundamental questions:

- Would curtailing base erosion and profit shifting in lower-income countries be in the interests of the people of those countries, especially in facilitating the alleviation of poverty?
- What are the political and economic roots of BEPS-style corporate tax planning?
- What policies might lower-income countries realistically pursue to reduce their vulnerability to base erosion and profit shifting?

With respect to the first of these questions, the book concludes that BEPS-style tax planning does properly demand the continuing attention of policymakers around the world. The world’s poorer countries are chronically short of the public revenue needed to combat persistent severe poverty, and as a practical matter the income generated by multinational companies within those countries represents one of the few realistically accessible sources of additional public funding, at least for the foreseeable future. As will be discussed, there are, of course, limits to the extent that lower-income governments should seek to increase corporate tax revenue above current levels: at some level of increased corporate taxation, the social costs of reduced inbound investment will override the social benefits of generating additional revenue. As discussed in Chapter 2, however, profit shifting has become so pervasive in lower-income countries that corporate tax revenue today is almost certainly below socially optimal levels.

Therefore, curtailing BEPS-style tax avoidance should increase the likelihood of gains in social welfare for people in lower-income countries. This is not to say that increases in government revenue will inevitably lead to improvements in social conditions – many obstacles, including corruption and other shortfalls in governance, can obstruct the path between the collection of revenue and its successful use in promoting social well-being. Nevertheless, enhanced revenue should make badly needed social improvements more feasible than they are today, and for this reason curtailing tax avoidance in lower-income countries appears to represent a desirable policy goal.

The conceptual core of this book consists of a historical interpretation of the phenomenon of BEPS-style tax planning. This history is a remarkably long one: all the techniques by which multinational groups currently use subsidiaries in zero- and low-tax countries in avoidance planning were already in use within a few years after the end of World War II, when the cessation of hostilities and wartime technological innovations permitted a flowering of cross-border trade and investment. I argue in this book that

BEPS-style tax avoidance can be understood most usefully, not primarily as a product of corporate wrongdoing, but rather as a consequence of the longstanding desire of: (i) taxpayers to minimise their liabilities, and (ii) the governments of countries at all levels of economic development to encourage investment by offering companies full or partial exemption from corporate taxation.

To some extent, countries offer investors tax exemptions through explicit means, for example by enacting laws permitting tax holidays for investments in new businesses, or tax exemptions for starting businesses in economically disadvantaged areas within a country. All governments, however, face some degree of political resistance to the use of explicit tax exemptions to attract investment, on the grounds that the governments are showing excessive largesse to corporate interests. I argue in this book that the techniques that multinational companies employ to avoid taxes, and the international system of tax laws that protects the avoidance from successful challenge by revenue authorities, evolved as a means by which companies could obtain, and governments could tacitly provide, de facto exemptions from taxation with less political visibility than is entailed in explicit tax incentives.

My interpretation of base erosion and profit shifting as reflecting not only the desire of multinational companies to avoid taxes, but also the desire of governments to facilitate that avoidance to encourage inbound investment, raises the question of whether the recommendation that the international community take steps to curtail the avoidance incorporates an undesirable element of paternalism. After all, if governments of lower-income countries have tolerated high levels of avoidance for many years, with the view that the resulting encouragement of investment outweighs the potential social value of increased investment, what standing do NGOs, journalists, tax scholars and international organisations like the OECD, IMF, and World Bank have to encourage lower-income governments to try to curtail avoidance?

An answer to this question is found, I believe, in the nature – indeed, in the elementary mathematics – of international tax competition. If lower-income countries did not see themselves as competing with their neighbours to attract inbound investment, they could presumably drive a tougher tax deal with investing multinationals, increasing the amount of corporate tax revenue closer to socially optimal levels. But, in fact, virtually all countries are eager to attract inbound investment. Whatever level of taxation a country might be willing to offer a potential investing multinational, often one or more other countries will be willing to offer a lower level of taxation. The result is in effect a kind of auction, a ‘race to the bottom,’ in which governments perceive little practical alternative but to permit investing companies to engage in some measure of tax avoidance.

The indispensable role of corporate social responsibility

In view of all this, it seems clear that a successful mix of policy initiatives to enhance corporate tax revenue in lower-income countries will need to include measures by which countries can to some extent be shielded from the pressure of tax competition. There really is only one way in which market competition, of which international tax competition is an example, can be mitigated, and that is by some degree of coordination among market competitors. Thus, for example, if lower-income governments could bargain with multinational groups as a bloc instead of individually, they could in theory obtain agreement on a level of corporate taxation that would optimally balance the competing goals of raising public revenue and maintaining a favourable environment for investment. Currently, there is little coordination of tax policies among lower-income countries, and, given the persistent pressure of tax competition, the degree of coordination that is possible is likely to remain limited for the foreseeable future. Nevertheless, it seems unavoidable that lower-income countries will need to achieve some degree of additional policy coordination, especially on a regional basis, if they are to implement policies to better shield themselves from BEPS-style tax avoidance.

Achieving this degree of enhanced market coordination is unlikely to occur without assistance and encouragement from other parties, in addition to lower-income countries. We see today the inevitable result of leaving lower-income countries to counter the presence of tax competition without the support of outside intervention – the race to the bottom continues to operate largely unimpeded, leading to a very high volume of corporate income shifting. Better results will require more effective political counterweights to the forces of international tax competition. Those counterweights will need to be provided, not only by the world’s lower-income countries themselves, but also by other politically-empowered groups that are involved in the international tax lawmaking process.

In other words, it seems inescapable that a substantial increase in corporate tax revenue for lower-income countries will require the political acquiescence, and even proactive political support, of multinational companies and the governments of their home countries. This will involve the willingness of business interests, acting in concert, to refrain from exercising the full measure of economic power that tax competition affords them in their dealings with lower-income countries. In doing so, companies will need to be motivated by both economic and normative goals. Essentially, a political consensus will need to be reached that current corporate tax laws and practices generate revenue at levels below those that can support socially desirable programmes for the alleviation of poverty. Companies would therefore acquiesce to measures to increase the tax bases of lower-income countries for the same reason that they cooperate in, for example, international efforts to prohibit child labour or harmful environmental practices.

As discussed later in this book, the idea that multinational companies should voluntarily acquiesce to laws that limit their exercise of economic power in the tax context is bound to elicit political opposition. Asking for companies' partial voluntary forbearance from tax competition could be seen as interfering with global market mechanisms, which to some may be objectionable in itself. In addition, self-restraint by companies in the reduction of their tax liabilities could be seen as effecting a redistribution of income from the shareholders of multinational companies to populations of lower-income countries, which may also meet opposition. Nevertheless, some degree of forbearance on the part of business interests, from taking full advantage of the opportunities presented by tax competition, seems to me indispensable if the performance of corporate tax in lower-income countries is to be meaningfully improved.

The search for effective policy instruments

I will defer detailed comment on the third question of specific corporate tax policy initiatives that might prove most useful to lower-income countries until forthcoming chapters have provided additional background. Even at this preliminary stage, however, one common-sense prerequisite for effective international tax policies can be mentioned. Above all else, successful policy initiatives must be far less complicated than those that currently govern the taxation of cross-border trade and investment around the world. Later chapters of this book will argue that today's international laws have evolved over decades to generate, rather than reduce, complexity and unpredictability of application, and that this tendency has greatly impaired efforts to enforce the law and reform it legislatively in countries around the world. The undue complexity of current law is problematic in countries at all levels of economic development, but the difficulties are especially serious for lower-income countries that have limited resources to support both tax administration and legislative analysis.

There will be limits to the simplification of international tax laws. The many different kinds of business transactions engaged in by multinational companies are often inherently complex, and therefore require a certain irreducible amount of complexity in tax laws. Moreover, the enactment of tax laws typically requires political compromise, and compromise often results in legal provisions that, because of ambiguity, can be difficult to apply. Nevertheless, current international tax rules have evolved towards obscurantism as an end in itself. A new generation of international tax laws should be judged in significant part by the simplicity and transparency of their structure.

The main policy recommendations of this book will all involve simplification. For example, when examining the OECD's recent BEPS process, I will focus on two initiatives that the OECD has either recommended or addressed sympathetically in its work: proposals to simplify the manner in which tax authorities may apply transfer pricing rules,[7] and rules placing quantitative limits on the amount of interest payments that corporations are permitted to deduct. These BEPS-related initiatives represent well-conceived attempts to reduce the complexity of current laws, and can, I think, offer lower-income countries meaningful practical benefits.

I would extend the principle of simplification, however, beyond the policy initiatives that have figured during recent BEPS discussions. In particular, I explore in Chapter 5 the possibility of a relatively simple statutory ‘overlay’ that a country might place atop the more complex body of existing international tax rules, to ensure that reasonable minimum levels of tax revenue can be collected even from companies that engage heavily in profit shifting. Precedent for this kind of overlay is provided by ‘alternative corporate minimum taxes’, based on gross revenue (turnover) rather than net income, that some developing country governments have been applying for decades. Revenue yields from the minimum taxes could be calibrated to generate significant benefits to lower-income countries, while remaining below levels that would be expected to unduly discourage inbound investment.

As discussed in Chapter 5, the minimum-tax approach has potential drawbacks and limitations. Among other things, its use of gross revenue as a base poses some economic disadvantages, particularly in placing some taxpayers at risk of taxation even in the absence of profits. Also, implementation of the minimum tax could, like all potential measures that would increase tax revenue, be impeded by the pressure of tax competition. In addition, more must be learned about countries’ experience to date with alternative corporate minimum tax. Given that it has been in use for many years, surprisingly little research is available on how it has performed in practice. Nevertheless, under current political and economic circumstances, more widespread use of the tax may offer promise for lower-income countries, and it should be given careful consideration in international reform efforts. This book will suggest how minimum-tax proposals might be effectively researched, developed and possibly implemented by more countries on an internationally coordinated basis.

This book’s intended audience

I hope that this book will be useful to both specialists in the field of international taxation and, probably more importantly, non-specialists who are generally conversant with questions related to public finance and international development, but who are not familiar with the complexities of

[7] Transfer pricing laws govern the question of whether the different companies within multinational groups deal fairly with one another (on an arm’s-length basis), so that income is not shifted artificially to affiliates in low-tax jurisdictions. Transfer pricing laws have become especially complicated over the years; they are discussed in Chapters 3 and 4.

international tax laws and practice. The body of laws that protects the institution of base erosion and profit shifting has survived for more than 60 years, in part because it is protected by an impressive layer of verbal camouflage. The legal guidelines and other official documents that memorialise the current system reach remarkable heights of verbosity and circumlocution, raising forbidding obstacles to newcomers who desire to approach the system and understand it. Professional insiders, therefore, have enjoyed a near monopoly on policymaking in the field of international corporate taxation. Non-initiates need to be able to see through the law's protective covering of complexity and gain an understanding of how the tax laws function in practice, if the range of actors who can participate effectively in policymaking is to be widened. Therefore, although I try in this book to avoid oversimplification, I also try to avoid the unnecessary use of specialised terminology. I try to summarise legal rules and corporate business transactions in relatively straightforward language, with technical details consigned to footnotes.

There is a limit, however, to the extent to which the discussion in this book can be simplified (at least by me). Even if spurious complexity is pushed aside, corporate income taxation, especially in the international setting, remains an intrinsically complicated topic. I have therefore found the effort to keep this book accessible to non-specialists challenging, and I am certain that at best I have succeeded only partially in doing so. Non-specialists (and maybe even specialists), therefore, are bound to encounter prickly tangles of verbal complexity in journeying through this book. For this I apologise, and hope that the rewards of the trip outweigh any pain experienced along the way.

For those international tax specialists who might read this book, I hope that you will find the discussions stimulating and useful, even though much of the analysis that I present is likely to be familiar to you. We who make careers in the tax field tend to spend much of our time and intellectual energy probing the law's minute complexities. We can focus so intently on relatively confined, technical topics that we risk losing sight of the overall political, economic and ethical matrix in which we work. I hope that even the most sophisticated international tax specialists will find this book helpful in gaining insights into the broad policy implications of the work that we do, and possibilities for applying our expertise in new and helpful ways.

The forthcoming chapters

This book develops its argument in five chapters that follow this introduction.

Chapter 2, 'The corporate tax dilemma faced by lower-income countries', examines the basic economic dilemma faced by lower-income countries with respect to corporate tax, describing the trade-off between the conflicting desires to enhance public revenue and encourage inbound investment. The chapter explores the central policy question raised by tax competition in lower-income countries – whether it can be said with confidence that increasing corporate tax revenue in lower-income countries is likely to promote social well-being.

Chapter 2 also offers a historical overview of BEPS-style corporate tax planning, describing the origins of the phenomenon in the years following World War II and its remarkable durability over more than six decades. I argue that BEPS practices arose largely because they permitted both multinational companies and governments to afford companies de facto tax reductions on income derived from cross-border investment, but to do so in a relatively non-transparent manner. Chapter 2 offers what I hope will be a reasonably accessible, but not overly simplified, explanation of the mechanics of tax avoidance based on profit shifting, outlining four basic transactional formats that are present in virtually all BEPS-style planning structures.

Chapter 3, 'The historical evolution of base erosion and profit shifting', surveys the various principles of international tax law that are intended ostensibly to control profit shifting among members of multinational groups. I argue that these measures have in fact evolved over decades, not primarily in order to curtail profit shifting, but instead in practice to insulate profit shifting from successful legal challenge by national tax administrations around the world. The discussion in Chapter 3 focuses in large measure on the arm's-length principle that underlays international transfer pricing law, as that law is codified in guidelines issued by the OECD and followed by national governments around the world. Transfer pricing laws are supposed to provide tax authorities the means of limiting, to economically reasonable levels, the amount that companies can deduct for payments made to foreign affiliates. Chapter 3 argues, however, that today's arm's-length transfer pricing rules contain obvious conceptual and technical anomalies that limit their usefulness to tax authorities in many real-life tax audits. Chapter 3 reviews the historical development of the OECD's transfer pricing laws in an effort to pinpoint the political origin of those parts of the rules that are most problematic in developing countries.

In addition to transfer pricing laws, Chapter 3 explores other areas of tax law that are important to an understanding of base erosion and profit shifting. These include 'controlled foreign corporation' (CFC) rules, by which governments have sometimes sought to prevent their home-based multinationals from availing themselves of profit-shifting avoidance techniques in countries where the multinationals conduct business. In theory, CFC rules offer a means by which the home countries of multinationals could, by coordinating their legislation, effectively end BEPS-style avoidance by prohibiting their multinationals from participating in it. Historically, though, there has been little, if any, collaboration among capital-exporting governments to prevent their multinationals from engaging in tax avoidance around the world. Governments instead have feared that, by subjecting their home-based multinationals to effective CFC legislation, they might place those multinationals at a competitive disadvantage with respect to multinationals based in other countries, where effective CFC legislation is not in effect. As a result, although many countries maintain CFC rules on their statute books, the rules tend to be riddled with exceptions and other vulnerabilities, so that BEPS-style avoidance has been permitted to flourish despite the existence of these laws.

Chapter 3 addresses a recently prominent variation of the CFC approach, the minimum tax on companies' foreign income (the global intangible low-tax income (GILTI) tax), which is included in recently-enacted US tax reform legislation. Chapter 3 considers whether the enactment of the GILTI tax by the United States may trigger what amounts to an international revival of the CFC approach – this might reduce the pressure of international tax competition on lower-income countries to some extent.

Chapter 3 also examines the remarkably permissive laws that for decades have permitted companies operating around the world to deduct from their taxable incomes interest that they pay on obviously tax-motivated loans extended by zero- and low-tax affiliates. Chapter 3 considers why historical attempts to control profit shifting through interest payments have generally failed, and examines recent efforts by some countries – which during the BEPS process were endorsed by the OECD – to adopt more effective legislation to limit loan-based corporate tax avoidance.

Chapter 4, 'The OECD's BEPS project and lower-income countries', builds on Chapter 3's examination of the legal and political foundations of base erosion and profit shifting, assessing the extent to which the OECD's recent BEPS efforts offer practical promise for the curtailment of corporate profit shifting from lower-income countries. I argue that, inevitably, the BEPS process was heavily affected by political pressure from various quarters to retain the historically evolved structure of international corporate tax law. The BEPS project has therefore refrained from recommending fundamental revision of the legal principles that currently govern international corporate taxation. In particular, while the OECD has devoted considerable critical attention to the difficulties posed historically by arm's-length transfer pricing laws, recommendations in the BEPS reports leave some of the most important problems of current law unaddressed.

I nevertheless argue in Chapter 4 that the BEPS project has generated a number of policy recommendations that offer the prospect of significant improvement in the generation of corporate tax revenue in lower-income countries. First, in an effort to reduce profit shifting through the payment of interest on loans from affiliates, the OECD has recommended that countries adopt rules disallowing interest deductions that exceed a specified percentage of the borrowing company's net income. A number of relatively wealthy countries have already adopted limitations of this kind – they are relatively simple to administer, and probably could lead to significant revenue gains in lower-income countries that are willing to adopt them. In addition, notwithstanding the BEPS reports' hesitancy in addressing some central shortcomings of transfer pricing laws, I believe that plans of the OECD and other donor groups to provide technical assistance in simplifying the administration of transfer pricing rules – particularly the transactional net margin method under existing OECD guidelines – offer some practical benefits for lower-income countries and should be pursued. Similarly, I argue, the plans of the OECD and other organisations to engage in capacity building in the area of transfer pricing administration, while limited in their potential effect by remaining deficiencies in underlying laws, nevertheless offer promise for net benefits in lower-income countries and should be pursued.

I also argue in Chapter 4 that the OECD's recommendations for improving the performance of international tax treaties offer limited, but significant, potential benefits to lower-income countries.

Finally in Chapter 4, I consider the extent to which various developments related to but not part of the BEPS process might reduce demand for BEPS-style tax planning among multinational groups, thereby reducing the pressure of tax competition on lower-income countries. These developments include growing concerns by multinational companies regarding the reputational effects of BEPS-style tax planning, actions within the European Union to limit member countries' participation in tax planning structures, and the recently enacted GILTI tax in the US, which may reduce US groups' tax benefits from overseas profit-shifting arrangements.

Chapter 5, 'A corporate tax policy agenda for lower-income countries', seeks to build on the analysis in prior chapters by suggesting a programme of potentially useful policy instruments for lower-income countries. My recommendations are based on the overall assessment that the problem of profit shifting is extraordinarily complicated, politically as well as technically. Meaningful progress against it is likely to arise from a combination of incremental legal reforms, rather than a 'big fix' consisting of a fundamental redesign of the prevailing system of international tax laws. In accordance with this view, Chapter 5 considers how countries might best implement those of the OECD's recommended initiatives that are discussed in Chapter 4: (i) limitations on interest deductions; (ii) simplification of transfer pricing methods; (iii) capacity building, mainly in the area of enforcing transfer pricing; and (iv) the adjustment of national policies relating to income tax treaties.

In addition, Chapter 5 considers the potential benefits and limitations of the use, by additional countries, of an alternative corporate minimum tax (ACMT) applied at a low rate (e.g. 1%) applied to a taxpayer's gross revenue (turnover), rather than its net income. Because no deductions are allowed under a turnover-based tax, it would be immune from avoidance through BEPS-style deductible payments of any kind, including royalties and service fees, and also interest. A turnover-based ACMT should also be effective against tax planning based on the undervaluation of products shipped from a country, including natural resource and agricultural products. Further, the relative simplicity of a minimum tax suggests that it might be well-suited to coordinated implementation among groups of countries, thereby to some extent relieving pressure from tax competition.

Chapter 5 concludes by offering brief comments on the taxation of some industries that are often of particular importance to the economies of lower-income countries. These include natural resource extraction, electronic commerce, mobile telecommunications, and banking and insurance. There has been a great deal of specialised study of taxation of these industries, and this book cannot attempt to discuss their taxation in detail. Nevertheless, Chapter 5 offers a brief explanation of the special problems that taxation of these industries presents, as well as ways that have been considered to alleviate these problems.

Chapter 6, ‘BEPS in lower-income countries: a social responsibility perspective’, concludes this book with observations on the possibility of generating the political will among various interested actors that will be needed to implement even limited measures to curtail profit shifting as it currently affects lower-income countries. Today’s virtually universal use of BEPS-style tax planning among multinational companies reflects the operation over many decades of two mutually reinforcing kinds of competition – competition among countries to attract business investment, and competition among multinational businesses to minimise their tax burden in countries where they operate. Together, these two kinds of competition have constrained corporate tax receipts in lower-income countries at levels that seem significantly lower than would be socially optimal.

In light of the persistence of both kinds of competition, it seems inevitable that meaningful enhancements of corporate tax revenue in lower-income countries will require a supportive consensus among the major stakeholders in the global corporate tax system. These include businesses and business organisations, the national governments of both industrialised and developing countries, intergovernmental organisations like the OECD, IMF, World Bank and United Nations, and regional associations of governments of developing countries. What is needed, essentially, is an extension of the recent BEPS negotiations, but with a focus specifically on the needs of lower-income countries.

Chapter 6 considers, from an ethical perspective, both the desirability of this kind of effort, and the likelihood that support for it can be gathered from both the governmental and private sector actors who would need to implement it. Does there exist a moral duty to assist lower-income countries in improving the performance of their corporate tax systems, even at the financial expense of both the governments of other countries and multinational companies themselves? Further, if a duty of this kind exists, who specifically bears the responsibility for seeking to implement it, and in what ways? No piece of writing, including this book, can pretend to answer questions like these definitively, or to all readers' satisfaction. Nevertheless, I hope that the observations offered in Chapter 6 will prove helpful to those who seek to build a pragmatic policy framework for improving the performance of corporate income taxation in lower-income countries.

Chapter 2

Poverty, tax competition and base erosion

The corporate tax dilemma faced by lower-income countries

The need for public revenue

This book is, at its heart, about the alleviation of poverty. The last 20 years have seen a reduction of poverty in many areas of the world.[8] Despite this improvement, however, living conditions for millions of people in the world fall short of minimally-acceptable levels of dignity and personal security. As of 2015, approximately 700 million people, about 10 per cent of the world's population, were trying to live on less than the equivalent of $1.90 per day, which is the World Bank's indicator of extreme poverty.

High levels of poverty are reflected in dramatic differences in health and other social indicators between lower-income and wealthier countries. In Australia, for example, average life expectancy at birth is 82.8 years; in Malawi it is 58.3 years.[9] In Equatorial Guinea, 342 women die in childbirth for every 100,000 births; in France the comparable number is 8. In Myanmar, 50 of every 1,000 children who are born die by the age of 5; in Norway the mortality rate for children under age 5 is 2.6 per 1,000. The disparities also extend to education, even at the most basic level. For example, in Japan, as of 2013, virtually all primary-school-aged children were enrolled in school; in West and Central Africa, about 25 per cent were not.[10]

This book is motivated by the inescapable fact that lower-income countries will need to invest heavily in public infrastructure – in schools, hospitals and clinics, roads, water and sanitation systems, electricity-generating facilities, police, fire and ambulance departments, and many other kinds of facilities – if the lower-income residents of those countries are to have hope for dignified and reasonably secure lives. Moreover, the skilled personnel needed to staff this infrastructure will need to be trained and compensated. Funding these needs will require the governments of lower-income countries to generate substantially more public revenue.

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8 See generally World Bank Group and IMF (2016), which is the source of statistics in this paragraph.

9 The health statistics in this and the following sentence are from World Health Organization (2017).

10 Data from UNICEF (2018).

Special reliance of lower-income countries on corporate tax revenue

Lower-income countries, however, are typically far more limited in their ability to raise government revenue than the world's wealthier countries.[11] The bulk of government revenue in wealthier countries comes from broadly applied forms of personal taxation, including personal income tax and consumption taxes like value added tax (VAT). In poorer countries, however, low per capita earnings in themselves limit the amount of revenue potentially available from personal income and consumption taxes. Moreover, a large proportion of economic activity tends to be informal in lower-income countries, in the sense that many business transactions are conducted in untraceable cash, and many employment arrangements are not formally documented.[12] The combination of low per capita income and economic informality limits the ability of many developing countries to raise revenue from 'workhorse' taxes like personal income tax and VAT.

In addition to personal income and consumption taxes, corporate income tax exists in virtually every country in the world. Over time, corporate income tax has fallen out of favour politically in many of the world's wealthy countries. Many believe that, as a general matter, taxes on corporate income unduly discourage business investment and therefore economic growth. This concern has been magnified by the increase in the mobility of capital in recent decades, causing countries at all levels of economic development to engage in tax competition. In wealthier countries, the percentage of total government revenue raised by corporate tax is accordingly relatively low. Lower-income countries, however, generally have not been able to reduce the relative importance of corporate income tax in their fiscal systems. As of 2012, the IMF estimated that in the world's high-income countries corporate tax revenue accounted for slightly over 8 per cent of total government revenue, not including social contributions, whereas in both low- and lower-middle-income countries reliance on corporate taxation was about twice as high, at approximately 16 per cent of total government revenue less social contributions (IMF 2014: 7).

What level of corporate taxation is desirable for lower-income countries?

Despite the relatively large role that corporate income tax plays in their fiscal systems, lower-income countries face strong economic pressure to minimise the tax burdens they impose on corporations. Chronically high levels of unemployment, as well as other factors like the inability to offer investors the attractions of a trained workforce and well-developed physical infrastructure like roads and other transportation facilities, typically place pressure on

11 See generally IMF (2014: 7).

12 A high rate of subsistence agriculture, which does not generate taxable cash flows, contributes to the large proportion of informality in the economies of poorer countries. See, e.g., Bird (2012: 8).

lower-income countries to sacrifice potential corporate tax revenue in order to attract foreign direct investment.[13] The tension between (i) the apparent need for lower-income governments to rely heavily on corporate income tax for the generation of revenue, and (ii) the pressure on lower-income governments to limit corporate tax burdens in order to encourage investment and economic growth, stands at the heart of the unresolved problem of BEPS-style tax avoidance that this book seeks to explore. How vigorously should the government of a lower-income country seek to increase tax revenue by removing opportunities for companies to benefit from tax planning, if one of the possible effects of doing so is a reduction in foreign direct investment?

Development economists generally approach this question in two conceptual stages. First, they ask whether a lower-income country's aggregate revenue – revenue from all sources of taxation, including corporate income tax – is too low. That is, does the revenue generated by a country appear too low to finance the minimum level of public infrastructure and public services needed to give the country's residents a realistic promise of eliminating extreme poverty and creating opportunities for dignified and secure lives?

Economists try to get some sense of the answer by comparing the ratio of tax revenue to the overall size of the economy (measured by gross domestic product (GDP)) in countries at different levels of economic development. As of 2015, the median ratio of tax-revenue-to-GDP was 14 per cent in low-income countries, 17 per cent in lower-middle-income countries, 21 per cent in upper-middle-income countries, and 32 per cent in high-income countries.[14] It is clear that tax revenue per capita in lower-income countries tends to be far below the level in wealthier countries. These numbers, coupled with the obviously inadequate level of public infrastructure in the poorest countries, lead many development economists to conclude that significant increases in the ratio of tax-to-GDP in lower-income countries would make possible benefits in social well-being.[15]

Of course, raising additional revenue will not in itself generate greater social well-being. It will also be necessary to translate the additional revenue into high quality social infrastructure, which means avoiding misappropriation through, for example, corruption and governmental inefficiency.[16] Thus, achieving the goal of substantially enhanced social welfare in lower-income countries will require initiatives in areas of governmental function in addition to raising revenue. Nevertheless, even if not sufficient in themselves to

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13 Foreign direct investment (FDI) refers to cross-border investments representing controlling interests in business operations, such as the formation by a multinational company of a new subsidiary to be active in a country, or the acquisition of an ongoing business by merger or cash acquisition. FDI is distinguished from portfolio investment, meaning the acquisition by investors of non-controlling (minority) interests in business operations. See Investopedia, 'Foreign Direct Investment — FDI'.

14 Source: ICTD/UNU-WIDER, Government Revenue Dataset (Nov. 2017). The author is grateful to Kyle McNabb of UNU-WIDER for compiling the data reported in the text.

15 See generally IMF (2011).

16 See, e.g., Besley and Persson (2014).

promote welfare gains in lower-income countries, additional tax revenue seems to be a prerequisite for lower-income governments to achieve significant alleviation of poverty within their jurisdiction. Provided it is recognised that additional policy initiatives are also required for the alleviation of poverty, especially in the area of governance, it seems right to conclude that increasing government revenue represents a desirable and even urgent policy goal for lower-income countries.

The next question is the extent to which the government of a particular lower-income country would be rational in seeking enhanced revenue from corporate income tax as opposed to other forms of taxation. For purposes of analysis, it is useful first to consider this question on the concededly unrealistic assumption that the country is not subject to forces of tax competition – that is, potential inbound investors are not able to redirect their investments to other countries that might be able to offer a more attractive tax environment.

In the absence of tax competition, a rational government will choose to impose corporate income taxes up to the point at which the perceived social benefits from additional revenue collected (in terms of ability to meet social needs within a country) just balances the social detriment to the country from expected suppression of inbound investment due to an additional increment of corporate taxation. This level of corporate taxation can be described as the level that would be optimal for the country in the absence of tax competition.[17] The notion of an optimal level of taxation is largely theoretical – there is, of course, no exact way in which a government can determine its optimal level of corporate taxation. Both the social benefit and social harm from a given level of taxation cannot be qualified precisely, a great deal of subjectivity is involved, and the views of political actors will differ. Nevertheless, despite the practical limitations, all rational governments must make at least an implicit comparison between social benefits and costs when deciding the level at which to impose corporate income tax (or any other kind of taxation).

In weighing the social costs and benefits of corporate income taxation, it is important to bear in mind that all forms of taxation, including personal income and consumption as well as corporate taxation, impose costs on society through the distortion of economic activity. For example, personal income taxes, and even to some extent consumption taxes, suppress both work effort and savings in an economy. It is often argued, however, that corporate income tax imposes more serious economic distortions than most other kinds of taxes. Corporate income tax is imposed entirely on income from capital investment, whereas most other forms of taxation, like personal income and

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[17] The study of the extent to which it is rational for governments to attempt to raise revenue from different kinds of taxation is called optimal tax theory, and there is an extensive literature on the topic. Important statements of the theory include Boadway and Keen (1993); and Diamond and Mirrlees (1971).

consumption taxation, are imposed largely on income derived from individuals' labour. Many economists believe that if corporate tax burdens are increased corporations are likely to cut back on their level of investment to a greater extent than individuals are likely to reduce their labour effort if personal income and consumption taxes are increased. Therefore, it is often argued that corporate income taxation, by the suppression of investment and economic growth, imposes more serious welfare costs than other commonly used forms of taxation, including personal income and consumption taxation.

The literature on the extent, if any, to which corporate income taxation in fact constricts investment is very extensive, and there is legitimate room for disagreement among scholars as to its interpretation.[18] I can offer no resolution of this longstanding debate. Leaving aside disagreements over the interpretation of data, however, my professional experience provides anecdotal reason to believe that, even aside from the influence of tax competition, corporate income taxation imposed by a country generally does reduce capital investment into that country, probably to a significant extent. Companies typically base investment decisions on required threshold rates of return. That is, a company evaluates whether the after-tax rate of return from an investment is likely to exceed a minimum threshold level, based on the company's cost of capital and the risk that the company perceives in the investment.[19] Because imposition of corporate income tax lowers companies' anticipated after-tax rates of return, it seems likely that the tax prevents otherwise profitable investments from being made in at least some cases.

Corporate income taxation does not suppress investment in all circumstances, or equally for different kinds of companies. Some businesses, particularly those owning high-value intangible property like patents, copyrights and trademarks, enjoy unusually high levels of profitability (which economists call rent or quasi-rent) for extended periods of time. These businesses will be less likely to reduce investment in response to corporate tax increases than businesses earning only normal levels of profit. Even the most highly profitable businesses, however, will base their new investment decisions on expected after-tax rates of return, and there may be levels of corporate tax at which they will decline to invest. Therefore, I think it reasonable to assume that as a general matter there is some inverse relationship between the effective corporate tax rate imposed by a country and demand for inbound investment into that country.

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18 For analyses with extensive collections of citations, see, e.g., Djankov et al. (2010); and Department of Finance, Government of Ireland (2014).

19 For example, a company might consider opening a new manufacturing plant. The company estimates, that given the risk of the investment as well as the company's cost of raising funds, the factory will need to generate after-tax profit at the rate of at least 11% per year over the factory's useful life in order to represent a prudent investment. The company projects that the factory will generate a before-tax return of 15% per year. If the company's effective corporate income tax rate is 20%, the anticipated after-tax rate of return will be 0.80 x 15%, or 12%, and the company will decide to proceed with the envisioned investment. If, however, the effective corporate income tax rate is increased to 30%, then the company's anticipated after-tax return from building the factory will be 0.70 x 15%, or 10.5%. Because this is below the company's threshold anticipated return, the investment will not be made.

Economists have sought to approximate from empirical data the overall social cost of suppression of capital investment that results from corporate income tax. The analysis involves too many variables for results to be estimated with any real degree of confidence.[20] Nevertheless, the notion that corporate income taxation imposes significant costs in terms of social welfare, by suppressing demand for corporate investment and therefore constraining employment and economic growth, seems reasonably well grounded.

Of course, the effect on demand for capital investment is not the only criterion on which corporate income tax should be compared with other available forms of taxation. For well over a century, proponents and opponents of corporate income taxation have differed as to the desirability of the tax according to several additional criteria.[21]

Perhaps most importantly, it is often argued that corporate income tax brings additional fairness (progressivity) to a country's tax system, since the burden of the tax appears to be borne by the owners of corporate shares, who are likely to fall among the wealthiest persons in society. This argument may have special weight in the context of cross-border investment by multinationals in lower-income countries, since the shareholders who are taxed are likely to reside abroad, in countries wealthier than that in which the investment is being made. Some therefore view corporate income tax as desirable in reducing economic inequality on a global scale.

As an empirical matter, the distribution of the economic burden of corporate income taxation (its incidence), like so much else about corporate tax, is uncertain.[22] It seems clear that corporate shareholders bear a substantial part of the tax's burden; but workers also bear part of the burden because of the tax's suppression of capital investment and hence employment. Measurements of the relative extent to which the burden is shared between capital and labour, however, are obstructed by the same difficulties encountered in measuring the tax's effects on demand for capital investment. Indeed, the debates over the incidence of corporate tax, and the extent to which the tax suppresses capital investment, are largely co-extensive. Therefore, definitive answers to questions concerning the incidence of corporate tax have long been elusive and will probably remain so.

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[20] For insights into the complexity of seeking to measure welfare costs of taxation, see, e.g., Gravelle (2014) and Hines (2007).

[21] Arguments for and against corporate income taxation on various grounds have been debated especially intensively in the United States, where the origins of the corporate tax, in the late 1800s and early 1900s, involved deep disagreement over fundamental political ideologies. See generally Kornhauser (1990); and Mehrota (2010). See also Avi-Yonah (2004).

[22] See, e.g., Clausing (2012); Gentry (2007); Harberger (1962).

Another factor to be weighed in determining a desirable level of corporate income taxation in lower-income countries is the social value to be placed on encouraging foreign direct investment. On one hand, the persistence of extreme poverty in lower-income countries entails low levels of productive capital in those countries, resulting in a paucity of opportunities for employment. Encouraging inbound investment, in part through limiting corporate income tax burdens, would therefore seem to be a logical component of a national development policy. Against this, however, some have argued that FDI sometimes inflicts net social damage on a country. Among the concerns raised have been that FDI can: (i) confer excessive political influence on investing companies, leading, for example, to lax labour and environmental regulation; (ii) create opportunities for official corruption; and (iii) inhibit the growth of (crowd out) locally-owned businesses. These and other asserted drawbacks of FDI have been, and are likely to remain, the subject of extensive debate.[23] Despite the valid concerns regarding negative spillover effects of inbound investment, however, I believe the probable view among most residents of lower-income countries, including most political leaders in those countries, is that overall inbound investment is desirable in providing employment and increased per capita income. Certainly, most political leaders in lower-income countries would express this sentiment, and governments generally seem to make policy decisions in keeping with a perception of net social benefit from incremental inbound investment.

Many additional factors are relevant in seeking to judge a country's optimal rate of corporate taxation (continuing to leave the factor of tax competition out of the analysis for now). These include: (i) the feasibility of increasing yields from sources other than corporate taxation, like personal income and consumption taxes; (ii) whether a country offers special advantages to potential investors, like large consumer markets or valuable mineral deposits, which might reduce the dampening effect of corporate taxation on inbound investment; (iii) whether a country possesses the administrative capacity to translate additional tax revenue into socially-beneficial expenditure; and (iv) the extent to which a country is able to manage external costs, like environmental damage, from the kind of investment that will be made. There is, of course, no quantitatively precise way for the necessary balancing to be made – a great deal of subjective judgement is involved. Leaving aside the factor of tax competition, conceptually the point is that a rational country would make a judgement on the optimal level of corporate taxation to impose through its political system. This would be based (broadly speaking) on weighing the social value of revenue to be collected under corporate income tax against the social cost of the tax's anticipated inhibition of investment.

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[23] For a useful collection of essays on this topic, see Moran et al. (2005). See also, e.g., Brauner (2013: 25); Dagan (2013: 57); and Almfraji and Almsafir (2014).

The central role of tax competition

In all countries of the world, even the wealthiest, the level of revenue from corporate income tax is almost certainly lower than the country's government would find optimal in a world without tax competition. In recent decades, improvements in communications and transportation technology, and reductions in political obstacles like currency exchange controls and restrictions on foreign ownership of local assets, have combined to dramatically ease the process of cross-border investment. Today, multinational companies have substantial latitude in choosing in which country to locate a project or venture. This includes shopping among potential host countries for the most attractive total investment package, one important element of which will be the tax regime that is offered.

Investors do not have the opportunity to shop among countries in every instance, since sometimes circumstances dictate that an investment be made in a particular place. A country might have uniquely valuable and accessible deposits of a mineral that the investor seeks to exploit, or may be so populous that a seller of consumer products has little practical choice but to establish distribution operations within the country. Situations in which a company can only make an envisioned investment in one country are relatively unusual. For example, although possessing rich natural resource endowments does seem to provide governments with some insulation from tax competition,[24] natural resource developers cannot exploit all opportunities simultaneously, and governments may be eager to provide natural resource companies with tax or other financial incentives to encourage the prompt exploitation of local deposits. Similarly, companies selling consumer products need to prioritise among various available markets in which to establish distribution networks, and tax incentives might well influence the choice of which markets to enter first. Tax competition seems to play a strong role in virtually all negotiations between investing companies and the governments of potential host countries. Empirical evidence strongly supports that tax competition is an important influence on government policymaking throughout the world.[25]

This is not to suggest that relative tax burdens are the only factor that companies consider in deciding where to locate investments. A large variety of other factors are also influential, including the presence of infrastructure in a country, like roads, ports, communications facilities, and safety and law enforcement resources; political stability, including the reliability of legal

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[24] See Mansour and Swistak (2017) (observing based on the limited available empirical data that tax competition probably plays a relatively limited role in extractive industries, but that it nevertheless is a factor relevant to sound policymaking). It is my personal impression that tax competition plays an important role in circumstances involving natural resource deposits of relatively ordinary size and profit potential, like iron ore deposits in some parts of the world, although it is of probably limited significance in connection with deposits of unique or nearly unique potential profit potential, like the North Sea oilfields in the 1970s.

[25] See, e.g., Devereux et al. (2008); and Crivelli et al. (2015).

process; the availability of a trained workforce; and proximity to intended markets. Nevertheless, the different tax regimes that countries offer can also be an influential factor, and when countries are roughly similar with respect to the non-tax advantages they offer investors, differences in tax regime might well determine a company's choice of where to locate a proposed investment.

The presence of tax competition fundamentally alters a host government's estimation of the most desirable effective tax rate to offer potential inbound investors. In the presence of tax competition, a government does not possess the market power to insist upon a level of taxation that reaches an optimal balance among competing factors, like the social desirability of enhanced government revenue and the social cost of deterring investment. Instead, an investor may explicitly or implicitly insist upon a lower effective rate of taxation, on threat of redirecting the proposed investment to another country. What amounts to an auction – a race to the bottom – tends to ensue, in which the winning government in one way or another offers the investor a corporate tax rate of zero or near-zero (and might sweeten the pot with other incentives, like exemption from customs duties on imported supplies). As discussed below, the incentives offered might involve explicit exemptions from taxation, or tacit assurances that the government will in practice tolerate a substantial reduction of the investor's tax burden through the kind of base erosion and profit shifting on which this book focuses. *Whichever route to effective exemption the government chooses, the bottom line is that tax competition is likely to greatly reduce the burden of corporate tax on companies engaged in foreign direct investment, below the level that would appear socially optimal in the absence of tax competition*.

The picture of an inevitable race to the bottom is, to some extent, overly simplified. Not all countries are equally vulnerable to international tax competition.[26] A country that offers investors uniquely attractive geophysical advantages – for example, especially promising natural resource deposits or unusually favourable natural harbours – may have the economic power to refrain from pursing the race all the way to the bottom. Similarly, if a country already has developed infrastructure that offers advantages to investing businesses, such as a well-educated workforce, efficient transportation facilities and electricity-generating capacity, the country may have sufficient bargaining power to insist on an effective corporate income tax rate that is significantly higher than zero. In addition – and this factor is especially important for populous countries like India, China, Indonesia and Brazil – the presence of a large domestic consumer market might enable some countries to insist on positive corporate income tax rates on investment for companies that seek to exploit the local market.

[26] Useful discussions of the factors influencing countries' differing degrees of vulnerability to tax competition include Madies and Dethier (2012); and Crivelli et al. (2015).

Even when countries do not enjoy this kind of bargaining advantage, it is likely that the race to the bottom will not result in zero effective tax rates for foreign investors. In order to protect their reputation for social responsibility, or perhaps to promote comity with host governments, companies might not demand full exemption from taxation. Investors may accept explicit exemptions that are partial rather than complete, or companies engaging heavily in BEPS-style tax planning may refrain from reporting zero income on their corporate returns, even though they probably could prevail in that position under applicable law. In fact, tax competition does not appear to reduce any country's corporate tax collection all the way to zero. Nevertheless, it seems clear that tax competition significantly limits the ability of governments around the world to levy corporate income taxes. Owing largely to their limited existing infrastructure to support the activities of inbound investors, lower-income countries are especially vulnerable to the pressure of international tax competition.[27]

To summarise, while its effects will vary among countries and among different kinds of business investment, international tax competition seems almost certain to result in lower levels of corporate income tax revenue than governments would find socially optimal in the absence of tax competition. Therefore, policies that enable lower-income countries to increase corporate tax revenue to (or closer to) the levels that would prevail in the absence of tax competition should increase social well-being in the world's poorest countries. The reduction of corporate income tax avoidance as it currently affects lower-income countries therefore should be seen as a desirable policy goal – and, given the persistence of extreme poverty in these countries, as a humanitarian imperative. This is not to say that curtailing corporate tax avoidance can in itself reduce poverty in a country – but it could serve as an important step in that direction.[28]

The historical origins of BEPS-style corporate tax avoidance

Introduction

International tax competition is not a new phenomenon.[29] On the contrary, it has strongly affected governmental policies, in countries at all levels of

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[27] Although this book is concerned particularly with the effects of tax competition in lower-income countries, it is important to recognise that tax competition has to varying degrees affected public revenue in countries of all levels of economic development, and has important social and political implications for every country. See especially Avi-Yonah (2000).In addition to Professor Avi-Yonah's contribution, other thoughtful reflections on the nature and social consequences of international tax competition include Roin (2000); Dietsch (2015); Dagan (2018); and Faulhaber (2018).

[28] An important point should be raised to put the discussion in this book in proper perspective. Although this book urges continuing and serious efforts to improve the performance of corporate income tax in lower-income countries, improvements to corporate taxation represent only one of many policy initiatives, in and outside the field of taxation, that are needed to assist lower-income countries in mobilising revenue. The concentration in recent years on the BEPS problem, including the attention paid in this book, should not be permitted to divert policymakers from promising initiatives outside the area of corporate taxation. See, e.g., Forstater (2018); Moore and Prichard (2017); and Durst (2015).

[29] It is concededly anachronistic to use 'BEPS-style' in a discussion of events occurring in the immediate aftermath of World War II, as base erosion and profit shifting and BEPS did not come into common usage

economic development, from at least the start of the flowering of cross-border investment after the end of the Second World War. As amplified below, this book and its policy recommendations are based on the premise that governments have sought to encourage inbound investment through two parallel kinds of tax policy since the end of the Second World War. First, governments have offered inbound investors numerous kinds of explicit tax exemptions, for example tax holidays that exempt income from new inbound investments for a specified number of years. Explicit exemptions typically are authorised by statute, and governments generally grant them on a discretionary basis to multinational groups that apply for the exemptions on a project-by-project basis.

In addition, very soon after the War, multinational corporations began to use global tax avoidance structures centred on the use of subsidiaries in zero- and low-tax countries, in formats virtually identical to those used in BEPS transactions today, to reduce the global corporate tax burden on their growing international operations. As discussed in Chapter 3, governments of the countries from which income was being shifted might have raised various legal arguments against the new planning structures. In the immediate post-War decades, however, few if any host governments of cross-border investment would have felt much incentive to challenge companies' use of the new tax-planning structures. On the contrary, countries typically saw themselves as competing with one another for foreign direct investment, and many were already offering investing companies explicit tax exemptions. By refraining from serious challenges to companies' profit-shifting techniques, host countries could effectively expand the scope of tax incentives offered investors without the formal legislative action and possible political controversy entailed in offering additional explicit tax exemptions. I believe that in this manner tacit policies were adopted in many countries to refrain from seriously challenging companies' tax avoidance arrangements.[30]

Explicit tax exemptions

Since the flowering of cross-border investment that began after the Second World War and continues today, countries at all levels of economic development have offered corporations explicit exemptions from taxation to

until the initiation of the OECD's BEPS work after the 2008 financial crisis. I nevertheless use BEPS and BEPS-style even in historical discussions, in part to emphasise the remarkably long continuity of the kind of tax planning structures that the world continues to try to address.

30 Other commentaries have observed that the tacit acceptance of governments hosting foreign direct investment has been necessary for the perpetuation of BEPS-style tax avoidance. These include Roin (2000: 600); Faulhaber (2018: 318) ('Countries are complicit in tax avoidance schemes …'); Altshuler and Grubert (2005) *passim*. Ault and Arnold (2017: 1, 47 say in this regard:

> Tax incentives for foreign investment can be divided into two major categories:
>
> (a) Incentives that directly reduce the cost to a non-resident of an investment in the source country (for example, a tax holiday or reduced tax rates); and
>
> (b) Incentives that indirectly reduce the cost to a non-resident of an investment in the source country (for example, the lax enforcement of thin capitalisation or transfer pricing rules by the source country).

incentivise investment.[31] These tax exemptions have taken many different forms.[32] An especially common form have been tax holidays, which generally are established by statute in developing countries. Under a tax holiday, investors generally apply to a governmental administrative body for exemptions on a project-by-project basis. Holidays are granted for a specified period (e.g. 15 years), although extensions of holidays are not unknown. Other common forms of explicit tax incentives include exemptions for investment in a particular geographic area of a country, and the allowance of generous tax write-offs for investment in plant and equipment. The demand of inbound investors for explicit tax exemptions has seemed unlimited over the past 60 years, and their growth appears to have accelerated in recent decades.[33]

Commentators sometimes criticise explicit tax incentives because they often seem wasted on inbound investments that would have been made even if the incentives had not been provided. In other words, incentives often seem to offer investors the prospect of after-tax returns that are higher than the threshold returns that would be necessary to justify a proposed investment. This should not be surprising, however, because governments perceiving severe pressure of tax competition can be expected to offer tax incentives that are more powerful than would be needed in the absence of tax competition. In the presence of tax competition it can be rational for a government to offer incentives designed to provide after-tax returns substantially higher than investors' threshold levels.

In the early post-War decades, policymakers and researchers seem to have directed little criticism towards countries', including developing countries', use of explicit tax incentives to attract cross-border investment. Instead, it seems generally to have been assumed that the offering of incentives represented a rational means of promoting social welfare through economic growth. Indeed, the dominant question among governments of the world's wealthier countries seems not to have been whether to discourage developing countries from offering tax incentives, but whether the wealthier countries should actively promote the practice by granting certain tax credits (tax-sparing credits) to their home-based multinationals that had availed themselves of explicit tax exemptions in developing countries.[34] Most of the world's wealthier countries

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31 A discussion of the early use of tax incentives by developing countries is provided in Heller and Kauffman (1963).

32 Recent comprehensive explanations of the various kinds of explicit tax incentives that countries offer are provided by Zolt (2017: 523-570) and Tavares-Lehman (2016: 17, 25-27).

33 See James (2016: 153-176); IMF et al. (2015: 8).

34 Based on governmental policies developed in the UK in the 1950s, a number of governments of wealthy countries began offering tax sparing credits to their home-based multinationals that benefited from tax exemptions in developing countries. Under a tax-sparing credit regime, multinationals that avoided paying tax on income earned in a developing country through a tax holiday or other incentive could, when sending the income back to the home country (i.e. repatriating the income), receive a credit against home-country tax for the tax they would have paid in the developing country in the absence of the exemption. The home-country credit serves to protect the incentive effect of the exemption by the developing country, by preventing the imposition of home-country tax on repatriation of the income that had been earned. (The US, in contrast, generally has declined to offer tax-sparing credits to its investors in developing countries, on the grounds that the subsidisation of foreign tax exemptions was inconsistent with prudent public policy.) For a

at the time decided to grant the credits. The United States did not, indicating less official enthusiasm for developing countries using explicit tax exemptions to attract investment. Even in the US, however, the rationality and normative wisdom of offering tax incentives to attract investment do not seem to have been questioned seriously in the early post-War period.

The invention of BEPS-style corporate tax avoidance

Explicit exemptions, like tax holidays and tax relief for companies operating in special economic zones, have never been the only means by which countries use corporate tax exemptions to attract inbound investment. Very soon after the Second World War, multinational companies and their tax advisers developed techniques for avoiding the imposition of taxes on income earned in countries around the world where they operated, without the need for those countries to extend formal tax exemptions through explicit legislation. These techniques have involved the use of four basic transactional structures. All of these have remained in use uninterruptedly, with remarkably little serious legal challenge until very recently, since at least the early 1950s.[35] All these transactional patterns feature prominently in the recent OECD studies of base erosion and profit shifting, as described in Chapter 4.[36]

The four basic kinds of BEPS transactions include the following:[37]

- *Loan-based income-shifting transactions*. Example: a multinational group establishes a finance company in a zero-tax country, contributing a large amount of cash to the finance company. The finance company then extends a loan to a group member that performs manufacturing operations in a higher-tax country. The manufacturing company deducts interest paid on the loan, thereby reducing taxable income in the country where it operates, but no tax is imposed on receipt of the interest by the zero-tax finance company. Therefore, the group enjoys a reduction of its income tax in the country where manufacturing is performed, with no corresponding increase in its tax anywhere in the world.

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useful general discussion of tax sparing, see Toaze (2001); see also Dharmapala and Azémar (2019) (discusses continuing significance of tax sparing today).

35 A 1955 study of the taxation of cross-border investment contains detailed descriptions of all kinds of BEPS-style avoidance plans that are in common use today (Barlow and Wender 1955: 168-171, 245-246).

36 As will be seen in Chapter 4, in some circumstances the use of the kinds of transactions described below will be limited by recently enacted legislation in some countries. Nevertheless, the descriptions of the four basic kinds of BEPS transactions provided below continue to describe transaction patterns that are commonly found in tax planning today, including in many circumstances involving developing countries.

37 The following summary in the text is adapted from Durst (2017a). Extended explanations of the various kinds of BEPS transactions in use today are available in Kleinbard (2011a, 2011b); and US Joint Committee on Taxation (2010).

- *Intangibles-based income-shifting transactions*. Example: a group contributes valuable intellectual property, like the trademark to a popular brand of beer, to an intangibles holding company established in a zero-tax country. Members of the group who distribute the group's beer in higher tax countries pay royalties to the zero-tax intangibles holding company for the use of the trademark. The royalty payments are deductible in the countries where the beer is distributed, but no tax is imposed when the royalties are received by the intangibles holding company.
- *Income-shifting transactions involving related-party transactions in services and tangible property*. Example: a multinational construction group might establish a hub company in a zero-tax country. The hub company might purchase valuable construction supplies and equipment from a group member based in one country, and resell the supplies and equipment, with a profit markup, to a subsidiary based in another country. Alternatively, the hub company might contract for the performance of technical services by employees of the multinational group's parent company and resell the services, at a profit, to the other group members. Under both scenarios, the group effectively escapes taxation anywhere in the world on that portion of the group's income that is attributed to the zero-tax hub company. (Moreover, the items that are purchased and sold by the hub company are typically never actually shipped to that company; rather, title is held only momentarily by the hub company while the items are in transit from the seller to the ultimate purchaser.)
- *Income-shifting transactions involving outbound sales of products*. These kinds of income-shifting transactions are common in the natural resources and agricultural sectors.[38] Example: consider a metals manufacturing group that operates mines through subsidiaries the group has established in several resource-rich countries around the world. The group establishes a marketing company in a country that imposes corporate income tax at a very low rate. The group arranges for its various mining subsidiaries around the world to sell all their output of ore to the low-tax marketing company. The marketing company then resells most of the ore, at a markup, to manufacturing affiliates within its group; the remainder of the ore is sold to unrelated manufacturing companies. The purchase and resale of the ore by the marketing company are essentially fictional. The ore itself never touches the marketing company's country, but is instead shipped directly from the mining subsidiaries to the related or unrelated users of the ore. The marketing company merely takes legal title to the ore briefly while it is in transit, pursuant to the contracts the group has drawn up among its various members. Despite the marketing company's lack of physical involvement in the purchase and resale of ore, however, a significant portion of the group's net income is assigned to the company, thereby escaping income taxation anywhere in the world.

[38] See generally Durst (2016a).

These four common tax planning techniques have, over the seven decades since World War II, become universal in international business practice. Virtually all large multinational companies use these techniques as their standard means of structuring their foreign direct investments. The point of all these techniques is to shift taxable income from countries where business is conducted to affiliates that the groups have established in low- or zero-income tax countries,[39] thus lowering multinational groups' overall international tax burdens. The large number of these transactions means that very large amounts of corporate income tax are avoided every year around the world.

Given the complexity of international transactions, and the limitations of available data, it is not possible to estimate with precision the volume of corporate tax revenue that national governments lose to these transactions each year. Some indications are provided by the very large financial flows in and out of zero- and low-tax countries around the world, and the low global effective tax rates reported in annual financial statements of large multinational groups.[40] Two recent attempts to use econometric techniques to estimate the revenue losses, both of which are presented only as very approximate, suggest that global losses of tax revenue to these transactions are in the range of $500 billion to $600 billion annually, with non-OECD countries accounting for about half the total (Crivelli et al. 2015; Cobham and Jansky 2017). Developing countries would appear especially likely to incur revenue-losses owing to their heightened vulnerability to tax competition.[41]

The legal fiction at the heart of BEPS-style tax planning

The four kinds of profit-shifting structures share a common feature. They all involve the supposed earning of a portion of a multinational group's income by a zero- or low-tax subsidiary that needs to perform little if any observable business activity to generate its purported income. Thus, the finance company might have few or even no employees in the loan-centred avoidance plan. Other group members might simply deposit cash in the finance company's bank account, typically through electronic transfer, and the cash can then be sent on immediately, via additional electronic transfer,

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[39] The list of countries that have facilitated the establishment by multinationals of low- or zero-tax subsidiaries is quite wide. The list includes not only small island countries that conform to the typical public image of tax havens, but other countries, including some of the world's major economic powers. A 2010 study of profit shifting by the US Congress's Joint Committee on Taxation (2010: 51-102) presents six extended case studies of profit-shifting plans involving US-based multinationals. Countries mentioned as hosting entities involved in the profit shifting include the Netherlands, Bermuda, Switzerland and the Cayman Islands. Other countries often mentioned as central to profit-shifting planning include Mauritius (see, e.g., ActionAid (2010; updated 2012)), Ireland (see, e.g., Drucker (2013a); and Luxembourg (see, e.g., Burow (2014a). The countries just mentioned represent only a very partial list of jurisdictions that have been host to corporate subsidiaries used in profit-shifting planning.

[40] A useful discussion of the difficulty of estimating revenue losses to BEPS-style tax avoidance is provided by Kleinbard (2011a: 737-750).

[41] See generally Crivelli et al. (2015).

to the group members to which money is lent. There is no need for personnel based anywhere to perform credit analyses on the loans, since all the loans are made among members of the same, commonly-owned multinational group.

Similarly, in the intangibles-centred tax-avoidance structure, the licensing subsidiary that receives legal title to the group's intangible property, and then licenses use of the intangibles to other group members, typically performs no observable activities in return for its royalty income. The licensing subsidiary's ownership of the group's intangible property, and its licences of that property to group members, exist only on paper. There is no need for employees of the zero- or low-tax subsidiary to do anything in return for the income that the subsidiary receives. In the same vein, when hub subsidiaries that multinational groups establish in zero- or low-tax countries purchase tangible property or services from some members of a group and resell the property or services at a markup, the subsidiaries typically have no physical contact with the property or services in which they supposedly deal. The involvement of the subsidiary arises only on paper, in contracts drafted by the multinational group's lawyers.

Likewise, in the various kinds of planning that involve the ostensible purchase and resale of property or services by zero- or low-tax subsidiaries, the subsidiaries typically never take physical possession of the property they are buying and selling or have any physical involvement in performing the services they are supposedly providing. The involvement of the purchasing-and-reselling subsidiary occurs only on paper, yet tax laws around the world treat its transactions as genuine.

Chapter 3 The historical evolution of base erosion and profit shifting

Introduction

This chapter examines the evolution, over almost a century, of the body of international tax law that continues to insulate BEPS-style planning arrangements from successful legal challenge in countries around the world. The chapter focuses on two aspects of current laws: (i) their acceptance of contractual arrangements among members of commonly-controlled multinational groups that treat low- or zero-tax subsidiaries as conducting income-producing activities that they do not in physical reality perform; and (ii) the failure of current laws – specifically, transfer pricing laws, controlled foreign corporation (CFC) rules, and laws that seek to limit the payment of interest on loans from related parties – to place effective limits on the amount of profit that multinational companies are permitted to shift to zero- or low-tax affiliates under their contractual arrangements.

The inherent formalism of corporate tax law

A starting point in the analysis is to recognise that corporate law, and the corporate income tax laws that represent a component of the broader law of corporations, are both pre-disposed to legal formalism – respecting the written terms of contractual arrangements even when they appear to depart from the apparent economic substance of the transactions that the contracts govern. A corporation is itself a product of legal formality. The corporation's existence as an entity is based upon the corporate charter, a document that grants shareholders assurance (subject to limited exceptions, as will be discussed later) that they will not face personal liability for debts arising from business that is conducted in the corporation's name.

The protection against liability that the corporate charter affords often lends importance to the question of whether a particular business activity is conducted by the corporation in its capacity as a legal entity, or instead by the shareholders in their individual capacities. To prevent endless legal controversy over this question, the law long ago developed a strong presumption that if the contracts governing a business activity consistently treat the corporation rather than the shareholders as conducting the activity, that characterisation will normally be respected. In light of this presumption, much of corporate legal practice consists of ensuring that the activities of a corporation are clearly documented by contracts in the name of the corporation rather than the shareholders, and that all the i's are dotted and t's crossed in those contracts.

Corporate law places some limits on the extent to which shareholders can shield themselves from liability through contracts specifying that a business is being conducted by the corporation as an entity rather than its shareholders.

Under the doctrine of 'piercing the corporate veil', some kinds of behaviour by shareholders – like certain kinds of negligence, or the misleading of lenders or customers – can cause shareholders to become directly liable for obligations of a corporation.[42] The law, however, usually permits piercing the corporate veil only in atypical circumstances. Generally, there is a strong presumption that if the applicable contracts identify a corporation rather than its shareholders as performing a business activity, the corporation should be treated as performing the activity for all purposes of the law.

There are countless circumstances in which the law respects a corporation as the performer of business activities, notwithstanding that corporate employees perform little if any physical activity. In particular, it is generally irrelevant whether a corporation performs business activities through its own employees or outsources the activity to other persons. For example, an investor might have the idea of manufacturing and distributing a particular kind of kitchen implement. The investor might form a corporation (let's call it Ladelco) to accomplish these purposes. Ladelco might then contract with a separate company (Manuco) to: (i) purchase the raw materials needed to manufacture the implements, (ii) perform the manufacturing, (iii) advertise the implement through online sellers, and (iv) accept orders from and ship products to customers. The contract may provide for Ladelco to compensate Manuco for these services by reimbursing that company for its costs plus a markup of, say, 5 per cent. Any remaining profit is to be remitted to Ladelco, the initiator of the arrangement. (These kinds of cost-plus arrangements are quite common in practice.)

The law generally will, for all purposes, respect the various elements of this contractual arrangement, particularly (i) the right of Manuco to receive its cost-plus compensation, but no more, in return for its services; and (ii) the right of Ladelco to receive all residual profits from the sale of the kitchen utensils. The law has no choice but generally to respect contractual formalities in situations like this and many others, since otherwise the law would have no practical means of sorting out the rights and liabilities of the various parties involved. Commerce would become chaotic. As a general matter, a high degree of formalism in corporate law seems to be unavoidable.

Corporate law's general policy of respect for the terms of contracts extends not only to contracts among unrelated companies like Ladelco and Manuco, but also to arrangements among corporations within the same commonly-owned group. In many instances, a group will desire to conduct several different business operations simultaneously – for example, to operate several different hotels in different locations. The group will place each operation in a separate subsidiary to shield the assets of each from claims arising from other operations. The use of multiple entities within a single

42 For a discussion of situations in which courts might choose to pierce the corporate veil and hold shareholders liable for corporate obligations, see, e.g., Macey and Mitts (2014). Courts generally are willing to pierce the corporate veil only where special circumstances are present, such as active misrepresentation by shareholders, or failure to maintain the procedural requirements of corporate existence under applicable law.

group is especially frequent among businesses operating internationally. For many reasons, including the need to comply with different countries' legal and tax requirements, operations in different countries are frequently placed in separate subsidiaries established under local law. It is in this manner that commonly-owned multinational business groups are typically formed.

The parent and various subsidiaries of multinational groups typically enter into numerous contracts among themselves, under which the different affiliates supply goods, provide services and lend money to one another. Unless special factors are present to justify piercing the corporate veil,[43] courts will generally respect the division of responsibilities and rights to receive income that are stated in the contracts into which the different group members have entered.

Corporate law's respect for the terms of contracts made among both unrelated and related companies also extends to countries' corporate income tax laws. For the purposes of corporate income taxation, courts generally will respect the division of income among corporations that results from application of the corporations' contractual arrangements with one another. This is not surprising: other than the contracts into which corporations have entered, tax authorities and courts would have no means of determining how much income each corporation should be treated as earning. (As discussed below, the situation might be different if the countries of the world were to adopt an alternative means of dividing corporate income for tax purposes among commonly-owned companies, perhaps through use of an apportionment formula. This approach, however, while often suggested by commentators, has consistently been rejected by national governments.)

Respect for the terms of contractual arrangements among commonly-owned companies is not absolute under countries' corporate tax laws. Tax laws generally contain a doctrine of 'substance over form', under which tax authorities may in some circumstances override the terms of written contracts if the terms of the contract diverge too far from what appears to be the economic substance of the underlying transactions.[44] (In some countries, the substance over form doctrine is explicitly included in tax statutes, under the label of a general anti-avoidance rule (GAAR).) The doctrine of substance over,form in tax law can be seen as somewhat analogous to that of piercing the veil in corporate law, in that both doctrines allow a safety valve to permit the overriding of formalistic results in especially compelling circumstances.[45]

Under the substance over form doctrine, courts may re-characterise the arrangements described in contracts between companies if the economic reality of the arrangements plainly departs from their contractual form. Courts typically are willing, however, to apply the substance over form doctrine only

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43 See generally Matheson (2009).

44 For a useful overview of the principle of substance over form, see, e.g., Arnold (2017: 715-766). For a historical discussion, see Weisbach (1999).

45 With respect to the connection between the corporate-veil doctrine and the problem of BEPS-style tax planning, see the essay by Wilkie (forthcoming), which includes an exploration of the topic and review of prior literature.

in especially compelling circumstances, where a taxpayers' contractual arrangements are very plainly contrived for tax-avoidance purposes. To apply the substance over form doctrine more readily would risk injecting an untenable degree of unpredictability to the operations of corporate tax laws.

Thus, courts generally have not applied the doctrine to override the arguable legal fiction on which tax avoidance from BEPS-style planning arrangements depends. Despite the presence of the substance over form doctrine, courts often accept the desired tax consequences of the contractual arrangements made among companies, even where a strong argument can be made that the substance of an arrangement differs from its form. The tradition of formalism has long been, and remains, strong within corporate income tax laws. It was against this background that the practice of BEPS-style tax planning was invented, and over the decades became increasingly prevalent among the world's multinational companies.

How the international corporate tax laws developed

Those areas of tax law that are most central to the history of base erosion and profit shifting around the world – transfer pricing laws, controlled foreign corporation rules, and rules governing the extent to which companies can deduct interest paid to other members of their multinational groups – have developed in a long historical progression, beginning early in the twentieth century and continuing through the present. The following summarises important aspects of this history, beginning with the early statement of the principles of international corporate tax law under League of Nations auspices beginning in the 1920s, through the attempt by the United States to adjust its international tax laws to post-World War II economic realities in the US Revenue Act of 1962, and culminating in the 'transfer pricing wars' of the early 1990s, which gave rise to the OECD *Transfer Pricing Guidelines* in roughly the form they have today. Chapter 4 will then describe how the world's governments are trying to resolve problems that have accumulated during this long history through the OECD's BEPS process.

The period between the two World Wars: pre-occupation with double taxation

After the First World War, three factors combined to direct the attention of countries to the task of designing a workable system of international tax laws.[46] These included: (i) the increasing international trade and investment made possible by the ending of the War; (ii) widespread increases in tax rates around the world; and (iii) the emergence of international organisations, notably the League of Nations and, within the private sector, the International Chamber of Commerce (ICC), an organisation of business leaders organised in Paris in 1919 (Collier and Andrus 2017: 8).

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[46] For important historical discussions of the development of international tax law between the First and Second World Wars, see Collier and Andrus (2017: 6-49); Carroll (1934); Picciotto (1992, as revised by author 2013); Rixen (2010); and two articles by Wells and Lowell (2012, 2013). The historical summary in this book is based largely on these resources.

The ICC initiated the post-War discussion of international tax laws. In particular, the ICC sought the assistance of the League of Nations in designing a system of laws that would permit companies to avoid double taxation under corporate income tax laws when engaging in business spanning national boundaries. The basic concept of double taxation is easy to understand.

Consider a company based in Italy that manufacturers automobiles for the UK market. The company manufactures the cars in Italy, then sells and ships them to a wholly-owned distribution subsidiary established in the UK, which then sells them to independent car dealerships around the country. Assume that the Italian-based group as a whole, during a particular year, earns total net income of $100 million from the manufacture of the cars in Italy and their marketing and sale in the United Kingdom. Of this income, how much is properly taxable by Italy and how much by the United Kingdom? In the absence of rules establishing some means of apportionment, the Italian tax authority is likely to argue that the lion's share of the income is attributable to the excellent design and skillful manufacturing of the cars, which both occurred in Italy. The UK tax authority is likely to argue that the lion's share of the income is attributable to the skillful advertisement, marketing and customer service activities that took place in the UK. Both Italy and the UK, therefore, might assert the right to tax a majority of the income from the manufacture and sale of cars, leaving the Italy-based company with an inflated total tax bill.

The ICC argued after the First World War that, if the threat of double taxation was not to pose a serious impediment to international commerce, some reliable means needed to be found for apportioning income for tax purposes among the different countries in which an international business operates. This problem later came to be referred to as the transfer pricing problem. In response, the League of Nations initiated a process of studying the problem of income apportionment and numerous other important problems of international taxation, which extended until the outbreak of the Second World War.[47]

From the start of their review of the transfer pricing problem, those conducting the League's study had before them two competing policy models, which continue to figure prominently in international tax policy

[47] In addition to addressing the problem of methods for apportioning income, the League of Nations' efforts considered the important problems of: (i) how an internationally coordinated system of tax rules might be implemented through a system of income tax treaties among countries (a topic to be addressed in Chapter 4 of this book); and (ii) how the right to tax income of an international business group should be divided between the group's country of residence (i.e. its home country) and the various other countries in which members of the group earn income from conducting business operations (source countries).

This book does not seek to address an important problem that figured prominently in the League of Nations discussions and continues to pose serious technical difficulties in tax policymaking and tax administration today: the fact that multinational groups operate in countries around the world through two different kinds of legal entities, separately incorporated subsidiaries and unincorporated branches of parent companies - for a recent discussion of this problem, see OECD (2017a). Questions related to the differing tax treatment of subsidiaries and branches are of substantial practical importance in international tax practice and lawmaking, although trying to discuss this highly technical topic in this book would risk unduly distracting non-specialist readers.

debates: a model of formulary apportionment (generally referred to at the time of the League of Nations studies as fractional apportionment), and separate accounting. Under formulary apportionment, governments of different countries treat all the members of a multinational group as a single taxable entity, and apportion the group's combined income among countries according to a formula.

Consider, for example, a manufacturing group that sells products through affiliates in three different countries. As a simple kind of formulary apportionment, the governments of the three countries might agree to treat the group as a single taxable entity, and divide the group's total income among the countries according to the relative level of sales to customers by the different affiliates. Thus, for example, if the affiliate in Country A accounts for half the group's total sales, then half the group's combined income would be taxable in Country A; if 15 per cent of sales were made in Country B, 15 per cent of the group's combined income would be taxable there, and so on.

In reviewing the possibility of international formulary apportionment, the League examined three then-existing instances in which jurisdictions were using formulary apportionment for tax purposes: the states of the United States, the cantons of Switzerland, and Austria, Hungary and Czechoslovakia under a treaty implemented after the First World War.[48] These three systems employed various kinds of apportionment formulas, in which not only sales but other indicators of corporate activity were taken into account, such as the value of business assets owned or local payroll expenses of different members of the group.

Not only was there precedent for the use of formulary apportionment for the division of taxable income among affiliates, but the ICC itself had suggested a formulary approach in its early communications with the League of Nations.[49] The League's experts, however, concluded that a system of international formulary apportionment did not offer practical promise for the prevention of double taxation. The primary objection to formulary apportionment appears to have been (as is often argued today) that different countries would adopt and apply differing apportionment formulas, inevitably giving rise to overlapping claims of tax jurisdiction and therefore to double taxation.[50]

For these reasons, the League established separate accounting as its basic principle for the international division of income for tax purposes.[51] Under this principle, there is no attempt to consolidate the accounts of different affiliates within a multinational group. Instead, the separate books and records of each

48 See Carroll (1934: 481, 488-489, 491-494).

49 See Wells and Lowell (2013: 14-18).

50 See Carroll (1934: 473-476).

51 One expert commissioned by the League of Nations, Mitchell B. Carroll of the United States (the author of the article by Carroll cited at various points in this chapter), played an especially influential role in the later stages of the League's deliberations in the late 1920s and 1930s. In the 1980s, a prominent commentary strongly criticised Carroll's analytical work, claiming that it overstated the difficulties of formulary apportionment (Langbein 1986: 625, 632-633).

affiliate, which of course reflect the results of the contracts under which the affiliate conducts business, are accepted as valid for tax purposes, unless the taxpayer appears to have been departing from normal business principles in dealings with its affiliates, thereby artificially reducing its taxable income. In other words, the contracts and other business arrangements of each member of a commonly-owned group are to be respected for tax purposes, unless the tax authority can show that the member has departed from what has over the years become known as the arm's-length principle in its dealings with other members.[52]

The League of Nations discussions addressed the important question of how tax authorities might enforce the arm's-length principle. The League envisioned generally that in those cases where comparable prices can be found for a group's internal dealings – where, say, a manufacturing affiliate sells identical products to both related and unrelated parties – the comparable price should be used to determine whether intra-group dealings have been at arm's-length. The League provided only limited guidance for tax authorities to use in the many situations in which comparable prices are not readily available. The League did, however, indicate that two methods that were already used by some tax authorities could be useful.[53]

First, tax authorities could employ a fractional approach, under which the income of different affiliates is split between them according to an ad hoc formula (e.g. based on relative sales levels and manufacturing costs) devised for the taxpayer. This approach (which survives today in the form of the profit split transfer pricing method) was, according to the League's analysis, sharply distinguishable from a formulary approach, under which a single formula would be applied to all taxpayers on a one-size-fits-all basis. A second approach accepted by the League in the absence of useful comparables was an empirical approach, under which tax authorities sought to identify a reasonable profit margin on sales for companies operating within their countries. The empirical approach survives today in the form of the transactional net margin method (TNMM) of the OECD *Transfer Pricing Guidelines*, which, as will be seen below, plays an especially important role in the taxation of businesses operating in lower-income countries.

The arm's-length principle can be seen as a kind of substance over form rule, under which a commonly-owned group's contractual arrangements will be respected for tax purposes unless the arrangements are inconsistent with those that might be found among unrelated entities dealing with each other in an arm's-length manner. It was inevitable from the outset that courts would exercise restraint in applying the new arm's-length standard to re-characterise taxpayers' contractual arrangements, for the same reason that courts are reluctant to apply the substance over form doctrine as a general matter. Excessive eagerness by courts to over-ride companies' contractual arrangements would inject uncertainty into international tax laws, and this

52 Collier and Andrus (2017: 33). Note use of the words 'arm's length' by Mitchell Carroll in the early 1930s.

53 See Carroll (1934: 484-485).

uncertainty could be a significant obstacle to commerce. Therefore, the League's approach created an obvious danger that commonly-owned groups of companies might be able to engineer their contractual arrangements to steer income artificially to companies that the groups could establish in low-tax countries, without serious risk of successful legal challenge.[54]

Although participants in the League debates recognised the possibility that the arm's-length approach might be used to facilitate international tax avoidance, those steering the League's efforts were more concerned with what they saw as their immediate goal of avoiding double taxation than they were of tax-avoidance practices that might arise in future (Wells and Lowell 2012: 563; Rixen 2010: 15). As the main danger perceived was that of over-reaching by tax examiners in different countries, it was quite logical for the League to lean, consciously or not, towards a regulatory regime that tax authorities would find relatively difficult to enforce. Excessive interference by tax authorities with the intended results of taxpayers' transactions would risk subjecting taxpayers to inconsistent treatment by different countries, resulting in double taxation.

Another important aspect of the League of Nations study, with implications for lower-income countries today, is the role played by a particular model of international business operations – the mercantilist paradigm – in shaping the League's perceptions of what constitutes arm's-length arrangements among affiliates.[55] In the inter-War years a large amount of international commerce consisted of trade in commodities, like mineral and agricultural products, between parent companies headquartered in countries holding overseas colonies, and corporate subsidiaries that had been established in the colonised countries. The League's analyses reflected the idea that, in dividing income between the parent and the colonial subsidiary, the natural approach was to apportion to the subsidiary a relatively limited amount of income in return for its activities in growing or extracting physical product. The rest of the parent's and subsidiary's combined income was to be treated as attributable to the parent's role in providing investment capital and overall supervision, and therefore taxable to the parent company. The mercantilist model may have reflected paternalistic assumptions regarding the economic role of colonial dependencies. It may also have reflected a desire by colonial powers to encourage foreign direct investment in their colonies by limiting the taxable income attributable to colonial enterprises.[56]

Whatever the League's motivation for propagating the mercantilist model, it has had a lasting effect on the vocabulary and imagery of international tax law. International tax rules continue to rely heavily on a conceptual paradigm under which developing countries typically are envisioned as source countries, where supposedly uncomplicated (routine in the parlance often

54 See Wells and Lowell (2012: 561 ff.); Rixen (2010).

55 See Wells and Lowell (2013: 10-13), on which the discussion below is largely based. See also Carroll (1934: 474-476).

56 See Gann and Duignan (1975: 8): 'From the very beginning, colonial governments sought to make colonies pay. They encouraged investors, bankers, traders, plantation owners and business groups. Tax systems were drawn up to attract investment'.

used by tax practitioners) activities like farming, mining, the performance of services in places like call centres, and basic manufacturing operations take place. Wealthier countries are seen as residence countries that provide the capital, as well as the valuable intellectual property, that are used in the operations conducted in the source countries.[57] As will be seen later in this chapter, the persistence of this imagery has helped lend legitimacy to tax planning structures under which subsidiaries of multinational groups operating in lower-income countries tend to be apportioned low levels of income in return for the routine activities they are treated as performing.

Emergence of BEPS-style tax planning in the aftermath of World War II

Foreign direct investment resumed with unprecedented intensity at the end of the Second World War – especially from the United States, whose industrial infrastructure was undamaged. In the early post-War years, former combatant countries needed foreign capital to rebuild their physical infrastructure. The colonial system also began to dissolve, leading to a desire for cross-border economic development in the former dependencies. Wartime innovations in communications and transportation technologies eased the task of managing multinational businesses on a centralised basis, and increased the speed and reliability with which products and services could be delivered internationally. Further, wartime technological developments – for example, in antibiotics and other pharmaceuticals – gave rise to global demand for high-value, easily transportable products.

Companies needed to devise corporate legal structures through which to conduct their rapidly expanding international operations. Consider, for example, a US-based pharmaceutical company that wished to expand sales of products in numerous countries on five continents. An initial question facing the group would have been whether to operate in different countries around the world through separately incorporated local subsidiaries, or through unincorporated branches of the US parent company. Even leaving aside tax considerations, several factors would have encouraged the establishment of separately incorporated subsidiaries. These would have included a desire to limit cross-liability for claims against the different national operations of the group. In addition, separately incorporated subsidiaries might have been needed to comply with countries' requirements that, say, local citizens serve on companies' boards of directors.

Moreover, a number of business and tax considerations encouraged multinationals to adopt a particular corporate structure that soon became central to BEPS-style tax planning – the use of holding companies in low- or zero-tax countries to own the stock of companies established in the various countries in which the group conducted business. For example, if a US-based multinational group established subsidiaries in, say, France, the United Kingdom and Spain, it would naturally have arranged for the US

[57] Thought-provoking analyses of the development of the concepts of source and residence are provided by Graetz and O'Hear (1997) and Wells and Lowell (2013).

parent company not to own the stock of the French, British and Spanish entities directly, but instead through a holding company established in a low- or zero-tax country like, say, Panama.[58] The group could then accumulate earnings from all three foreign operating entities in the holding company without incurring significant local Panamanian tax, and reinvest the earnings abroad wherever the group desired. There was no need to distribute the foreign earnings all the way up to the group's parent company, where they would have become subject to US tax under tax laws in effect at the time.[59] The use of the holding company structure also could simplify the task of accumulating and reinvesting profits under the restrictive national currency exchange regulations that were common around the world during the post-War era (Barlow and Wender 1955: 168). Thus, the basic three-tier corporate structure, with a zero- or low-tax holding company in the middle, quickly became standard for multinational companies expanding their international operations after World War II.

Once the model of a zero- or low-tax holding company structure was in place, the technique of shifting income from the operating subsidiaries to the holding company through, for example, intangibles-licensing and lending arrangements, would have been apparent to tax planners. In theory, the amounts shifted from the operating subsidiaries to the low- or zero-tax holding company should have been limited by the arm's-length standard. That is, the holding companies should have been permitted to charge only arm's-length royalty amounts under their licensing arrangements with the operating companies, and the holding companies should have extended to the operating companies only economically reasonable amounts of interest-bearing debt. In practice, however, the arm's-length principle appears to have exerted little restraint on the growth of BEPS-style tax planning around the world, and BEPS-style planning grew over the years to become standard practice among multinational groups.

Post-War legislative developments in the United States

The United States, which served as the source for much of the world's cross-border investment in the years following World War II, appears to have been the first country to perceive profit shifting by its home-based multinationals as posing a significant public policy issue. At first, in the immediate post-War years, US officials generally took a benign view of the avoidance of tax by US firms on income from their foreign operations.[60] US policymakers apparently saw foreign direct investment by US firms as a useful adjunct to the Marshall

[58] See generally Barlow and Wender (1955: 168-170). Barlow and Wender mention Panama, Canada, Puerto Rico, Uruguay and Liechtenstein as countries that hosted international holding companies.

[59] In the post-World War II era, the tax laws of countries around the world generally subjected the parent companies of multinational groups to taxation on income from their foreign subsidiaries only when that income was repatriated to the parent in the form of dividends. Therefore, the use of separate entities delayed the premature home-country taxation of foreign earnings. In recent decades, most countries in which multinationals tend to be based (including, as of 2018, the US) have adopted territorial systems under which dividends from foreign subsidiaries are exempt from home-country taxation, even when repatriated.

[60] For contemporaneous discussion of this topic, see Barlow and Wender (1955: 77-94). See generally Ram (2018) - Ram's excellent article provides substantial historical background on the events of the 1950s and early 1960s described in this chapter.

Plan in stimulating economic recovery among war-damaged countries, as well as an aid in competing with the Soviet Union for influence in post-colonial areas.

By the early 1960s, however, important political actors in the US began to perceive that outbound investment by US-based multinationals had blossomed into too much of a good thing. The ex-combatant countries had largely completed their post-War reconstruction, and some were becoming potent economic competitors of the United States. Also, outbound investment was contributing to currency strains.[61]

In 1961, President John F. Kennedy released a message to Congress urging action to end the deferral of US taxation on income earned by foreign companies within US-owned multinational groups (Kennedy 1961). This would have made it pointless for US-based multinationals to accumulate foreign income in holding companies, and also generally would have removed the benefit to US-based groups from any explicit exemptions, like tax holidays, offered by a country to investors, since income untaxed by the host country would have become immediately taxable in the US. The Kennedy proposal contained a carve-out for explicit exemptions provided by specified underdeveloped countries, on the condition that the exempted income was reinvested in the underdeveloped country. Income exempted from taxation only implicitly, however, through what the Kennedy proposal referred to as tax haven planning devices, would be subject to immediate US taxation under all circumstances.[62] If enacted, therefore, the Kennedy proposal to eliminate deferral would have ended BEPS-style tax planning by US multinational groups.

Business interests, however, expressed the view that the elimination of deferral would place US-based multinationals at a competitive disadvantage with respect to their non-US competitors, who could still avail themselves of tax exemptions offered by countries around the world. Ultimately, the Congress passed and the President signed, in what became the Revenue Act of 1962, legislation that stopped short of the full elimination of deferral, but which attempted to curtail the use of tax planning by US-based multinationals centred on holding companies established in zero- or low-tax countries.

Congress made two important decisions in the 1962 Act, which ended up having a long-term effect on the shape of international tax rules around the

61 Ram (2018) ascribes a central role to US balance of payments concerns in stimulating tax reform in the early 1960s.

62 The language used by President Kennedy in describing these avoidance devices makes clear that by 1961 BEPS-style tax avoidance planning had taken on essentially the same form as it displays today. Kennedy said: 'The undesirability of continuing deferral is underscored where deferral has served as a shelter for tax escape through the unjustifiable use of tax havens such as Switzerland. Recently more and more enterprises organized abroad by American firms have arranged their corporate structures – aided by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and similar practices which maximize the accumulation of profits in the tax haven – so as to exploit the multiplicity of foreign tax systems and international agreements in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad'.

world. First, Congress adopted the world's first body of controlled foreign corporation rules, by which the US and many other countries have sought, generally with only limited success, to curtail their multinational groups' involvement in BEPS-style tax planning. Second, Congress considered, but rejected, a proposal to adopt a system of formulary apportionment for the international division of income earned by related-party groups, instead reaffirming a commitment to the arm's-length approach to transfer pricing that had been developed under the auspices of the League of Nations.The following discussion offers an introduction to both CFC rules and post-War arm's-length transfer pricing rules as they have developed globally in the more than 50 years that have elapsed since the 1962 US legislation.

Controlled foreign corporation (CFC) rules

The Revenue Act of 1962 generally defined as a controlled foreign corporation any foreign corporation that was more than 50 per cent owned by US corporate or individual shareholders.[63] Therefore, the foreign subsidiaries of US-owned multinational groups generally fell within the definition of CFCs. If a CFC was located in a country with a low or zero tax rate, any income received by the CFC, falling within specified categories, would be subject to immediate US taxation as if the income had been repatriated to the United States. The categories of 'tainted' income included interest, royalties, and profits from purchases or sales of goods and services to or from related parties – precisely the kinds of income transferred to zero- or low-tax subsidiaries under BEPS-style tax avoidance planning. The 1962 US CFC rules, therefore, if they had worked as intended, would have removed from US-based multinationals the financial incentive to pull income from foreign subsidiaries into offshore collection points, and presumably would have dramatically reduced US companies' involvement in BEPS-style tax avoidance structures.

From the time of their enactment in 1962, however, the effectiveness of the US CFC rules in discouraging BEPS-style tax planning has been limited. In part, problems have arisen from weaknesses in the wording of the statute. For example, the 1962 legislation defined a CFC as a company that is more than 50 per cent owned, by vote or value, by a US parent company or certain other US shareholders. But the 'more than 50 per cent by vote or value' test proved susceptible to manipulation. For example, there are an infinite number of ways in which voting rights can be spread among different classes of a corporation's stock (with e.g. some shares given voting rights for some purposes rather than others), and it can be very difficult to assign values to particular classes of stock with unique voting or other rights. It soon proved possible to avoid classification as a CFC of some companies that appeared as a practical matter to be controlled by US shareholders.

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[63] The following discussion in the text seeks to provide only non-technical and simplified descriptions of the CFC rules of the US and other countries. More detailed background on CFC rules around the world can be found in the OECD's BEPS report (2015a), Office of Tax Policy (2000) and Avi-Yonah and Halabi (2012).

Similarly, the language defining the kind of payments that are subject to home-country taxation under CFC rules raises difficulties. For example, interest received by a CFC in a low- or zero-tax country generally is subject to home-country taxation under the US CFC rules, but if the CFC also performs some banking services for unrelated customers – something that can easily be arranged among friendly multinationals – its interest income may under complex rules qualify as 'active financing' income, and therefore as exempt from home-country taxation.

As another example, although the US CFC rules generally tax income of a zero- or low-tax CFC from purchasing and reselling property in related-party transactions, the rules do not apply this treatment if the low- or zero-tax company substantially transforms the property through manufacturing processes (i.e. the CFC rules provide a manufacturing exception). Early in the history of the US CFC rules, US multinationals adopted contract manufacturing arrangements, under which CFCs claimed the right to the manufacturing exception by virtue not of their own manufacturing activities, but of manufacturing performed by others under contract. Over time, contract manufacturing arrangements, which US tax authorities generally proved unable legally to curtail, have been used to escape much taxation under the CFC rules.[64]

Finally, in 1997, an unexpected regulatory incident in the United States delivered the coup de grace to the US CFC rules as a meaningful constraint on BEPS-style planning by US multinationals.[65] The Internal Revenue Service (IRS) issued a regulation that was apparently intended to simplify, under US tax rules, the process of qualifying business entities as partnerships or other forms of pass-through entities (like limited liability companies) for tax purposes, thereby providing the entities with tax advantages in certain circumstances. There is no indication that this simplification was intended fundamentally to alter the operation of the CFC rules. The new regulation, however, contained language to the effect that, in some circumstances, entities qualifying for pass-through classification would be treated 'for all purposes of US taxation' as transparent entities – that is, treated as if they did not exist.

Immediately, US multinationals recognised that they could structure their operating entities in various countries around the world as subsidiaries of low- and zero-tax companies within the group, and then cause the operating subsidiaries to 'check the box' so that they would be treated not as separate companies for US tax purposes, but instead as unincorporated branches of the low- or zero-tax companies. This means, as a formal legal matter, that payments of interest, royalties, and other kinds of passive income made by the operating companies to their low- or zero-tax parents were not payments at all – they were, as a formal matter, non-events – so that the low- or zero-tax company should not be treated as receiving CFC income.

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[64] For a historical discussion, see Bates and Kirkwood (2008).

[65] The history of the check-the-box rules is described in, e.g., Sicular (2007).

The US IRS and Treasury quickly announced their intention to modify the recently-issued regulations to clarify that they could not be applied to defeat operation of the CFC rules. But once the horse of the check-the-box regulations had bolted, it was politically impossible for the Treasury to retrieve it. Businesses argued that to restore the US CFC rules to health would place US-owned multinationals at a competitive disadvantage with respect to their foreign counterparts. Supporting the business position, Congress made clear that it would legislatively block action to limit the operation of the check-the-box rules in a way that would resuscitate the CFC rules; indeed, in 2006 Congress enacted legislation that effectively confirmed this position. The result is that the US CFC rules have been of little effect in limiting the participation of US-based multinationals in BEPS-style tax planning since 1997.

Since 1972, dozens of countries have adopted CFC rules that are at least broadly similar to those of the United States.[66] Inevitably, however, these CFC rules have been vulnerable to the same kind of definitional ambiguities that impaired the operation of the US CFC rules, even before the final blow of the tick-the-box regulations. It is not clear how successful different countries' CFC rules have been in curtailing BEPS-style tax planning among multinationals based outside the US. My experience as a practitioner suggests that the degree of effectiveness has varied substantially among countries. The large volume of avoidance visible around the world today, however, suggest that overall CFC rules have operated at a low level of efficacy.

The basic problem with CFC rules, which very likely has prevented them historically from interfering decisively with the growth of BEPS, relates to competition among capital-exporting countries – the countries where multinational groups tend to be based. A country's CFC rules prevent that country's own home-based multinationals from benefiting from BEPS-style tax planning in countries where they conduct business. The multinationals of other countries that have not enacted CFC rules, however, remain free to engage in tax planning. Countries therefore tend to be reluctant to enact effective CFC rules, which can be seen as placing their home-based multinational companies at a competitive disadvantage.[67]

Chapter 4 gives further attention to the topic of CFC rules in the course of a discussion of the OECD's BEPS recommendations. As will be seen, in its 2015 BEPS reports the OECD, while noting the possible value of CFC rules in curtailing BEPS-style tax planning, does not offer concrete recommendations for strengthening them. Conceivably, the adoption of effective CFC rules would be made more feasible if all, or at least most, capital-exporting countries were willing to adopt the rules in concert. The BEPS process, though, did not offer concrete suggestions for international

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66 The OECD's 2015 final report on BEPS Action 3 (OECD 2015a: 9), notes that 30 of the countries participating in the BEPS deliberations had CFC rules.

67 See generally Durst (2016b: 316).

coordination of CFC rules, and overall did not display optimism that the institution of CFC rules would be reinvigorated around the world soon.

As I discuss further in Chapter 4, however, the United States enacted a new tax on the global intangible low-tax income (GILTI) of US-owned corporate groups in its December 2017 tax reform legislation.[68] The GILTI rules are complex – their overall intention is to impose a US tax on much of a US group's foreign income, at a rate of about 10.5 per cent, to the extent the group's foreign income was not subject to foreign taxes of at least that rate. The GILTI tax therefore imposes a minimum tax on a US group's low-tax foreign income. The GILTI tax serves much the same purpose as a CFC rule. In addition, as discussed in Chapter 4, the European Union has been engaged in an effort to enact effective CFC rules among member countries. Chapter 4 considers whether, despite the reserved tone taken towards CFC rules in the BEPS report, US adoption of the GILTI tax, and efforts in other countries to enact strengthened CFC rules, might signal a revival of the concept of CFC rules as a means of controlling BEPS-style tax planning.

Post-1962 transfer pricing laws

In addition to CFC rules, the US Congress in 1962 focused on the possibility of strengthening the arm's-length approach to transfer pricing. Legislative consideration of transfer pricing rules, in what became the Tax Reform Act of 1962, began in a perhaps surprising manner.[69] The House of Representatives (the lower house of the US Congress, where revenue-raising legislation must originate) approved a provision under which, if a comparable price could not be identified in sales of tangible property between related parties, income from the production, purchase and resale of the property generally was to be divided among entities according to a formula based on companies' assets, payroll expenses and advertising expenses. The formulary method was to apply only to related-party transfers of tangible property, so it is not clear how the method would have applied in connection with avoidance planning involving transfers of rights to intangibles or of services. The formulary method also would not have applied if relevant comparable prices could be found, or if the taxpayer could agree upon a more accurate transfer pricing methodology with the US tax authorities.

Businesses objected strongly to the House proposal, claiming both that the legislation was unacceptably vague, and that applying a single formula to many different factual circumstances would inevitably lead to unfair results. When the House-passed bill was transmitted to the US Senate for its consideration, the Senate eliminated the formulary-apportionment provision from subsequent versions of the legislation. Ultimately, in the 1962 Act Congress decided against making any change to existing transfer pricing law, thus in effect retaining the arm's-length approach as it had been developed by the League of Nations. Congress, however, directed the US Treasury

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68 The new GILTI tax is contained in Section 951A of the US Internal Revenue Code.

69 The following discussion of the US 1962 Revenue Act, and ensuing transfer pricing regulations of 1968, is based on Durst and Culbertson (2003: 48-58) and the authorities cited therein.

Department to re-examine the question of whether additional regulations might be needed to govern transfer pricing. Congress directed the Treasury specifically to consider whether regulations should include ‘guidelines and formulas for the allocation of income and deductions’.

In 1968, after a substantial delay, the US Treasury issued transfer pricing regulations in response to Congress’s request. The new regulations generally rejected Congress’s 1962 invitation to consider the use of formulas. Instead, the 1968 regulations introduced the idea of transfer pricing guidelines, which the new regulations called methods. It was clear that these methods were to be governed by the arm’s-length principle, with its heavy dependence on information derived from comparables.

The 1968 regulations established three basic transfer pricing methods: (1) a comparable uncontrolled price method, which was to be used if apparently reliable comparables information for the related-party transaction in question could be located; (2) a cost-plus method, to be applied to sales of manufactured products between related parties, under which the arm’s-length nature of pricing was to be evaluated according to whether the manufacturer’s gross markup on costs was similar to the markups obtained in comparable sales involving unrelated parties; and (3) a resale price method (sometimes called a resale minus method), to be applied to purchasers-resellers of products within a commonly controlled group, under which pricing was to be evaluated according to whether the reseller’s gross profit (i.e. its gross margin) was similar to that observed in comparable sales between unrelated parties. If none of these three methods could be applied, the 1968 regulations permitted the use of other methods, which in practice was taken to mean individually crafted profit-split methods like the fractional methods of apportionment to which the League of Nations had referred.

In addition to creating the concept of transfer pricing methods, the 1968 US regulations also established the precedent of remarkably wordy and complex governmental transfer pricing guidance, built around the expectation that tax authorities would conduct highly detailed factual analyses of the operations and history of each taxpayer before proposing tax adjustments. It has been my experience that the kind of extraordinarily detailed factual inquiries for which the US regulations call (and, as will be seen, the OECD *Transfer Pricing Guidelines* later modelled after the US regulations) are sometimes beyond the practical capacity of even the most skilled government tax examiners or private-sector tax advisers to perform comprehensively in the context of real-life tax examinations.[70]

[70] One prominent commentator in 1968 made the following observation: ‘The first question that arises after a close reading of the proposed … regulations is how much simplicity and reduction of uncertainty will be effected thereby. Their constant references to all facts and circumstances and the numerous valuation complexities created by the various formulas contained therein, bode ill for ease of administration hopes. Moreover, the incredible mass of detail contained in the proposed regulations, coupled with their almost equally consistent retreats to vaguely worded general principles, tend to weaken the cohesive nature of these provisions. The net effect of the regulations seems more likely, on balance, to increase rather than decrease disputes … It may well be that the new proposals, despite their general readability, just cannot be effectively applied to concrete situations in practice’ (Eustice 1968).

The efficacy of the 1968 regulations was soon tested in a series of high-profile court controversies in the United States. Most of these cases involved a particular fact pattern associated with BEPS-style avoidance planning, 'outbound migrations of intangibles', which bedevilled US tax authorities in the 1960s, and with which the US IRS continues to struggle today, largely unsuccessfully.[71] These cases have usually involved the question of whether a US-based multinational has received adequate compensation, typically in the form of royalties, when transferring patent or other intellectual property rights to a low- or zero-tax affiliate under a BEPS-style tax plan.[72] The taxpayers have prevailed against the IRS in almost all these cases,[73] typically by submitting to courts extensive analyses by consulting economists, arguing that the royalties received by the US parent company are similar to royalties received by companies in comparable arm's-length arrangements. Although outbound transfers of intangibles of the kind involved in these cases are unlikely to arise frequently in lower-income countries, the US cases afford general caution regarding the practical limitations of comparables analysis as the basis for reasonably administrable transfer pricing rules.

Continuing official frustration with the comparables-based rules resulted in a comprehensive congressional review of US transfer pricing law in connection with what became the Tax Reform Act of 1986.[74] Early in the consideration of the 1986 Act, the House Ways and Means committee speculated that the arm's-length approach to transfer pricing laws might be untenable as a conceptual matter.[75] Ultimately, however, Congress in 1986 chose to make only minor adjustments to the existing transfer pricing rules of the Internal Revenue Code, leaving the law's foundation in the arm's-length principle generally unchanged.[76] In addition, following the approach it had taken in

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71 For summaries of these historical cases, see Avi-Yonah (2007: section 4). Recent examples include Veritas Software Corp. v. Commissioner, 133 T.C. 297 (2009) and Amazon.com, Inc. v. Commissioner, 148 T.C. number 18 (2017) (case remains subject to review by US Court of Appeals). Legislation included in the December 2017 US tax reform act, however, revised some of the rules for valuing outbound transfers of intangibles from the United States. It is possible, therefore, that the 'intangibles migration' cases will be of largely historical significance in the future. See H.R. Conf. Rep. No. 466, 115th Cong., 1st Sess. (2017) at 661-662.

72 e.g. a US-based multinational in the pharmaceuticals business might have developed, through research and development in the United States, a valuable patent to a new drug, enjoying large US tax deductions in the process. Then, pursuing the format of an intangibles-centred avoidance plan described in Chapter 2, the US might have licensed the patent to a low- or zero-tax affiliate in return for a royalty of 5 per cent of sales; the affiliate might then have on-licensed the rights to companies operating around the world for a royalty of 10 per cent of sales. This arrangement would permit the rapid accumulation of high levels of profit within the low- or zero-tax company. The US tax authorities have typically argued in this kind of situation that the royalty initially paid by the low- or zero-tax company (5 per cent in this example) is below arm's-length levels, thereby depriving the US of adequate taxable income from the arrangement.

73 For a recent US judicial decision, however, siding with the IRS in a case involving an outbound intangibles migration, see United States v. Medtronic, case number 17-1866, US Court of Appeals for the Eight Circuit (2018). See generally Finley (2018).

74 The following discussion of the US 1986 Reform Act and the ensuing Treasury Department white paper on transfer pricing is based on Durst and Culbertson (2003: 64-77).

75 The Committee said: 'A fundamental problem is the fact that the relationship between related parties is different from that of unrelated parties. Observers have noted that multinational companies operate as an economic unit, and not "as if" they were unrelated to their foreign subsidiaries' (H.R. Rep. No. 99-426, reprinted in 1986-3 C.B. (vol. 2) 424 (footnote omitted)).

76 In particular, Congress added the 'commensurate with income rule' to Section 482 of the US Internal Revenue Code. This was intended to permit the IRS, in a tax controversy involving the arm's-length level of a royalty that should be received in return for the outbound transfer of an intangible, to treat as evidence the level of income actually earned by a low- or zero-tax company from the intangible, even though that knowledge would not have been available to the multinational group at the time the transfer was made.

1962, Congress in the 1986 Act instructed the Treasury Department to perform a comprehensive study of the problem of transfer pricing, to examine whether the regulations should be changed ‘in any respect’.

The Treasury issued its report on transfer pricing, usually referred to as the Treasury White Paper, in 1988.[77] The report did not recommend wholesale replacement of the arm’s-length standard with a formulary approach. The White Paper, however, introduced a novel approach to transfer pricing enforcement that fundamentally changed how tax authorities around the world try to enforce the arm’s-length principle.

The White Paper recommended the creation of a new transfer pricing method, which Treasury labelled the basic arm’s-length return method (BALRM). The method appears to have originally been largely conceived as a means of addressing the pricing of outbound transfers of intangibles by US parent companies, although, as will be seen, its use in other contexts has become substantially more important. Under BALRM, the IRS would have examined the level of profitability being earned by the low- or zero-tax affiliate within an intangibles-centred avoidance arrangement. If the level of profit earned by the affiliate seemed higher than reasonable in view of the actual functions performed by the affiliate – which under the typical BEPS-style avoidance plan would be minimal – the excess profit would be assumed attributable to the intangible that had been transferred by the US parent and included in the parent’s US taxable income. The net effect would be to increase the royalty paid by the low- or zero-tax subsidiary back to the United States.

Even when seen primarily as a means of addressing the longstanding US problem of outbound migration of intangibles, the proposed BALRM approach, of attributing to specified corporations market levels of routine income, would have been criticised by many as an excessive departure from the arm’s-length paradigm. By the late 1980s, however, the BALRM proposal also had become embroiled in a transfer pricing dispute of a different kind, between the United States and some of its major trading partners, including, notably, Japan.

The root of the controversy was a substantial decline in the value of the US dollar during the second half of the 1980s against a number of world currencies, especially the Japanese yen. This was a period in which Japanese manufacturers of automobiles, and other durable goods like industrial machinery, were making dramatic inroads into the US marketplace. The rapid appreciation of the yen versus the dollar made it very difficult for manufacturers to build cars and other expensive products in Japan, paying for labour and supplies in yen, and to sell the products profitably for depreciated dollars in the United States.

[77] The White Paper, and the international controversy over transfer pricing laws that followed, are discussed in detail in Durst and Culbertson (2003: 64-88).

Japanese manufacturing groups therefore were experiencing losses, or substandard levels of profitability, from their US operations. The Japanese companies, supported by Japan's National Tax Administration, argued that, for tax purposes, the losses or other substandard results should be shared between the Japanese parent company and its distribution subsidiary in the United States. The US IRS, however, argued that the distribution subsidiary was performing a service for its parent company for which it should be compensated, even if for the time being the corporate group's US operations, as a whole, were experiencing losses or unusually low profitability.[78]

Japan and other trading partners of the US feared that the IRS would use the BALRM approach, contrary to international tradition, as a de facto minimum tax on the operations of US distribution subsidiaries of foreign-owned manufacturing groups. Moreover, it appeared the US envisioned applying the new approach on a somewhat mechanical basis, under which economists employed by the IRS would be permitted to estimate reasonable minimum levels of income for foreign-owned US subsidiaries, without the need to conduct factually intensive, case-by-case analyses of potentially relevant comparables.

Alarmed trading partners convened what turned into a multi-year session of the OECD's tax arm to try to forge a compromise between the US and non-US positions with respect to net-income benchmarking of subsidiaries. The negotiations in the OECD were at times unusually heated for that forum, and the debates are still sometimes referred to laconically as the 'great transfer pricing wars' of the early 1990s. The result was the release in 1994 of new US transfer pricing regulations, and the near-simultaneous release of a set of OECD *Transfer Pricing Guidelines* in 1995.[79]

In response to concerns that the proposed BALRM method would be applied overly mechanically, the new US regulations introduced a new transfer pricing method called the comparable profits method (CPM), and the 1995 OECD guidelines introduced an essentially identical method called the transactional net margin method (TNMM).[80] Under TNMM, tax authorities are permitted to require that a local subsidiary of a multinational group earn at least a minimum level of income, commensurate with the functions the subsidiary performs and the business risks that it faces. However, the tax authority is required to base its determination of a minimum permissible level of income only on the basis of a case-by-case factual analysis of the subsidiary, including a search for financial information on companies that are comparable to the subsidiary under examination.

Here is how a tax authority is in theory supposed to apply TNMM in ensuring, for example, that a local distributor of brand-name farming equipment,

78 See generally Guttentag and Miyatake (1994); Daily Tax Report (1994); and Akamatsu (1997).

79 The 1994 US regulations and 1995 OECD Guidelines are described in Durst and Culbertson (2003: 90-98).

80 Despite the differing names of the US and OECD methods, in practice the two methods are applied identically – see Culbertson (1995). This book will use the OECD terminology and call the method TNMM, as that is the term generally used in countries other than the US.

established in a lower-income country by a multinational group, earns adequate income from its operations.[81] First, the local tax authority is to perform a detailed functional analysis of the taxpayer (called the tested party in the language of TNMM), to obtain an understanding of how its business operates. For example, does the distributor perform only routine functions like the receipt and delivery of products, or does the distributor also perform extensive advertising functions for which additional income might be expected? Then, after having completed the functional analysis, the tax authority is to review commercially available electronic databases of financial information gathered from publicly-traded companies to locate companies that perform functions comparable to those of the tested party but are independent, in the sense of not being parts of commonly controlled business groups. If any reasonably comparable independent distributors of brand-name farming equipment are identified through the database search, their operating profit margins are subjected to statistical analysis. If the actual operating profit margin of the tested party is not below the median of the comparables' margins by a statistically significant extent, the tested party's results are accepted as reflecting arm's-length pricing in its transactions with the other members of its multinational group. If, however, the tested party's results fall below the median of the comparables' results to a statistically significant extent, then the tax authority is permitted to adjust the tested party's income for tax purposes up to the median.

The insistence of the OECD Guidelines that tax authorities apply TNMM only based on detailed functional analyses of the tested party, and that tax authorities apply the method by reference to data from uncontrolled comparables, reflected the continuing concerns of trading partners of the United States within the OECD. The thinking at the time was, in my observation, that by placing formidable procedural hurdles in the way of successful application of the TNMM, countries' tax authorities would be able to apply the new method successfully only in the case of relatively egregious income-stripping by locally operating subsidiaries.

The negotiators at the OECD do not appear to have had BEPS-style avoidance structures prominently in mind when hammering out the details of the new TNMM in the early 1990s. Nevertheless, it soon became clear that TNMM was the natural – and as a practical matter the only – OECD-approved transfer pricing method potentially available for tax authorities, including those in low-income countries, to use in seeking to enforce reasonable minimum levels of incomes for the 'stripped risk' distributors, manufacturers and service providers that figure prominently in BEPS-style tax planning arrangements. Indeed, TNMM appears to have become the world's most commonly applied transfer pricing method.[82]

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81 Rules governing the TNMM are contained in Paragraphs 2.64 to 2.113 of the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, as revised in 2017 following the OECD's BEPS studies.

82 See Collier and Andrus (2017: 111).

Despite the very wide application of TNMM around the world, however, tax administrations, even in the world's wealthiest countries, have never been able to administer the TNMM effectively. The root of the problem lies in the OECD's insistence that tax authorities apply the method only by reference to searches for financial data for uncontrolled comparables. Typically, tax authorities are simply unable to locate reasonably satisfactory uncontrolled comparables for the kinds of stripped-risk distributors, manufacturers and service providers that multinational groups establish as part of their tax planning structures.

Part of the problem is that uncontrolled independent businesses generally do not enjoy the high degree of insulation from business risks that intragroup contracts afford to the limited-risk entities that multinational groups establish under BEPS-style plans. Therefore, the uncontrolled companies that tax authorities might identify through searches of financial databases are systematically noncomparable in economic terms to the tested parties that the tax authorities are trying to examine. In addition, those independent distributors, manufacturers and service providers that might happen to exist, and to perform functions roughly similar to those of the tested parties in TNMM examinations, are unlikely to sell stock or other securities on public exchanges, so that their financial information is not typically included in available financial databases.

The practical result is that tax authorities are not usually able to identify enough high-quality comparables to apply TNMM persuasively in determining acceptable arm's-length margins for local distributors, manufacturers and service providers within multinational groups. Any comparables that might be identified are likely to differ in obvious ways from the stripped-risk entity that is being examined. For example, efforts to locate purported comparables for, say, a local distributor of high-margin branded food or beverages might result in the identification of a few local wholesale food distributors that handle lower-margin unbranded products, at volumes significantly lower than those of the large brand-name distributors.

Even with highly imperfect matches of this kind accepted, moreover, searches typically result in very small sample sizes of purported comparables – in my experience, sample sizes of only five or six purported comparables are often used in practice. Tax authorities then attempt, following the OECD Guidelines, to use statistical techniques to determine an arm's-length range of profitability for the taxpayer that is under examination. If the taxpayer's actual profitability is within that range, the taxpayer will be considered to have satisfied the arm's-length pricing standard under the Guidelines.[83] As the OECD Guidelines recognise, however, basic statistical theory makes clear

[83] e.g. in examining a particular stripped-risk distributor, a tax authority might locate, using commercially available databases, financial information for six at least arguably uncontrolled comparables. Those six comparables might have a medium operating margin of 2.7 per cent of sales; and applying some form of statistical technique to the available data the tax authority might determine an arm's length range of operating margins extending from 1.0 to 4.5 per cent. So long as the tested party has earned an operating margin of at least 1.0 per cent, therefore, the tested party will be considered to have complied with the arm's-length standard in its operations.

that it is impossible to conduct reliable statistical analyses using very small sample sizes, especially when the data being used is of low quality to begin with.[84] The result is that the statistical ranges estimated in practice tend to be far too wide to be of real use in tax administration – basically, the range is so wide that even implausibly low margins are found to be within the arm's-length range. In sum, TNMM as used around the world today provides tax administrations with only a very flawed means of attempting to prevent excessive profit shifting by the kinds of limited-risk distributors, manufacturers, and service providers that are used under BEPS-style tax planning structures.

This book will return to the topic of transfer pricing rules, and in particular the TNMM, in Chapter 4, which analyses the OECD's recent BEPS reports. The OECD and other international organisations have recognised the importance of rectifying the problem of insufficient comparables if TNMM is to function effectively in tax administration, especially in developing countries.[85] Chapter 4 considers the potential feasibility of improving the operation of the TNMM as a component of policies to enable lower-income country tax administrations to achieve better control over profit shifting from their jurisdictions.

Profit shifting through interest deductions

As described in Chapter 2, a very common kind of BEPS-style tax avoidance structure is based on lending money between members of multinational groups. Members of multinational groups routinely establish financing subsidiaries in low- or zero-tax countries and fund the financing subsidiaries with large amounts of cash. The financing subsidiaries then extend loans to the group's various operating subsidiaries around the world (which often are risk-limited companies established pursuant to BEPS planning). The operating subsidiaries pay interest on the loans, which they deduct for tax purposes, thereby reducing their tax bills in the countries where they are located. There is no corresponding tax cost when the interest is received by the low- or zero-tax financing company, so the overall result is to reduce the multinational group's global tax bill.

Corporate income tax laws around the world typically allow corporations to deduct interest on loans, and claiming a deduction for interest is not in itself evidence of tax avoidance. The problem, however, is that under BEPS-style avoidance plans risk-limited subsidiaries can incur interest-bearing debt from

84 OECD Guidelines paragraph 3.57: 'It may also be the case that, while every effort has been made to exclude points that have a lesser degree of comparability, what is arrived at is a range of figures for which it is considered, given the process used for selecting comparables and limitations in information available on comparables, that some comparability defects remain that cannot be identified and/or quantified, and are therefore not adjusted. In such cases, *if the range includes a sizeable number of observations*, statistical tools that take account of central tendency to narrow the range (e.g. the interquartile range or other percentiles) might help to enhance the reliability of the analysis' [emphasis added].

85 See especially Platform for Collaboration on Tax (a group comprised of OECD, World Bank, IMF and UN) (PCT 2017).

related lenders far in excess of the level of debt that is necessary for a company to incur for business reasons.

For illustration, consider the situation of a global multinational group as a whole. The group might find it desirable for business reasons to borrow money from banks and other outside lenders to a certain extent – say, to the point at which the group's debt-to-equity ratio (its ratio of debt outstanding to the total value of its outstanding stock) is 1.5 to 1 (a typical debt-to-equity ratio for companies in some industries). The group will refrain from borrowing more because then its debt will become too risky, forcing the group to pay overly high interest rates. Also, incurring high levels of debt might subject the group to an excessive risk of bankruptcy if economic conditions change for the worse. Thus, at arm's length, there are natural limits to a multinational group's desire to incur additional debt to outside lenders.

Within a commonly-owned multinational group, however, there are no substantial business constraints on the volume of loans made from one group member to another. As a matter of economic reality, since the same parent company owns the lender and the borrower, the loans place no one at genuine economic risk. The tax benefits that can be derived from the loans, nevertheless, can be very large. Not surprisingly, therefore, financing companies under BEPS-style planning structures often lend large sums to group members operating in countries around the world, causing those members to be much more heavily indebted than the group as a whole. For example, whereas a group as a whole may have a debt-to-equity ratio of 1.5 to 1, some companies within the group might have ratios that are substantially higher. This kind of leverage permits massive amounts of tax avoidance through deduction of interest paid to group financing companies in low- or zero-tax countries.

Although in theory the arm's-length principle should limit the amount of debt between related parties to levels justified by bona fide business considerations, in practice the OECD's transfer pricing methods, including TNMM, do not impose effective limits on tax avoidance through related-party lending arrangements. This is largely because the OECD's transfer pricing methods, including TNMM, seek to place a floor on the amount of 'operating income' that a subsidiary is treated as earning for tax purposes – and operating income in accounting terminology generally means income before the deduction of interest paid by an entity. Therefore, even if a company earns, say, the minimum operating profit margin required by TNMM, the company can reduce its taxable income further by deducting interest paid, even to related parties.[86] The inability of transfer pricing methods, especially the commonly-used TNMM, to meaningfully limit taxpayers' interest

[86] e.g. consider a member of a multinational group that distributes products in a particular country, and has sales revenue during the year of $10 million. Despite the difficulties of applying TNMM, the tax authorities of the country establish successfully that the distributor should earn an operating margin of at least 3 per cent, so the distributor should earn an operating income of at least $300,000. The distributor nevertheless remains free under the transfer pricing rules to reduce its taxable income below $300,000, perhaps even to zero, by claiming deductions for interest on loans from related parties.

expenses has historically represented a serious loophole in the OECD's approach to controlling BEPS-style tax planning.

For many decades countries around the world have maintained rules, separate from their transfer pricing rules, that attempt to limit deductions for interest paid by a company to related lenders based on whether the company is thinly capitalised – that is, whether the corporation has more debt relative to equity than seems reasonable given business needs. For example, a country's statutes might disallow deductions for interest on a company's loans to the extent the company's debt-to-equity ratio exceeds, say, 3 to 1. This thin capitalisation approach to the control of interest deductions has been flawed, however, in part because, as the OECD describes in its report on BEPS Action 4,[87] companies have been able to avoid application of the statutes by contributing cash to the taxpayer company, thus increasing the value of its equity and artificially reducing the company's debt-to-equity ratio.

As discussed further in Chapter 4, the OECD has recommended that countries adopt tighter limitations on corporate interest deductions, generally limiting interest deductions to 30 per cent of a company's net income before payment of interest. Because these rules do not depend on a company's debt-to-equity ratio, they cannot be avoided by injections of additional cash to the company. As discussed in Chapter 4, the OECD has modelled its recommendation on income-based interest limitations that some, mainly relatively wealthy, countries have adopted over the past ten years.

As will be seen in Chapter 4, by the OECD's own analysis the recommended 30 per cent limitation would allow companies to continue to deduct interest on substantially larger loans than companies in most industries need to meet their genuine business needs. Therefore, even if lower-income countries adopt the OECD recommendation, companies in the countries will still be able to accomplish significant tax avoidance through the payment of interest on loans from low- or zero-tax finance companies. Moreover, because of perceived pressure of tax competition, it is not clear that many lower-income countries will choose to adopt even the limited controls on interest deductions that the OECD has recommended. As will be seen in Chapter 5, however, it is my view that the OECD recommendation, in part because of its relatively moderate effects, promises significant net benefits even for countries that feel heavily constrained in their policymaking by considerations of tax competition. Lower-income countries should give careful consideration to adopting the OECD's recommended approach.

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87 See the discussion of the OECD Action 4 report in Chapter 4 of this book.

Chapter 4

The OECD's BEPS project and lower-income countries

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 organisation like the United Nations? The OECD's membership consists of 35 industrialised and relatively wealthy countries,[88] whereas the United Nations consists of 193 member states at all levels of wealth and economic development. Especially given that, as discussed in Chapter 2, the fiscal consequences of BEPS-style tax planning seem disproportionately severe for lower-income countries, why did the BEPS process originate under the auspices of an organisation 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.[89] 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. This task, as a practical matter, involved articulating a standard pattern for countries to use in enacting their international tax laws. However, the League of Nations dissolved after the Second World War, and its successor, the newly-formed United Nations, was slow to assume the League's former work on model tax treaties. Instead, the Organisation for European Economic Cooperation (OEEC), a group of 16 Western European countries that was established to help administer post-War US aid under the Marshall Plan, assumed the work of studying and reviewing the League's model treaties. The OEEC was succeeded by the OECD in 1960, with a membership extending beyond Europe, and the new organisation continued the OEEC's tax treaty work. The OECD issued a new model income tax treaty in 1963, replacing the prior versions of the League. Since then the OECD, despite its relatively limited membership, has maintained the position of primary global standards-setter in the design of international tax legislation.

88 OECD members at the time of writing are Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

89 See generally McIntyre (2005), on which the following historical discussion largely relies.

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, 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 UN, unlike that at the OECD, was not designated as a formal collaborative process among sovereign governments. Instead, the UN process was to be conducted by a committee of government officials and other tax experts from 20 countries, who were to act in their individual capacities. Decisions of the UN committee therefore could be seen only as informal recommendations of experts, not resolutions agreed to among UN member governments.

In 1980, the UN Tax Committee issued its own model income tax treaty for use between developed and developing countries. The new UN model treaty paralleled the OECD model in overall format, 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 – the UN model treaty accorded countries greater power to tax investors than the OECD model.[90] With respect to central concepts, however, including notably the arm's-length principle that governs the division of a multinational group's income among countries, the UN model treaty was virtually identical to that of the OECD. Since 1980, both the OECD and the UN 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.[91]

The establishment of the UN Tax Committee, and the issuance by the Committee of its own model treaty, did not 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 UN; it has extensive physical facilities based in Paris for which the UN Tax Committee has no counterpart; and the OECD's formal status as an intergovernmental organisation gives its pronouncements and publications greater apparent weight of legal authority than documents generated by the UN Tax Committee.

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90 For a useful summary of differences between the OECD and UN model treaties, see Lennard (2009).

91 The texts of the most recent versions of the OECD and UN model tax conventions - extensive documents with lengthy official commentaries - are maintained on the websites of the two organisations. In addition to the UN model treaty, an important UN Tax Committee document is the *United Nations Practical Manual on Transfer Pricing for Developing Countries* (UN 2017 2nd ed). The UN 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*.

In addition, for many years the OECD has worked closely with international business representatives through its Business and Industry Advisory Committee (BIAC).[92] Although BIAC has no formal decision-making role within the OECD, the OECD generally appears to try to reach a 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 gives 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 non-governmental organisations criticised the notion of giving the OECD leadership over a tax reform study that would affect the interests of many countries that were not OECD members.[93] Developing countries along with the NGOs engaged in a global lobbying effort to upgrade the UN Tax Committee to an intergovernmental organisation 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 entailed informal consultations among government officials from OECD member and non-member countries, both at OECD headquarters in Paris and in regional conferences held around the world.[94] Later, as the BEPS process was concluding and the 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 called an Inclusive Framework for implementing BEPS. About 100 countries have participated in meetings of the Framework.[95]

Developing country governments have generally appeared eager to associate themselves with the OECD's tax reform efforts through the Inclusive Framework and other institutional means of cooperation with the

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92 For a critical look at the OECD's historical relationship with business interests, see Drucker (2013b).

93 For an account of NGOs' arguments to this effect, see, e.g., Burow (2014) and Johnston (2015).

94 The OECD describes its efforts to engage developing country governments in the BEPS process in its online discussion of Frequently Asked Questions on the BEPS process. It should be recognised as well that the initial political impetus for the BEPS process came both from the OECD and the G-20 Group of countries, a group that includes Brazil, China and India - see G-20 (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 are often seen as developing (although their interests are likely to diverge from those of other developing countries with substantially lower per capita income).

95 See Johnston (2016).

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, whatever doubts might be expressed as to the appropriateness of the OECD as the main articulator 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 discussed further in Chapter 6, however, this does not mean that the role of the UN Tax Committee, and especially its analytical resources, should not be enhanced. There are ways in which the interests of OECD and UN member countries are likely to differ systematically, 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 on 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 shifted from the OECD to the UN seems, at least at the current time, politically unrealistic and potentially distracting from important substantive matters.

Content of the OECD's BEPS studies: overview

The OECD's BEPS studies address 15 Action items, each of which involves a difficult technical topic in international tax law.[96] All 15 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 of more fundamental importance than others to the tax systems of lower-income countries.

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

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96 The OECD organised its BEPS study around 15 Actions: Action 1: Address the tax challenges of the digital economy; Action 2: Neutralise the effects of hybrid mismatch arrangements; Action 3: Strengthen CFC rules; Action 4: Limit base erosion via interest deductions and other financial payments; Action 5: Counter harmful tax practices more effectively, taking into account transparency and substance; Action 6: Prevent treaty abuse; Action 7: Prevent the artificial avoidance of PE 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.

countries. These include the OECD's treatment of: (i) transfer pricing rules; (ii) controlled foreign company (CFC) rules; (iii) companies' deductions of interest on loans from related parties; and (iv) income tax treaty shopping. The chapter then discusses some measures that relatively wealthy countries have recently taken outside the boundaries of the BEPS recommendations to protect their tax bases from erosion.

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 a large portion 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 towards the development of a multinational group's intellectual property have historically been treated as entitled to a large portion 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 bearing genuine risk in 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 (OECD 2012). 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 benefits or returns with respect to intangibles without more' (OECD 2012: 12).

A few months later, an early public release of the OECD during the 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' (OECD 2013a: 8). Soon afterwards, in the BEPS Action Plan the OECD similarly endorsed the goal of ensuring 'that transfer pricing outcomes are in line with value creation' (OECD 2013b: 20).

Some practitioners perceived the OECD's intention as a substantial departure from existing transfer pricing rules, which generally rejected the notion of apportioning income among affiliates in proportion to their levels of observable business activities as an unacceptably formulaic departure from the arm's-length principle. 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'.[97] 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 formulary approaches to the division of income among related companies (PwC 2014).[98]

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 (OECD 2017b: paras 1.61 ff).

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

[97] OECD Action Plan (2013b: 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'.

[98] See also Johnston (2014).

> decision-making function. It is not necessary for a party to perform the day-to-day mitigation … 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 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 (OECD 2017b: para 1.65).

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 controversy between tax planners and tax authorities inevitable: 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. Tax practitioners have for years been reluctant to endorse tax plans in which a zero- or low-tax company has no employees or observable business activity, being concerned with the substance-over-form doctrine or general anti-avoidance rules that most countries have had for a long time, as described in Chapter 3. The standard of practice instead generally has been to require at least some observable quantum of personnel and activities. 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. A key question is whether the new control-of-risk test has sufficient verbal teeth to limit companies' tax-planning practices employing low- and zero-tax subsidiaries of arguably limited economic substance.

In practical tax enforcement, the new test is more likely to be of immediate use to tax authorities in residence countries where multinationals are based, than in source countries where operating subsidiaries are often based. To some extent, tax administrations in source countries might attempt to counter taxpayers' claims to treatment of local subsidiaries as risk-stripped on the grounds that substantial risks are in fact controlled by personnel of the subsidiaries.[99] Making an argument of this kind might afford the source country additional leverage in seeking to increase the profit margin of local subsidiaries under the Transactional Net Margin Method (TNMM). Given the subjectivity inherent in determining whether risks are controlled locally, however, it may be hard for the source country tax authority to make the argument persuasively. In particular, it may be difficult for the tax authority to prevail upon a particular transfer pricing adjustment as appropriate to a local subsidiary's arguable control of risks.

In residence countries, however, the control-of-risk might be of use to tax authorities in seeking to challenge the results of offshoring, of intangibles ownership or of economic functions like intragroup lending. For example, the tax administration of a country in which a multinational group is based might argue that a low- or zero-tax intangibles holding company with few apparent activities 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 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.

Even if the control-of-risk test does prove to be of more immediate practical use in residence than source countries, the test might nevertheless offer revenue benefits to source countries. To the extent residence 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 level 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 to which that effect will materialise remains to be seen.

The BEPS project and the TNMM

The BEPS reports do not directly address problems of the 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, UN

99 This approach is suggested in the context of Indian tax administration in UN (2017) at paras D.3.4.3 and D.3.4.4.

and 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 (Toolkit) of the administrative challenges posed by different OECD transfer pricing methods, including the TNMM (PCT 2017). The Toolkit can be 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 have often been unable to identify sufficient numbers of uncontrolled comparables from commercially available financial databases or other sources to apply the TNMM effectively.[100] 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 in many circumstances these measures will not suffice 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 comparability analysis provides only an approximate answer, and that some flexibility is needed to determine a principled answer in many cases' (PCT 2017: 66).

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 negotiating a resolution with the taxpayer.[101] A transfer pricing method that provides only a starting point for

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[100] The Toolkit says: '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' (PCT 2017: 12).

[101] PCT (2017: 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,

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 in many cases the only OECD-endorsed transfer pricing method that is practically available to lower-income country tax administrations to try to control base erosion and profit shifting, the method remains too flawed to serve this purpose effectively.[102]

The Toolkit mentions several possible routes towards improving the performance of TNMM. First, it describes (but does not endorse) the approach to transfer pricing that is used by Brazil (PCT 2017: 76). Brazil employs a transfer pricing method that is similar to TNMM, but 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.[103] 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 individualised searches for comparables.[104] Even today, in light of growing recognition of the difficulties of applying TNMM, it is unlikely that many OECD members would consider favourably an approach like Brazil's, which dispenses with case-by-case identification of comparables.[105] 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 harbour net margins for specified categories of local subsidiaries of multinational groups (PCT 2017: 75, 82-84). For example,

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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'. (Footnote omitted.)

102 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 (2017: 28-29). The profit split method, however, requires tax administrators to analyse 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.

103 The Brazilian transfer pricing rules are described in detail in Chapter D.1 of the *UN Practical Transfer Pricing Manual for Developing Countries* (UN 2017 2nd edition). The Brazilian approach is described in PCT (2017: 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.)

104 See the discussion of the origins of TNMM in Chapter 3.

105 In connection with Brazil's proposed membership in the OECD, the Brazilian government and the OECD are, at the time of writing, exploring means of harmonising the current Brazilian approach to transfer pricing with the OECD Guidelines. See Johnston and Finley (2018).

minimum safe-harbour profit margins might be prescribed for subsidiaries engaged in distribution, manufacturing and the provision of various kinds of services. Taxpayers would be assured that if their operating margins were at least as high as the safe-harbour levels, the tax authority would not subject them to further transfer pricing examination. The safe-harbour margin levels would not be binding on taxpayers – that is, if a taxpayer believes that the applicable safe-harbour margin is too high, the taxpayer would remain free to state a lower margin on their tax return. The overall success of the safe harbour therefore depends on the hope that many taxpayers would choose to comply with it to avoid the costs and uncertainties of undergoing intensive transfer pricing examination.[106]

The 1995 OECD *Transfer Pricing Guidelines*, reflecting their overall aversion to any departure from the use of comparables in transfer pricing enforcement, expressed disapproval of transfer pricing safe harbours.[107] However, in 2013 the OECD revised the Guidelines and endorsed the use by countries of safe harbours as an aid to transfer pricing administration (OECD 2013c). Therefore, at least in theory, transfer pricing safe harbours 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 harbours 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 harbours on a large scale.[108] Practitioners, however, appear to have perceived the Indian safe harbour margins as unrealistically high, and reportedly few taxpayers have followed them. The difficulties seen in the Indian safe-harbour regime reflect a problem inherent in safe harbours under TNMM. If the tax authority sets the required safe harbour margins too low, they will be seen as permitting taxpayers to report income below the proper arm's-length level. If they set the safe harbour margins too high, taxpayers will report income below the safe-harbour levels and risk examination.

Another problem in designing safe harbours is determining the extent, if any, to which taxpayers who report income below safe-harbour levels should be subjected to heightened scrutiny by tax authorities. Arguably the most common-sense approach 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-harbour levels. However, a safe harbour with this kind of relatively strong presumptive effect, arguably would be difficult to distinguish in practice from the politically problematic Brazilian

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106 The discussion in the following paragraphs is based in large part on the analysis of transfer pricing safe harbours in Durst (2017a).

107 See OECD (1995: chapter 4(E) (text subsequently replaced as described below)).

108 See generally Lewis (2017). See also Collier and Andrus (2017: 269-270) (noting the historical lack of use of transfer pricing safe harbours and encouraging countries to give safe harbours closer consideration).

approach. Moreover, even if a country attempts to subject taxpayers with margins below safe-harbour 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 to be the TNMM, which remains largely ineffective in application because of the difficulty of identifying comparables.

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

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. For example, the Toolkit 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, this kind 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 organisations to provide training to transfer pricing examiners in developing countries. The still-unresolved problem of comparables under TNMM raises the question of whether this training is likely to be cost-effective in generating significant revenue recovery. The discussion in Chapter 5 shows even the best-trained of tax examiners is unlikely to be able to generate sufficiently large numbers of comparables to support a strongly defensible TNMM analysis during the course of a tax audit.

Against this, however, as the Toolkit points out, in practice transfer pricing examinations are sometimes resolved based not upon scientifically conclusive analysis of comparables, but instead upon de facto negotiation between taxpayers and examiners (PCT 2017: 67). 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 kind of resolution 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 is recovered through negotiation. Revenue recovery through increased transfer pricing audit coverage is especially likely if audit coverage in a jurisdiction has been limited historically. Therefore, despite the defects of current transfer pricing methods, revenue recovery after training efforts could be substantial – especially in the initial years following the training.

Tax Inspectors Without Borders (TIWB), a collaboration of the OECD and United Nations Development Programme (UNDP), has provided on-the-job training to transfer pricing examiners for several years, and revenue recovery has reportedly been significant – greatly exceeding the costs of the programme.[109] It seems sensible to continue and even expand current efforts in technical assistance in transfer pricing administration efforts, so long as the revenue benefits appear to significantly outweigh the costs.

It is nevertheless important that training and other forms of technical assistance do not mask the need for transfer pricing methods that can be applied more persuasively and predictably 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 term, given the obvious dangers with respect to the integrity and effectiveness of revenue administration.

Transfer pricing documentation under BEPS

BEPS Action 13 addressed the topic of transfer pricing documentation and country-by-country (CbC) reporting.[110] The requirement that taxpayers maintain transfer pricing documentation originated in the US during the early 1990s, and has now spread to dozens of countries around the world at all levels of economic development.[111] 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 tax inspectors to perform more effective transfer pricing audits.

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109 Tax Inspectors without Borders (2018: 19-20). The TIWB reports revenue gains in excess of the equivalent of $100 for each dollar spent on the programme.

110 The OECD's recommendations under Article 13 are contained in two documents, *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting* (OECD 2014) and a brief *Final Report on Action 13* (OECD 2015d).

111 For historical background, see Durst and Culbertson (2003: 96-98).

In practice, it has been my impression that in many instances transfer pricing documentation is of surprisingly limited value to tax examiners. During the 1990s, as first the US and then dozens of other countries began requiring documentation, its drafting quickly became a routinised 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 standardised format. Much of the factual description of the taxpayer's business in the documentation 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' computerised 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 are generally, 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 US, it became clear that in practice many examiners were not reviewing the documentation.[112] Examiners in the US are now required to memorialise 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 recovery.

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. The group's business activities are measured by the group's sales, the value of its tangible assets and its number of employees in each country. The CbC

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[112] See Memorandum from IRS chief corporate enforcement official Larry Langdon to IRS Executives, Managers, and Agents (22 January 2003) (reminding of the need for examiners to request transfer pricing documentation).

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 favourably to the OECD's recommendation with respect to CbC reports, and many member as well as non-member countries are implementing the new requirement.[113]

The OECD promotes CbC reporting as a potentially valuable risk assessment tool for tax administrations in conducting transfer pricing examinations. Presumably, the CbC breakdown will assist examiners in identifying situations where income is being shifted from their jurisdictions to zero- or low-tax affiliates.

It should be noted, however, that in their final form the OECD's CbC rules differ from the version originally proposed in an important respect. The CbC proposal originated not with the OECD or national tax administrations, but instead with NGOs, which had a broader function in mind for it.[114] The NGOs advocated that multinational groups' CbC reports be made available not only to tax authorities, but also to the public. The apparent hope was that public dissemination of the CbC reports would generate continuing political pressure for change to international tax rules, particularly in the direction of formulary apportionment. The proposal for public disclosure, however, departed from a longstanding global consensus in favour 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 CbC reports from public disclosure. In addition, the OECD emphasises that, although it expects the CbC 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 CbC reports as the basis for tax adjustments made on formulary principles.

I believe it is important to be cautious in expectations that the new documentation rules, including the CbC rules, will fundamentally enhance the capacity of tax examiners in practice. In my experience, a barrier to effective transfer pricing examinations is often 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 organised and digested in a real-life tax audit.[115] Presenting the same or a higher volume of information, but in an internationally standardised format,

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[113] See OECD (2017c).

[114] See generally Murphy (2012).

[115] A sample functional analysis questionnaire, to be used by examiners in transfer pricing examinations, is attached to the PCT Toolkit (PCT 2017: 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.

may have only a limited effect on the quality of transfer pricing examinations that can be performed under applicable rules. Tax examiners, moreover, have long had access to information concerning the kinds of outbound flows of royalties, service fees, interest payments and other items that produce base erosion and profit shifting. Obtaining confirmation in CbC reports that a multinational group as a whole is accumulating profits in low- or zero-tax countries may not tell examiners much that they were not previously aware of.[116]

This is not to say that CbC reports will have no effect on compliance: they might, for example, assist tax administrators in building support within their agencies for additional compliance efforts involving multinationals that make especially heavy use of profit shifting. In addition, companies may temper their tax planning out of concern that CbC reports might in practice become publicly available.[117] Moreover, CbC reports should make available statistical data that will shed light on the effectiveness of BEPS measures generally, thereby building a knowledge base that could prove valuable in improving tax administration around the world.[118] Country-by-country reporting, though, is unlikely to have substantial immediate effects on the effectiveness of tax examinations. Its primary effects are likely to result gradually from effects on the culture of multinational tax planning over time.

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 corporation (CFC) rules. CFC rules, it will be recalled from Chapter 3, are laws, following a pattern originating in the US in 1962, by which many countries have sought to limit 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

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116 It is even possible that CbC reports might impede the transfer pricing audit process to some extent, by requiring examiners to assimilate voluminous information of potentially little operational relevance. In this connection, 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 2017d: 46).

117 In this connection, it is not out of the question that one or more countries might mandate public disclosure of CbC reports at some time in the future.

118 See Johnston (2018a).

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, including in lower-income countries, would be substantially reduced if not eliminated. As described in Chapter 3, however, capital-exporting countries generally 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’ (OECD 2015a: 15). 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.[119] The report, however, perhaps bowing to political reality, makes no move towards 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.[120] 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 substantially curtailing BEPS around the world through collective action by capital-exporting countries.

The Action 3 report notes that some countries’ CFC rules attempt to only tax income that is shifted from the multinational’s home country (i.e. from the country that has enacted the CFC rules), rather than from other countries.[121] 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

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119 OECD (2015a: 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’.

120 One practitioner’s critique of an intermediate draft of the Action 3 report was entitled, ‘How Not to Engage with CFC Rules’ (Blanchard 2015).

121 This topic is discussed in OECD 2015a: 15-16. An example is provided by the CFC rules currently maintained by the UK; see the UK government explanation of the rules at UK Government (2013).

countries, including lower-income countries.[122] Arguably, rules incorporating this approach should not be considered CFC rules at all, but should be seen as a different species of base protection measure that countries might implement.[123]

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 that EU member states were to enact by the end of 2018.[124] It is not clear at the time of writing 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 as requiring 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 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 around the world. Depending on how member countries choose to interpret the test, CFC practice in the EU might devolve into gamesmanship, with companies seeking to satisfy the test through assigning only a token number of employees and minimal level of physical business activity to zero- or low-tax affiliates. 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 level of observable, profit-motivated business activities to be

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122 The OECD's Action 3 report criticises this characteristic of CFC rules that protects 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' (OECD 2015a: 16 [footnote omitted]).

123 cf. the related discussion of the UK and Australian Diverted Profits Tax rules, and the US Base Erosion and Anti-Abuse Tax (BEAT), below at notes 62-63 and accompanying text.

124 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.

exempted from CFC rules. This kind of interpretation might make it difficult for EU-based multinationals to continue to engage in BEPS-style tax planning, thus affording significant protection to lower-income countries around the world. Moreover, EU countries maintaining effective CFC rules could establish a normative standard for capital-exporting countries outside the EU, resulting in further reductions in profit shifting globally.

Finally, another EU-related development that should be mentioned has been the willingness in recent years of the European Commission to challenge member countries' extensions of tax benefits to multinational companies under the doctrine of state aid.[125] Although the long-term significance of the Commission's state aid campaign is yet to be determined, it seems possible that, like more effective CFC rules, application of the state aid doctrine could reduce the availability of low- and zero-tax jurisdictions for multinationals to use in connection with BEPS-style tax planning. This effect might be sufficiently widespread to measurably reduce global demand for BEPS-style tax planning as it affects countries at all levels of economic development.

The GILTI tax: revival of CFC concept in 2017 US 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 US-owned multinational groups. The GILTI tax is complex in its structure.[126] Somewhat simplified, it generally imposes a US tax, at a rate of 10.5 per cent (half the regular US corporate rate of 21 per cent), on that portion of a US-owned group's foreign income that exceeds a 10 per cent 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 US taxpayer of foreign tax credits), the GILTI tax subjects the non-US income of US-based multinational groups, above a routine level (defined as a return of 10 per cent on the group's foreign tangible assets), to a minimum tax of 10.5 per cent.

The GILTI tax would appear to remove some of the financial benefit to US-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 to lower-income countries may be limited.

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[125] e.g. see European Commission (2017).

[126] The GILTI tax is contained in Section 951A of the US Internal Revenue Code. It is described in detail at pp. 622-627 of H.R. Conf. Report No. 466, Tax Cuts and Jobs Act, 115th Cong., 1st Sess. (2017).

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.[127] That is, the minimum tax would have applied to the extent the US-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 US-owned group becomes subject to the minimum tax only if the average effective non-US tax rate on all the group's non-US income falls below a threshold level, generally 13.125 per cent. 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 does not fall below the threshold. An overall minimum tax like the GILTI tax therefore discourages BEPS-style tax planning less strongly than a similar tax imposed on a per-country basis.[128]

Given the large role played by the US 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 pressure 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 behaviour of US multinational groups in lower-income countries appears to be affected, may provide valuable information for policymaking in the future.

Finally, it should be mentioned that, at the time of writing, France and Germany reportedly are considering the adoption of minimum tax rules that are in some respects similar to the US GILTI rules.[129] Should these and other countries adopt such rules, the resulting global reduction in demand for profit-shifting tax planning might be significantly reduced, especially if the new rules are applied on a per-country basis.

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127 For discussion of the Obama Administration proposal, see Herzfeld (2016: 807). For formal statement of the proposal, see US Treasury Department (2016: 9-12).

128 As a simplified example, consider a GILTI-style minimum tax that subjects to home country taxation all foreign income that a group earns that is not subject to a local tax of at least 12 per cent. Assume that a multinational group 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 per cent, and Country B imposes corporate tax at a rate of 5 per cent. Under an overall GILTI-style minimum tax, the taxpayer is considered to pay tax at an average rate of 17.5 per cent on all its foreign income, which is above the 12 per cent 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 per cent threshold so that minimum tax is imposed on income earned in that country.

129 See, e.g., VanderWolk (2018).

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 focuses on this topic, and offers policy recommendations that seem well-suited to the situation of lower-income countries.[130]

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 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 create debt to affiliates in excess of the group's actual total indebtedness to outside parties.[131]

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 (i.e. the excess of interest deductions over interest income) to a fixed percentage set at a point in the range of 10 to 30 per cent of their earnings before interest, taxes, depreciation and

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

131 Consider e.g. 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 (e.g. 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, of EBITDA prior to payment of taxes and interest. Under a group ratio approach, since the parent in Country A earns 50 per cent 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 per cent 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.

amortisation (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 capitalisation 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 capitalisation rules deny interest deductions if a taxpayer's ratio of debt to equity exceeds a specified level (e.g. 3 to 1). The OECD points out in its Action 4 report that multinationals can relatively easily avoid application of thin capitalisation rules by injecting additional equity into its subsidiaries.[132]

The OECD based its EBITDA recommendation on the actions of a number of countries around the world, including Germany and Italy, which already had adopted 30 per cent of EBITDA limitations, as well as Spain, Finland and Norway, which have 25 per cent limitations.[133] Since the BEPS reports the UK has implemented a 30 per cent of EBITDA rule effective 1 April 2017,[134] and the US has done so effective 1 January 2018.[135] Under France's interest deduction limitations, which set forth several alternative limitations on deductions, interest deductions can in some circumstances be limited to approximately 25 per cent of a taxpayer's EBITDA.[136] In addition, the EU now prescribes limitations based on BEPS Action 4 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.[137] South Africa enacted limitations in 2013, which became effective in 2015, based generally on 40 per cent of EBITDA, although the limitation can be higher or lower based on fluctuations of market interest rates.[138] In addition, as of early 2018, the OECD has reported that Argentina, India, South Korea and Vietnam had enacted 30 per cent of EBITDA rules, and Norway, Japan, Malaysia and Turkey were taking legislative steps to align their rules with the OECD Action 4 recommendations (OECD 2018: 117).

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132 OECD (2015b: 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'.

133 See Sheppard (2014).

134 PwC (2017). Although the OECD's Action 4 report recommends that countries limit interest deductions to anywhere from 10 to 30% of EBITDA, because a number of countries have in practice enacted 30% limitations, the OECD recommendation is often perceived as a 30% limitation.

135 See pp. 385-392 of H.R. Conf. Report No. 466 (2017).

136 See PwC (2018).

137 European Union, Council Directive (EU) 2016/1164 (establishing rules against tax avoidance) (12 July 2016).

138 Republic of South Africa, Income Tax Act (revised) section 23M. See generally Readhead (2017).

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 per cent of the group's EBITDA, suggesting that a 30 per cent limitation will continue to allow substantial scope for loan-centred, BEPS-style tax planning (OECD 2015b: 49). Nevertheless, it seems likely based on the OECD data that a 30 per cent limitation has the potential to reduce loan-based tax avoidance to substantially below current levels in many countries.[139] Moreover, although some elements of EBITDA-based deduction limitations raise administrative complexity,[140] 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.

In view of the continuing pressure 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 is also 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 considers how lower-income countries might incorporate EBITDA-based interest deduction limitations into a comprehensive 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, first under the auspices of the League of Nations after World War I, and then of both the OECD and the UN since World War II. Income tax treaties address a very wide range of tax issues that arise when individuals or companies conduct cross-border

139 A 2017 study concludes that the introduction of a limitation in Finland, based in part on approximately 25 per cent of EBITDA, has been effective in raising revenue (Harju et al. 2017).

140 For discussion of this topic, see Barnes (2017: 179 ff).

activities. Virtually all the BEPS Action items have some connection with the topic of income tax treaties.[141]

Procedural aspects of tax treaties

For example, income tax treaties typically provide for exchange of taxpayer information between countries' tax administrations for enforcement purposes. Treaties 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.[142]

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 (e.g. in terms of 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 a permanent establishment in tax treaties. 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 circumstances in which the solicitation of sales orders within a country can give rise to a permanent establishment (OECD 2015g and 2017a). In addition, a more extensive expansion of the

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141 For a comprehensive discussion of the many connections between the BEPS Action Items and questions related to international tax treaties, see Brauner (2016).

142 Discussion of the procedural aspects of income tax treaties is found especially in the Final Reports on BEPS Action 15 (OECD 2015f) and BEPS Action 14 (OECD 2015e).

permanent establishment concept, under which online 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 EU, and has already been adopted by a few countries.[143] 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 corporate income tax at a rate of 25 per cent, and also impose a withholding tax of 20 per cent on outbound payments of royalties.[144] If a local member of a multinational group makes a payment of $1,000 to a licensor of intellectual property (which might be a related party located in a zero- or low-tax jurisdiction), deducting the royalty 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 licensing arrangement, therefore, will be substantially reduced.

143 This topic is discussed in OECD (2018) and European Commission (2018).

144 A summary of the withholding taxes levied by countries around the world can be found at Deloitte (2018).

If source countries 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 per cent statutory rate, they might agree in their income tax treaty to reduce that rate to 10 or 5 per cent, 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 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 perceived pressure of tax competition induces 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.[145] 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 revenue lost to BEPS-style tax planning, has probably 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.[146]

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

[145] A quantitative study of treaty negotiation outcomes involving lower-income countries is provided by Hearson (2016). See also Beer and Loeprick (2018).

[146] A 2014 IMF staff policy paper 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 2014: 28).

country, Country H, which happens to have a tax treaty with Country B eliminating withholding taxes. 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 per cent 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 tax 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.

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) that would in effect substitute for the thousands of bilateral tax treaties now in effect around the world. The centrepiece 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.[147]

More than 100 countries, at all levels of economic development, have signed the MLI, expressing at least symbolic support for its provisions. Before the MLI comes into effect, however, pairs of countries must formally indicate their desire to be bound by its terms. Participating countries must also 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.[148]

Moreover, the principal purpose test, which in most cases is likely to control treaty shopping under the MLI, is factually vague, and tax administrations may encounter substantial practical difficulties in attempting to apply it.

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[147] 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 modelled after language that the US has used in a number of its treaties. See generally Brauner (2016: 1004-1006). Relatively few countries, however, are likely to adopt the US-style language.

[148] See Sheppard (2017): 'Signing the MLI is like a dating service - a lot of work, a lot of dashed expectations, and no joy'.

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 legislature to protect their own corporate tax bases from erosion, when these fall outside the recommendations of the BEPS reports. For example, both the UK and Australia have enacted diverted profits taxes (DPTs) which essentially disallow deductions taken from the enacting countries in connection with BEPS-style planning strategies.[149] The UK and Australian DPTs have attracted a good deal of attention among tax practitioners. However, in determining whether profits have been inappropriately diverted, both the UK 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 UK 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 US Base Erosion and Anti-Abuse Tax (BEAT)

In late 2017, as part of comprehensive tax reform legislation, the US enacted a new Base Erosion and Anti-Abuse Tax (BEAT) in an effort to curtail profit shifting from the US through the making of deductible payments to foreign related parties.[150] The BEAT requires a US taxpayer to add back into its taxable income many kinds of payments, including interest expenses, some royalties and some service-fee payments made to related foreign persons. A 10 per cent tax is then computed on the expanded taxable income, and if that amount exceeds the taxpayer's regular tax liability the 10 per cent tax is imposed instead of the regular tax.[151] The BEAT therefore operates as a form of minimum tax on companies engaged in cross-border business in the United States.

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[149] See generally Wasimi et al. (2017).

[150] 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 (2017: 653-660).

[151] The tax is phased in, with a 5% rate applying in 2018. The rate is scheduled to rise to 12.5% in 2025.

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 US. 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 transfer pricing rules and 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 US Congress that transfer pricing rules and limitations on interest deductions are not in themselves sufficient to limit base erosion from the US to acceptable levels, but that an additional back-up is needed to strengthen those rules.

As an economic matter, the US 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 more beholden than the US to pressures of tax competition, may be hesitant to follow the US example for fear of suppressing inbound investment. Moreover, the US BEAT is administratively demanding, counselling against its application in lower-income countries without substantial modification. Nevertheless, the new tax is intriguing. Chapter 5 will discuss how a minimum tax overlay that is administratively simpler than the US 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 towards corporate tax avoidance in the aftermath of the 2008 financial crisis. In response to this political pressure, statements from 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.[152] In particular, in emphasising 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

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[152] The OECD's 2013 Action Plan (OECD 2013b: 14) declared: '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, (G-20 2013: para 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 minimise 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'.

tenets of arm's-length transfer pricing rules, under which groups are able to steer income towards affiliates in zero- and low-tax countries through intragroup contracts, even when the affiliates perform little if any physical business activity (see earlier section of this chapter on the new control of risk test). 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.[153] Popular political pressure 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 has long stood at the centre of a global political equilibrium under which companies' effective tax rates are constrained in practice at levels significantly below the rates stated in countries' tax statutes.

Even in view of the political pressure that arose from the 2008 crisis, upsetting this equilibrium in favour 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 a modest extent. The decision of whether to adopt these measures, and how vigorously to enforce them, is left to each country. To date, it appears that the world's wealthier countries, which 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 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, possibly strengthened

[153] cf. generally Rixen (2010).

CFC rules under the EU's Anti-Tax Avoidance Directive and the US GILTI tax (especially if its overall approach is adopted by additional capital-exporting countries) – might have the spillover effect of mitigating the pressure of base erosion on lower-income countries. Similarly, revised transfer pricing rules around the world, modelled on the OECD's new control-of-risk test, might reduce global demand for BEPS-style tax planning, thereby reducing base erosion pressure on lower-income countries. Efforts by the EU to discourage the use of EU countries as zero- or low-tax jurisdictions could also 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 US 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, it is likely that if lower-income countries are to raise corporate tax revenue 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.

Chapter 5

A corporate tax policy agenda for lower-income countries

Introduction

In the preceding four chapters of this book, I have sought to explore: (i) the economic and political roots of base erosion and profit shifting in lower-income countries and (ii) the recent (and continuing) efforts of the OECD and other international organisations to redress the problem, especially in connection with the BEPS studies. Based on this analysis, I offer in this chapter suggestions for policy initiatives that seem especially promising for lower-income countries. These include some measures recommended by the BEPS studies and others that are outside their scope.

In particular, this chapter explores the following options:

1) incremental improvements to transfer pricing administration, including modifications to current practices for selecting comparables, the possible use of transfer pricing safe harbours, and capacity building to increase audit coverage of multinational companies;
2) limitations on interest deductions;
3) modifications to countries' tax treaty policies to prevent treaty-shopping;
4) a policy instrument that the BEPS reports do not address, but which is already used by some developing countries around the world – alternative corporate minimum taxes based on taxpayers' gross revenue (turnover); and
5) for hard-to-tax industries, greater use of tax instruments based on gross revenue rather than net income, such as carefully structured royalties in the area of natural resource taxation, and excise taxes in industries like telecommunications and electronic commerce.

Improvements to transfer pricing methods and practices

Simplifications relating to searches for comparables

After the publication of the BEPS reports, in 2016 the Platform for Collaboration on Tax (PCT), a joint undertaking of the OECD, World Bank, IMF and UN,[154] published a *Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses* (PCT 2017). The Toolkit responds to complaints by tax administrators that the standards for selecting comparables under the OECD's transfer pricing methods are unrealistically restrictive, preventing tax inspectors from persuasively supporting arguments that locally operating companies are not earning sufficient levels of income under the arm's-length standard.[155] The Toolkit discusses various ways in

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[154] See generally OECD (2016b).

[155] The PCT summarises the tax administrations' concerns in the following language:

> 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 license from database providers. However, even putting aside the financial cost of acquiring access to such databases, challenges for developing country tax

which tax administrations might modify their practices with respect to the selection and analysis of comparables to improve their revenue recovery from transfer pricing examinations.

Based on my experience as a practitioner, I am confident the Toolkit is correct in identifying difficulties in locating usable comparables as a central and pervasive problem in transfer pricing enforcement. In practice, as described in Chapter 3, the problem often arises under a particular transfer pricing method that the OECD incorporated in its Guidelines in 1995, the transactional net margin method (TNMM). This is the transfer pricing method that tax administrations in lower-income countries often use in trying to test whether members of multinational groups operating in their jurisdiction are earning reasonable, arm's-length levels of income, as opposed to shifting income excessively in BEPS-style planning structures.

As described in Chapter 3, the drafters of the OECD *Transfer Pricing Guidelines* in the 1990s were concerned that tax inspectors might apply the TNMM against inbound investors in an automatic fashion, essentially requiring minimum levels of taxable income with insufficient regard to the facts and circumstances of the taxpayer under examination. In an effort to prevent this, the drafters included language requiring that tax administrations apply the TNMM only after an exhaustive factual study of the taxpayer under examination (often called a functional analysis), and the identification of comparable companies that are closely similar to the taxpayer.[156]

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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.

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. In response to this challenge and under a mandate from the Development Working Group of the G20, the Platform for Collaboration on Tax (PCT) - a joint initiative of the IMF, OECD, UN, and World Bank Group - has developed a toolkit to assist tax administrations of developing countries (PCT 2017: 12).

156 A flavour of the level of detailed inquiry that the OECD Guidelines expect of tax administrations is provided in the current (2017) version (OECD 2017b paras 1.34 and 1.35):

1.34 The typical process of identifying the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations requires a broad-based understanding of the industry sector in which the MNE group operates (e.g. mining, pharmaceutical, luxury goods) and of the factors affecting the performance of any business operating in that sector. The understanding is derived from an overview of the particular MNE group which outlines how the MNE group responds to the factors affecting performance in the sector, including its business strategies, markets, products, its supply chain, and the key functions performed, material assets used, and important risks assumed. This information is likely to be included as part of the master file as described in Chapter V in support of a taxpayer' analysis of its transfer pricing, and provides useful context in which the commercial or financial relations between members of the MNE group can be considered.

1.35 The process then narrows to identify how each MNE within that MNE group operates, and provides an analysis of what each MNE does (e.g. a production company, a sales company) and identifies its commercial or financial relations with associated enterprises as expressed in transactions between them. The accurate delineation of the actual transaction or transactions between the associated enterprises requires analysis of the economically relevant characteristics of the transaction. These economically relevant characteristics consist of the conditions of the transaction and the economically relevant circumstances in which the transaction takes place. The application of the arm's length principle depends on determining the conditions that independent parties would have agreed in comparable transactions in comparable circumstances. Before making comparisons with uncontrolled transactions, it is therefore vital to identify the economically relevant characteristics of the commercial or financial relations as expressed in the controlled transaction.

These requirements have raised two serious problems for tax auditors. First, the level of detailed factual analysis that the OECD Guidelines require is beyond the budgetary and personnel capacity of even well-resourced revenue agencies, and in practice tax examiners must typically conduct analyses that are far more perfunctory than the Guidelines purport to require. Second, the standard of similarity that the OECD Guidelines require for the selection of comparables is unrealistically demanding. Even after extensive combing through available financial databases examiners typically can identify a very few companies (in my experience, often less than 10) that are plausibly comparable to the taxpayer under examination. The resulting sample of, say, five to ten approximate comparables is much fewer than necessary under standards of reasonable statistical practice to offer a persuasive indication of the 'true' arm's-length level of income of the taxpayer under examination.[157]

At best, the kinds of comparables examinations performed in practice can pin the taxpayer's arm's-length profit level within a very wide range – for example, between a net operating margin of 2 and 8 per cent. This would mean that, for a taxpayer with $100 million of sales, the arm's length range of income might be found anywhere between $2 million and $8 million. Arm's length ranges this broad are of limited use to tax administrations in seeking to enforce reasonable levels of taxable income for locally operating subsidiaries of multinational groups. Accordingly, TNMM has not served as an effective enforcement tool even in relatively wealthy countries, and the problems appear to be especially serious in developing countries.

The Toolkit recommends several ways tax administrations might improve the performance of TNMM by expanding the pool of acceptable comparables. For example, tax administrations might accept comparables located in countries other than their own, making adjustments for differences in prevailing economic conditions (PCT 2017: 57-60); or they might accept comparables with less functional similarity to the taxpayer under examination than has been considered necessary in the past (PCT 2017: 47-48). The Toolkit even mentions the adoption of transfer pricing regimes similar to Brazil's as a possibility to be evaluated, under which margins to be used for transfer pricing enforcement are not generated through case-by-case searches for comparables, but are instead prescribed by fiat by the tax administration (PCT 2017: 75-76).

These suggestions of the Toolkit are intriguing. I have little doubt that adding flexibility to the identification of comparables could improve the performance of TNMM as a tax enforcement tool. Broadening the definition of

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Detailed instructions for implementing these principles occupy many additional paragraphs of the Guidelines.

157 As mentioned in Chapter 4, the OECD *Transfer Pricing Guidelines* (OECD 2017b para 3.57) point out that in cases of relatively inexact comparables, '*if the range includes a sizeable number of observations*, statistical tools that take account of central tendency to narrow the range (e.g. the interquartile range or other percentiles) might help to enhance the reliability of the analysis' (emphasis added). The PCT Toolkit also cautions that large sample sizes are necessary for proper application of statistical techniques in determining arm's-length ranges (PCT 2017: 61, 140).

comparability, however, would challenge the implicit political settlement from 1995 that tax inspectors should have the capability to make tax adjustments under TNMM only in cases of exceptional non-compliance. Even if one or more lower-income country governments were willing politically to adopt a standard of comparability that is more permissive than that applied generally around the world today, taxpayers might resist the new approach vigorously in tax audits, arguing with some justification that the new permissiveness departs from the arm's-length principle as envisioned by the drafters of the 1995 Guidelines. Tax inspectors' determinations might be overturned in administrative or judicial appeals, or government officials might feel compelled to intervene in favour of taxpayers, especially those that play large and visible roles in the local economy.

This is not to say that research aimed at widening the pool of comparables under TNMM is not desirable. The potential revenue benefits from successfully easing the barriers to large-scale and effective application of TNMM could be considerable. Nevertheless, the effort should be pursued with recognition of the political resistance, both explicit and tacit, that it is likely to encounter.

Transfer pricing safe harbours

The PCT recommends that developing country governments consider adopting transfer pricing safe harbours as part of their efforts to improve the performance of TNMM.[158] Under a programme of safe harbours, the tax authority prescribes minimum operating margins for different kinds of businesses (e.g. distributors, manufacturers and providers of various kinds of services, like the operation of call centres or the performance of research and development). Taxpayers that report incomes of at least the safe harbour level are protected from transfer pricing examination (except to the extent needed to verify the taxpayer's compliance with the safe harbour).[159] The hope is that taxpayers will find it worthwhile to comply with the safe harbours, rather than taking more taxpayer-favourable positions on their returns and facing the cost and inconvenience of a detailed audit, as well as the risk of a tax adjustment and possible penalties.

A safe harbour regime requires compromise on the part of both the taxpayer and the tax administration. The taxpayer voluntarily reports a relatively high level of income (perhaps higher than the taxpayer believes is necessary under the arm's-length standard). The government specifies required safe harbour levels somewhat lower than it might seek to insist upon in the course of a tax audit. Through this compromise, both the taxpayer and the government are relieved of the costs and uncertainty of transfer pricing audits.

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158 Transfer pricing safe harbours are described generally in Chapter 4 of this book. The PCT Toolkit also discusses safe harbours (PCT 2017: 69-73).

159 e.g. a country's tax administration might provide that so long as a local distributor of consumer goods, on behalf of a multinational group, earns a net operating margin of at least x per cent, the distributor will be immune from transfer pricing examination other than as might be necessary to verify compliance with the safe harbour.

I believe safe harbours can provide benefits in countries of all levels of economic development, especially in developing countries where tax administration resources tend to be very constrained.[160] For this reason, I welcomed the OECD's decision in 2012 to end its prior opposition to the use of safe harbours. To date, however, transfer pricing safe harbours have not fulfilled the promise that I and others perceive in them. I am only aware of one country that has implemented a comprehensive system of safe harbour margins under TNMM – India, in 2013.[161] Few taxpayers, however, took advantage of the Indian safe harbour, apparently because taxpayers perceived the safe harbour margins as unrealistically high. In June 2017, India issued revised safe harbour rules with lower margins, but it is too soon to know whether taxpayer use of the system will increase.

As the Indian experience demonstrates, a barrier to the success of safe harbours is the tendency of taxpayers who challenge government positions in transfer pricing audits to achieve favourable resolutions. Statistics on transfer pricing audits in the US illustrate this phenomenon. In 1995, a US congressional report determined that on average less than 20 per cent of amounts that examiners proposed as adjustments in transfer pricing audits were upheld following administrative appeals (and litigation if needed) (US General Accounting Office 1995). During the subsequent two decades, although the US tax administration devoted substantial resources to improving transfer pricing administration, the situation did not change. A 2016 report by the US Treasury's Inspector General reported that the 20 per cent sustention ratio had remained virtually constant (US Treasury Inspector General for Tax Administration 2016). There is little reason to believe that the situation with respect to transfer pricing examinations is materially different outside the US. All countries that subscribe to the OECD Guidelines are beholden to the same indeterminate transfer pricing methods, which lead tax examiners to propose adjustments that cannot be sustained.

This situation poses a substantial challenge to the successful design and implementation of safe harbours. The root of the problem is that there tends to be a wide gap between the levels of income that tax auditors and taxpayers believe to be arm's length. Safe harbour income levels prescribed by tax administrations may therefore be too high to attract much taxpayer participation. For transfer pricing safe harbours to be effective, tax administrations need to be willing to prescribe safe harbour income levels closer to the levels that taxpayers can realistically expect to prevail in an audit.

This does not mean that the safe harbour income levels need to be as low as those on which taxpayers tend to prevail in audits. Taxpayers will probably agree to abide by safe harbour levels that are somewhat higher than the

160 e.g. see Durst and Culbertson (2003: 124-127, 132-133); Durst (2012).

161 See generally news analysis of KPMG India (2017). See generally the discussions of experience to date with safe harbours in Collier and Andrus (2017: 269-270) and Lewis (2017). It should be mentioned in addition that Mexico has in place a safe harbour regime for transfer pricing with respect to *maquiladoras*, which are regulated manufacturing subsidiaries of multinational groups. See UN (2017: section D.4.9).

results they believe likely to be sustainable on audit, as a reasonable trade-off for avoiding the cost and uncertainty of the examination process. Successful safe harbours, however, will need to incorporate prescribed income levels that are reasonably close to taxpayer expectations of what constitutes a fair arm's-length result. To date, no country appears to have succeeded in designing a safe harbour regime with margins high enough to satisfy the expectations of the tax administration, but low enough to invite widespread taxpayer participation. For safe harbour regimes to succeed, this gap will need to be narrowed.

At least in theory, it should be possible to identify safe harbour margins that viably balance the expectations of taxpayers and tax administrations. Safe harbour margins set at this kind of optimal level should generate additional tax revenue, while at the same time conserving tax administration resources and according enhanced certainty of result to all participants in the system. Experience to date suggests, however, that progress towards these kinds of balanced safe harbours may be both difficult and slow. Given the potential benefits of safe harbour regimes, especially in developing countries, efforts to develop workable safe harbours should continue. Policymakers should recognise, however, that safe harbours are unlikely to provide a comprehensive solution to the difficulties of transfer pricing administration, at least for the foreseeable future.

Capacity building in transfer pricing administration

For years, international organisations have offered instruction and other technical assistance to developing country tax administrations to increase the skill levels of tax inspectors in applying OECD transfer pricing methods.[162] I believe it is important, as an initial matter in considering this topic, to recognise the limitations of capacity building, in and of itself, as a means of improving the performance of transfer pricing administration. Even tax administrations with a high level of training and experience encounter serious difficulties in applying the available transfer pricing methods. Problems relating to the identification of comparables, and the need to perform extensive factual examinations, affect even the most highly trained transfer pricing examiners. There is even a danger that an excessive focus on capacity building may divert attention and resources from needed substantive improvements to current transfer pricing rules.

Despite these concerns, however, I believe that capacity building, even under current transfer pricing rules, can be cost-effective in many cases. This is especially likely to be true to the extent the capacity building leads to more extensive audit coverage of large taxpayers. Owing to the vagaries of existing transfer pricing methods, the amounts recovered in examinations may be substantially lower than the original assessments sought by the examiners. Nevertheless, the amounts recovered can be significant, and on

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[162] For an overview of technical assistance efforts by international organisations, including capacity building in transfer pricing administration, see PCT (2016).

average the revenue raised from expanded audit coverage could be substantial.

Tax Inspectors Without Borders (TIWB), a joint initiative of the OECD and United Nations, has reported significant revenue recovery from some of their capacity-building efforts to date (Tax Inspectors Without Borders 2018). These reports are somewhat anecdotal. It would be useful for TIWB to provide more details of the particular kind of audits and audit techniques that have generated the increased revenue. Nevertheless, it is reasonable to expect that if capacity-building efforts generate higher audit coverage, especially of relatively large taxpayers, additional revenue is likely to result. Accordingly, high-quality capacity-building efforts – efforts that lead directly to higher audit coverage – are likely to be cost-effective for the foreseeable future, even if the transfer pricing methods available to tax administration personnel remain flawed.

An important possible impediment to successful capacity building consists of fear, on the part of host country governments, of alienating inbound investors. The PCT observes, ‘An indispensable prerequisite to improving tax capacity is enthusiastic country commitment’ (PCT 2016: 3). Even overt conflict between those providing technical assistance and the governments they are supposed to be assisting is not unknown.[163] It is inevitable that political aversion to expanded tax enforcement will in some and perhaps many circumstances pose a challenge to successful capacity building. The potential benefits of capacity building, however, especially when those efforts lead to enhanced audit coverage, suggest that in many cases efforts should be cost-effective, in terms of revenue raised, despite the possibility of political ambivalence on the part of host-country governments.

Limitations on interest deductions

Chapter 4 described the OECD’s BEPS recommendation that countries adopt limitations on companies’ deductions for their net interest expenses, generally limiting deductions to no more than 30 per cent of a company’s earnings before interest, taxes, depreciation, and amortisation (EBITDA). This recommendation is based on rules that first Germany (in 2007), and later some additional countries, had implemented to protect their tax bases even before the OECD’s BEPS process had begun.

As discussed in Chapter 3, it is essential that a country’s base-protection measures include limitations on interest expenses in addition to transfer pricing rules. Transfer pricing rules under the OECD Guidelines generally seek to place a floor, at an arm’s-length level, on a taxpayer’s operating

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[163] The PCT acknowledges the presence of this conflict in some instances, and reports mixed results in addressing it: ‘In one country, the Ministry of Finance and the Revenue Agency could not agree on the implementation plan for a WBG project, leading to its failure. In another, the Tax Department refused even to meet with the IMF/WBG team that was diagnosing the situation. Ultimately, in a show of real commitment, the Prime Minister established an entirely new revenue agency - with a much smaller staff and fewer decentralized offices - which had been identified as a locus of much corruption. The ministry and new agency worked enthusiastically together to implement the CD project, contributing fundamentally to its success’ (PCT 2016: 18).

income.[164] Operating income is defined as all of a company's revenue, minus the cost of goods sold and all other expenses (like salaries and administrative expenses) except, generally, interest expense. That is, by accounting convention, a company's interest expenses are generally not considered operating expenses. OECD transfer pricing methods, therefore, generally do not prevent companies from reducing their income to a low level by paying interest on loans from related parties.

An EBITDA-based limitation along the lines recommended by the OECD, as described in Chapter 4, appears to represent a balanced approach to the problem of interest deductions. The data analysed by the OECD suggests that for most companies, a 30 per cent-of-EBITDA limitation should be in excess of the interest deductions needed for bona fide business purposes.[165] Nevertheless, the data indicates that many companies have been deducting interest substantially in excess of the 30 per cent level, so a limitation at that level should result in revenue gains.[166] Administratively, an EBITDA-based limit on interest deductions is relatively simple. While some complicated questions are raised (e.g. whether certain payments that are not labelled as interest nevertheless are 'the economic equivalent of interest'[167]), precedents for handling these questions already exist in a number of countries. Thus, implementation of the rules recommended by the OECD generally should be feasible for developing countries, especially with technical assistance from countries experienced in the implementation of similar provisions.

To date, however, lower-income countries appear to have been reluctant to adopt EBITDA-based interest limitations as recommended by the OECD. To some extent this undoubtedly reflects lower-income countries' generally heightened sense of vulnerability to tax competition. In this connection, a few large multinationals can account for relatively large proportions of the total corporate tax base in many lower-income countries. If one or more of these companies is currently deducting large amounts of interest in connection with BEPS-style tax planning, a legislative proposal to tighten limitations on interest expense becomes in effect a negotiation with these taxpayers, who may possess substantial political leverage.

Despite the apparent political constraints, EBITDA-based limits on interest deductions offer significant revenue potential for lower-income countries, and adopting these kinds of limits should be seen as an important policy goal – even if progress towards that goal may be gradual and uneven across countries. Technical assistance in estimating the potential revenue gains, using data from filed corporate tax returns, might be especially helpful to lower-income countries. Technical assistance of this kind could provide benefits even outside the field of interest limitations. It could provide an

164 e.g. see, OECD (2017b: para. 2.68).

165 See OECD (2015b: 87-89).

166 Preliminary results from adoption of a 30 per cent limitation by Finland support the expectation of revenue gains. See Harju et al. (2017).

167 See OECD (2015b: 29-31).

opportunity to diagnose the need for better collection and maintenance of tax return data – which is necessary not only to evaluate potential policy initiatives, but also to monitor revenue-agency performance.

Efforts to reduce treaty shopping

As described in Chapter 4, countries at all levels of economic development have entered into a network of thousands of bilateral income tax treaties. Among the many provisions typically contained in tax treaties are agreements by the parties to reduce, sometimes to zero, the withholding taxes that countries impose on outbound payments of dividends, interest, royalties and sometimes service fees. As discussed in Chapter 4, (i) the reduction or elimination of withholding taxes under treaties is inappropriate with respect to cross-border payments made in connection with BEPS-style tax avoidance plans, and (ii) the problem of inappropriate reductions or exemptions of withholding taxes is greatly exacerbated by the problem of treaty shopping.

The OECD has advised in its BEPS recommendations that countries include in their treaties provisions designed to deny benefits of the treaties, like exemptions from withholding taxes, when corporate groups use the treaties under conduit arrangements. As discussed in Chapter 4, however, the OECD's recommended standards for identifying improper conduit arrangements are subjective, and will probably be difficult for tax administrations to enforce. Therefore, even if a large number of lower-income countries adopt the OECD anti-treaty-shopping recommendations (and they may feel constrained from doing so by the pressure of tax competition), the resulting reduction in profit shifting may be relatively small.

In theory, lower-income countries could gain protection from treaty shopping simply by refraining from entering into tax treaties with countries that serve as conduits, and even terminating existing treaties to which they are already party. Indeed, countries have withdrawn from treaties that appeared to be used to facilitate excessive tax reduction in a few recent instances.[168] It is tempting to envision a coordinated refusal of lower-income countries to maintain tax treaties with countries that allow the treaties to be used in BEPS-style planning arrangements.

There are, however, two substantial barriers – one political and the other technical – to a 'just-say-no' policy for lower-income countries against maintaining tax treaties with zero- or low-tax jurisdictions. Politically, the treaties to which lower-income countries are already party may have been negotiated at the behest of particular investors. In general, the pressure of tax competition that induced low-income countries to agree to these treaties is unlikely to have disappeared. In many situations countries may not be able to garner the political will to terminate the treaties.

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168 For a discussion of circumstances in which developing countries have sought renegotiation of, or revoked, existing income tax treaties, see Hearson (2015: 26-28).

From a technical standpoint, refraining from entering into tax treaties would leave lower-income countries with an acute dilemma in the design of withholding tax rules, which it would be difficult to solve effectively. The basic problem is that withholding taxes are sensible for lower-income countries from a policy standpoint in some circumstances, but not in others. When deductible payments are made from a country in connection with BEPS-style tax avoidance plans, the withholding taxes compensate for tax revenue that the country is losing through artificially contrived deductions. When taxpayers are not engaged in BEPS-style planning, however, the deductions they take for outbound payments of interest, royalties and service fees may well represent legitimate costs of doing business, and to deny the benefits of these deductions could result in excessive levels of taxation.

In theory, a lower-income country might solve this problem by enacting legislation that imposes withholding taxes only on payments being made to recipients in zero- or low-tax countries. Legislation of this kind, however, would probably encounter the same kind of political resistance from investors as countries' attempts to terminate existing treaties. In addition, drafting the legislation would involve politically difficult definitional issues, including notably the definition of the zero- or low-tax countries to which the rule is to apply.

Further, even if legislation imposing withholding taxes only on payments to designated zero- and low-tax countries could be enacted, enforcement of the law would confront difficult practical challenges. Among the most serious would be the possibility of back-to-back conduit arrangements by members of corporate groups. By a virtually unlimited variety of possible conduit arrangements, taxpayers can channel through normally high-tax countries payments that ultimately are destined for companies in zero- or low-tax jurisdictions. For example, a loan might be made from a group member in Country L, a zero- or low-tax country, to another group member in Country A, which imposes corporate income tax at normal rates. The company in Country A might then on-lend the amount of the loan to a group member operating in Country B, another country with normal tax rates. Interest paid from Country B would theoretically be taxable in Country A, but the interest would be deducted when paid from Country A to Country H, thus zeroing out the group's Country A tax liability.[169] The net result is the same as if the group member in Country B had borrowed money directly from Country L. It would be difficult, if not impossible, for lower-income countries to track payments made from their jurisdictions to determine whether the payments are ultimately bound for zero- or low-tax countries under back-to-back arrangements.

Overall, therefore, the difficult problem of avoidance of withholding taxes through treaty shopping remains largely unresolved by the BEPS project. As discussed in Chapter 4, the OECD's new multilateral instrument (MLI) offers

[169] See e.g. Kandev (2017).

some potential benefits, but is unlikely to represent anything approaching a full solution to the problem of treaty shopping in lower-income countries.[170] Moreover, countries appear not to have available unilateral legislative solutions that are likely to be both politically and technically viable.

All things considered, the best policy position available to lower-income countries is probably to: (i) participate in the OECD's MLI project, but to do so with caution, recognising that, at best, the project can only provide partial protection against treaty shopping; (ii) consider terminating particular treaties that appear to be facilitating large volumes of tax avoidance (although there is likely to be political resistance to any movements towards termination); and (iii) avoid entering into new treaties unless strong protection is included against treaty shopping. Even countries that take all these steps, however, are likely to experience continuing difficulties in attempting to control BEPS through the use of withholding taxes.

The alternative corporate minimum tax (ACMT)

Structure and basic appeal of an ACMT based on turnover

An alternative corporate minimum tax (ACMT) based on a company's turnover can afford countries some degree of control over tax-base erosion. In basic structure, a turnover-based ACMT is relatively simple. Assume, for example, that a country imposes its regular corporate income tax at a rate of 30 per cent, and backs up the regular tax with an alternative corporate minimum tax of 1 per cent of turnover. Assume further that a particular taxpayer has turnover during a taxable year of $10 million, but because of high deductions for interest, royalties and service fees paid to related parties in zero- or low-tax countries, the taxpayer's net taxable income is only $200,000. The taxpayer therefore faces a regular corporate income tax liability of 30 per cent of $200,000, or $60,000. The taxpayer's alternative minimum tax liability, however, is 1 per cent of $10 million, or $100,000. Because the ACMT liability is larger than the regular tax amount, the ACMT liability becomes the taxpayer's corporate tax obligation for the year.

The primary appeal of a turnover-based ACMT is ease of enforcement. A taxpayer's liability under a turnover-based tax is unaffected by the kinds of tax deduction for interest, royalties and service fees that fuel BEPS planning structures. The tax administration therefore does not need to struggle with the limitations of existing transfer pricing methods in attempting to control these deductions. (It is particularly noteworthy that a turnover-based ACMT can compensate for the inability of transfer pricing methods, as described above in this chapter, to control taxpayers' interest deductions.)

Further, in addition to being unaffected by a taxpayer's deductions, a turnover-based ACMT is much less vulnerable than regular income tax to

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[170] In particular, as discussed in Chapter 4, the MLI affords countries the option to elect anti-treaty-shopping provisions based on a difficult-to-enforce 'principal purpose' test. Moreover, lower-income countries may encounter political difficulty in applying the MLI to some or all of their existing tax treaties.

another important kind of BEPS-style tax avoidance. As described in Chapter 2, this typically involves the below-market pricing of natural resource and agricultural products sold to related purchasing companies by corporate subsidiaries operating within a country.[171] The turnover-based ACMT therefore serves effectively as a backstop against BEPS-style tax avoidance of all kinds, not only avoidance through the overstatement of deductions.

ACMTs are already fairly widespread among developing countries – although many countries base their ACMTs on measures other than turnover, including corporate assets and gross income (turnover minus cost of goods sold). (Basing an ACMT on assets rather than turnover arguably causes the tax to correlate better with a taxpayer's net income,[172] but a turnover-based tax should be much easier to administer. Basing an ACMT on gross income rather than turnover would appear to introduce administrative difficulties related to the definition of cost of goods sold.) A 2015 article reports use of an ACMT in some form by 36 countries.[173] Based on review of national tax summaries in EY's *Worldwide Corporate Tax Guide* (EY 2017), I have identified 19 countries that appear to impose an ACMT that is based either entirely or partially on turnover.[174] The details of the taxes vary substantially from country to country. For example, as reported in the EY Guide, some countries in this group exempt certain taxpayers, like start-up companies, from the ACMT. In a few countries the amount of the minimum tax is capped at what appears to be a low level.[175]

Although, as discussed below, the turnover-based ACMT is worthy of much more research than has been conducted to date, the limited information that is publicly available suggests that where the tax is applied it is likely to account for an important component of corporate tax revenue. An analysis of a 0.5 per cent turnover-based ACMT in Pakistan found that over half of firms were liable for the tax, and that it accounted for more than half of corporate tax receipts (Best et al. 2015: 1331-1332). An IMF 2016 study of the tax

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171 To see the relative immunity of a turnover-based ACMT to this kind of tax avoidance, consider a mining subsidiary in Country X that produces for export and sells to a related purchaser, during a taxable year, ore with a true fair market of $10 million. Assume further that the subsidiary's total deductible expenses, including interest, for the year are $9.6 million, so that its properly measured net income is $400,000. Finally, assume that Country X imposes a regular corporate income tax of 25 per cent and backs this tax up with an ACMT of 1 per cent of turnover.

If the taxpayer accurately reports the value of the product that it exports, its regular income tax liability will be .25 x $400,000, or $100,000. The taxpayer's ACMT liability for the year will be .01 x $10 million, which also equals $100,000. It will not matter, therefore, whether the taxpayer pays the regular tax or ACMT.

Assume now, however, that the taxpayer reports a slightly below-market value for the ore that it sells, of $9.8 million. The taxpayer's ACMT liability for the year then decreases by 2%, from $100,000 to $98,000. The taxpayer's reported net income, however, is reduced from $400,000 to $200,000, and its regular tax liability is reduced by 50%, from $100,000 to $50,000. The regular tax liability is therefore far more sensitive to even a relatively small undervaluation of product sold than the turnover-based ACMT.

172 See generally Thuronyi (1996: 10-14) (generally expressing preference for asset-based approach).

173 The countries include Argentina, Bolivia, Cambodia, Cameroon, Chad, Colombia, Democratic Republic of the Congo, Ecuador, El Salvador, Equatorial Guinea, Gabon, Guatemala, Guinea, Honduras, India, Ivory Coast, Kenya, Laos, Madagascar, Malawi, Mauritania, Mexico, Morocco, Nigeria, Pakistan, Panama, the Philippines, Puerto Rico, Republic of the Congo, Rwanda, Senegal, Taiwan, Tanzania, Trinidad and Tobago, and Tunisia (Best et al. 2015).

174 Cambodia, Cameroon, Chad, Democratic Republic of the Congo, Republic of the Congo, Cote d'Ivoire, Equitorial Guinea, Gabon, Guinea, Guyana, Hungary, Madagascar, Mauritania, Morocco, Nigeria, Pakistan, Senegal, Tanzania, and Tunisia. This list may not be exhaustive.

175 Brief descriptions of the minimum tax regimes in each of the 19 countries from the EY summary are provided in an Appendix to this chapter.

system in Mali reports that the country's 1 per cent turnover-based ACMT was paid by 36 per cent of corporate taxpayers in 2013, and accounted for 11.8 per cent of corporate tax revenue (IMF 2016: 15).

The relatively high revenue yield of a turnover-based ACMT, and the high percentage of taxpayers affected by the tax, are not surprising. Even at a rate of 1 per cent, an ACMT based on turnover should in many cases generate tax liabilities larger than the regular income tax liabilities of companies that make even relatively restrained use of BEPS-style tax avoidance techniques.[176] This suggests that the rate of an ACMT might be calibrated to yield revenue that is higher than that raised under current circumstances, in which BEPS is largely unconstrained, but not so high as to place politically untenable tax loads on inbound investors.

An argument typically raised against turnover-based taxes, including ACMTs, is that a turnover-based tax can undesirably increase investors' perceptions of financial risk. Under a turnover-based tax, a company faces the possibility of being subject to taxation even if the company incurs a loss, or earns only sub-normal profits. In theory this risk, which is not posed by a net-income-based tax, should to some extent operate as a disincentive to investment. This disincentive undoubtedly involves some social cost, but the higher tax collection made possible by the minimum tax provides offsetting social benefits. It seems quite plausible that especially in lower-income countries, to the extent any disincentive to investment is raised under a turnover-based minimum tax, its social detriment would be outweighed by the advantages of more adequate corporate tax revenue.[177]

Another concern is that a turnover-based corporate tax would operate similarly to a consumption tax on the goods or services sold by the corporation, and therefore might be more regressive in its distributional effects than a tax based on corporate net income. Again, however, the low rate at which a turnover-based ACMT is likely to be applied, contrasted with the much higher rate typical of VAT, suggests that any regressivity introduced to a tax system by an ACMT would probably be limited compared to the social benefits made available from the additional revenue raised.

Politically, an ACMT, as a broad measure that targets tax avoidance of a number of different kinds, should pose an advantage over more narrowly directed measures like limitations on interest deductions, royalties or service charges. Narrowly targeted restrictions on deductions are likely to be opposed especially by companies that make intensive use of the particular

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176 e.g. consider a limited-risk beverage distribution subsidiary of a multinational group in a lower-income country, which realises $100 million of gross revenue. After deducting its cost of goods sold as well as royalties and service fees paid to an affiliate in a zero- or low-tax country, the taxpayer reports on its income tax return a net operating margin of 3%, leaving net income of $3 million. Assume also that the subsidiary deducts interest at 30% of net operating income, or $900,000, so that taxable income is $2.1 million. If the corporate income tax rate is 30%, the taxpayer's regular corporate income tax liability is $630,000. The taxpayer's alternative corporate tax liability, 1% of turnover, is $1 million. As this amount is higher than the taxpayer's regular tax liability, the taxpayer is liable for the alternative minimum tax rather than the regular tax liability.

177 This is the fundamental argument of Best et al. (2015).

deduction being targeted. For example, companies that have historically made extensive use of zero- or low-tax lending companies may argue particularly strongly against the imposition of limitations on interest deductions. An ACMT, on the other hand, which seeks to limit base erosion regardless of the particular avoidance technique used by the taxpayer, may encounter fewer concentrated pockets of opposition.

Another potential advantage of an ACMT is that its relative administrative simplicity, and its tendency to avoid targeting particular taxpayer groups more than others, might lend itself well to internationally coordinated adoption, perhaps on a regional basis. Coordinated implementation of an ACMT might mitigate to some extent the pressure of tax competition that stands at the heart of base erosion and profit shifting, and thereby enhance prospects for the ACMT's successful performance. It may not be entirely unrealistic to see in the ACMT potential for establishing a norm of tax policymaking for lower-income countries, coordinated through regional tax compacts.[178] International agreement might extend to a commitment not to grant exemption from the minimum tax, even to taxpayers that are exempted from regular corporate taxation under tax holidays or other arrangements. Of course, the political feasibility of regionally coordinated ACMT policies remains to be determined, but it is a possibility worth exploring.

Historical lack of attention to ACMTs

Given the already fairly widespread use of the ACMT, and the obvious potential for the ACMT to address the kinds of avoidance that motivated the initiation of the BEPS process, it is striking that the minimum tax did not receive greater attention in the course of the BEPS studies. Early during the BEPS process, the IMF raised the potential benefits of AMCTs as a component of the effort to control base erosion in developing countries,[179] but there appears to have been no serious follow-up to the IMF's suggestion by the OECD or any other intergovernmental body.

Possibly the bluntness of the AMCT as an instrument for controlling tax avoidance placed it outside the political and intellectual boundaries of what the OECD might have been expected to explore during the BEPS process. A central implicit element of the historical international consensus is that tax authorities should accept the burden of measuring taxpayers' net income with a high degree of precision to prevent subjecting taxpayers to excessive

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[178] The West African Economic and Monetary Union (WAEMU) provides member countries with the option of including an ACMT in their tax systems. See IMF (2016: 13).

[179] A 2014 IMF staff report observes:

> One possible approach to bolstering the CIT [corporate income tax] base in developing countries is through some form of minimum tax (MT). An MT aims to protect revenue by charging tax on something - commonly turnover, book earnings or assets - that is less subject to manipulation than is taxable income, with overall tax payment then being the larger of liability under MT and under the standard CIT. Corporate MTs are already found in over 30 countries. Schemes differ quite widely, and can lead to considerable complexity and significant distortion: a charge on net assets, for instance, can reinforce debt bias, while one on gross assets may introduce distortions between firms with differing capital structures. Nonetheless, MTs have proved both useful and practicable in protecting domestic tax bases, and might also be addressed to combating aggressive international tax planning in relation to inward investment. They could, for example, address in a simplified, aggregate way the need for increased limitations on deductibility of certain cross border payments flowing from developing countries, that is seen by many observers (IMF 2014: 36).

taxation. Taxes based on turnover contradict this paradigm. Instead, by their structure, they appear to elevate the goal of raising revenue above that of ensuring corporate taxpayers' accurate measurement of their net income. The BEPS episode nevertheless suggests that some shifting of the historical priority, in the direction of certainty in raising public revenue, may be desirable in the interest of overall public welfare, especially in lower-income countries where the social benefits of enhanced corporate tax collection are likely to be especially pronounced.

The need for country-specific research

Not only did the BEPS process give little attention to the ACMT, but the scholarly tax literature seems not to have accorded it much detailed study and analysis. This may reflect that, from the standpoint of a tax theorist, the ACMT is a fairly uninteresting creature. It is not based on the intellectual model of optimal taxation that has dominated scholarly tax analysis since the 1970s. Recently, by analysing quantitatively the trade-off between precision and administrability that the ACMT represents, the work of Michael Best and others (Best et al. 2015) has not only forged new intellectual ground, but also ideally will encourage additional research on the minimum tax. This effect would be welcome, since a programme for expanding use of the ACMT in lower-income countries and elsewhere should be based on a larger body of empirical knowledge than is currently available.

Research should assess the historical performance of the ACMT, both quantitatively and qualitatively, on a country-by-country basis. For example, in countries that have the tax, what percentage of taxpayers are covered by it, and what percentage of revenue is attributable to it? Has the ACMT been the subject of political controversy? To what extent if any is exemption of the tax afforded to start-up companies, and how have any start-up exemptions performed in practice? Under what other circumstances are taxpayers exempted from the ACMT (e.g. are companies that are granted exemption from regular corporate tax also routinely exempted from the ACMT)? Answers to all these questions would provide essential practical guidance with respect to whether expanded use of corporate minimum taxes based on turnover is likely to be of significant fiscal benefit to lower-income countries.

Additional uses for revenue-based taxes

In exploring above the possible merits of an ACMT based on turnover, I described some important general advantages of taxes based on revenue instead of net income in preventing base erosion and profit shifting. No deductions are allowed under revenue-based taxes, so the taxes are immune from profit shifting through payment of interest, royalties and service fees. In addition, revenue-based taxes are much less affected than net-income levies by the undervaluation of sales revenue, for example in connection with purchasing company structures that might be used by natural resource extractors operating in lower-income countries.[180] There are economic disadvantages of revenue-based taxes, including the risk of imposing tax liabilities on investors even if the investors are not operating at a profit. Nevertheless, as argued above in connection with the ACMT, there may well be situations where the administrative advantages of revenue-based taxes outweigh their disadvantages.

In this discussion, I explore some important additional ways that countries around the world, including lower-income countries, regularly employ revenue-based levies to avoid the administrative shortcomings of net-income taxes. These include (i) greater weighting of taxation towards royalties in natural resource taxation and (ii) excise taxes for hard-to-tax industries like telecommunications, banking and insurance.

Natural resource royalties

The extraction of natural resources – both oil and gas and hard minerals – is very important to many developing countries, and revenue from extraction sometimes accounts for a large share of some countries' total government receipts.[181] Moreover, the natural resources beneath the surface of a country are typically owned by the country's government. When the government imposes a tax on a producer that removes and sells part of the country's endowment of non-renewable resources, the government acts, not only under its taxing power, but also as proprietary seller of resources on behalf of the country's people. This consideration places a special public policy premium on ensuring that taxation of natural resource producers in a country occurs effectively, and at a high enough level to reflect the full value of the resources that the government is in effect selling to the extractor.

Historically, governments have exacted revenue from natural resource producers in two basic forms.[182] One form is a royalty, usually expressed as a percentage of the fair market value of the product produced. So, for example, a royalty charged to an iron-mining company might be set at 10 per cent of the fair market value of each ton of iron ore produced. Royalties are in effect taxes imposed on a producer's revenue rather than its net income.

Royalties, however, can be seen as an economically blunt instrument for taxing natural resource producers, since they can be imposed on producers before they have even begun to realise profits from their extractive activities. This risk can discourage companies from investing in extractive projects. To counter this effect, it has been customary for many years not to tax natural resource producers only through royalties, but instead to apply a 'fiscal mix' consisting in part of royalties, and in part of taxes based on net income. The

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180 See footnote 20 and accompanying text.

181 e.g. in many petroleum-producing countries natural resource taxes account for well over half of government receipts; in Botswana mining revenue accounts for almost 50%, and in Guinea about 30%, of government receipts. See Daniel et al. (2017: 1, 2).

182 The ensuing discussion of natural resource taxation is highly simplified, and is intended to permit readers to gain a basic understanding of the topic in a very brief format. Those seeking more complete information should see the comprehensive treatment in Daniel et al. (2017). See also Durst (2017b: 1167).

net income taxes used might consist of the country's regular corporate income tax, or a special kind of income tax known as the resource rent tax (RRT). (Under an RRT, a resource producer is not taxed until the producer has earned a specified return on their capital investment in a project; the RRT is therefore seen as especially effective in mitigating investors' risk of premature taxation.[183]

The inclusion of income-based taxes, as well as royalties, in the typical fiscal mix for extractive projects has reduced disincentives to investment, but at the same time has introduced serious BEPS-related enforcement problems to natural resource taxation. Royalties, as a tax on revenue rather than net income, are immune from the kind of BEPS-style tax avoidance that involves deductions for interest expense, intellectual-property royalties and related-party service fees. In addition, royalties are much less sensitive than income taxes to the understatement of the fair market value of the product that is produced.[184] In contrast, income-based taxes are highly vulnerable to profit shifting through deductible payments. Natural resource projects can be heavily debt-financed, raising the possibility of large related-party interest deductions.[185] Natural resource producers also often incur large costs for technical services, equipment and supplies provided by related parties, all of which can involve BEPS-style profit shifting.

Plainly, a trade-off is presented between the use of royalties and income-based taxes in natural resource fiscal regimes. Income-based taxes pose less disincentive to investment, but are much more vulnerable than royalties to BEPS-style taxpayer avoidance. While views can differ, it is my impression that, historically, policy-making in the natural resource sector has tended to under-appreciate the revenue losses arising from tax avoidance, and therefore to give excessive relative weight to the risk-mitigating advantages of income-based taxation. It may well be appropriate for fiscal regimes to give greater weight to royalties than they tend to do today.[186]

In this connection it should be understood that it is possible to structure royalties so that they offer investors at least some of the risk mitigation afforded by income-based taxes. For example, the rate of a royalty might be

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183 For a discussion of RRTs, see Land (2010: 256).

184 See the numerical example in Section II.A of Durst (2017b).

The OECD's report on BEPS Actions 8-10 attempts to alleviate the problem of related-party purchasing companies by endorsing the use of a so-called sixth method in valuing natural resource and agricultural products for tax purposes. The sixth method accepts, as valid comparable selling price information, publicly available posted price data, e.g. the posted prices of particular grades of crude oil or metal ores - see OECD (2017b: para. 2.18-2.22). The sixth method, however, is likely to be of only limited use to tax authorities, since in many cases the valuation of natural resource product requires difficult adjustments to posted product prices for factors like variations in ore or petroleum quality, distance of the mine or well from the marketplace, and whether the product is being sold at spot or under long-term contracts. Also, the sixth method does not address the problem of verifying the appropriateness of deductions taken by natural resource producers for expenses like interest, technical service fees and the cost of equipment rented or purchased from related parties. Overall, despite acceptance of the sixth method, the problems of transfer pricing enforcement for natural resource producers remain largely unsolved. See also, e.g., Readhead (2018).

185 e.g. see IMF (2014: 20).

186 See Keen and Mullins (2017: 11, 34): '[The availability of tax avoidance] may … mean tilting the balance between profit-based taxes and royalties further towards the latter than might otherwise be the case, on the grounds that monitoring deductible costs is harder than monitoring revenues'.

set to vary with the volume of production from a mine or field, and with the price level of the product being produced.[187] A variable royalty of this kind should be correlated to some extent with the profitability of a project, reducing the risk of inappropriately high taxation. Variable royalties, however, remain based on revenue rather than net income, so they should remain relatively immune to BEPS-style avoidance. Overall, variable royalties might be seen as a useful middle ground between royalties and income-based taxes.

Other uses of revenue-based levies

Natural resource production is not the only important industry in lower-income countries for which effective enforcement under an income tax is exceptionally difficult. For example, mobile telephone service providers tend to play an important economic role in lower-income countries. The companies are typically members of multinational groups, and they engage in a large variety of transactions with other members of their multinational groups, including borrowing, the obtaining of technical services and the purchase of equipment. Over the years, many countries have responded to the difficulty of taxing telecommunications providers by applying excise taxes based on the purchase price of services rendered. Given the difficulty of applying income taxes to telecommunications providers, it seems inevitable that much of the taxation of the industry will need to consist of excise taxes.[188]

Other kinds of cross-border businesses that rely heavily on information and communications technology also pose problems of tax administration similar to those posed by mobile telephony. These include, for example, providers of software and consulting services online, internet service providers, sellers of goods using electronic commerce and social media sites. For these kinds of businesses it appears impossible, based on normal transfer pricing analysis, to determine satisfactorily how much income should properly be taxed in the country where services or goods are consumed, and how much should be taxed elsewhere. Currently, much income from these kinds of businesses apparently goes untaxed in countries at all levels of economic development.

In Action 1 of the BEPS project, the OECD conducted an extensive review of what it labelled ‘the tax challenges of the digital economy’. In large measure, the OECD’s Action 1 report, released in November 2015, can be characterised as an inconclusive study of whether the concepts of income taxation can satisfactorily be applied to digital businesses, or whether much of the tax burden of the digital economy must inevitably consist of revenue-based based taxes. The Action 1 report found no consensus on this question, but noted that countries could if they desired experiment individually with the use of special measures, including excise taxes in the digital field.

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187 See Clausing and Durst (2016: 803).
188 See generally Matheson and Petit (2017).

At the time of writing, vigorous debate persists among countries concerning possible approaches to taxing the digital economy.[189] This debate is not likely to be resolved through consensus in the near future. The industries that may be subjected to additional taxation wield considerable political power. Also, serious questions are raised concerning whether additional taxation might unduly discourage desirable innovation, as well as the extension of digital services within lower-income markets. It seems unavoidable, however, that if the international digital economy is going to be taxed successfully, much of the taxation will need to take the form of excise taxes or similar revenue-based levies.

The extension of the use of excise taxes will involve some costs. First, the economic burden of excise taxes probably falls relatively more heavily on consumers than corporate income tax. In addition, the targeting of excise taxes to particular industries but not others raises a danger of economic distortion.[190] But the fact remains that in a global economy increasingly characterised by the electronic dissemination of services and goods, greater use of gross revenue-based taxes by all countries, including lower-income countries, appears unavoidable.[191]

Conclusion

This chapter has described five different initiatives that offer lower-income countries realistic promise of greater control of base erosion and profit shifting:

1. improvements to transfer pricing rules and administrative practices, especially relating to the application of the transactional net margin method (TNMM);
2. EBITDA-based limitations on interest deductions, as recommended by the OECD’s BEPS Action 4 report;
3. actions to control treaty shopping and thereby prevent the inappropriate avoidance of withholding taxes;
4. expanded use by lower-income countries of an alternative corporate minimum tax based on turnover, as a base-protecting overlay on a country’s regular corporate income tax; and
5. greater weighting of royalties in natural resource fiscal mixes, and the use of excise taxes in hard-to-tax industries, especially in the digital sector.

All of these measures could, I believe, offer at least incremental revenue gains for lower-income countries, and in the aggregate the revenue protection afforded by these measures might be substantial.

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189 See, e.g., Johnston (2018b).

190 This concern might be seen as especially important where external benefits are seen from the development of particular industries, like the provision of internet services in low-income areas. On the other hand, where industries generate external costs instead of benefits, as in, say, the tobacco and alcohol industries, the use of excise taxes seems especially appropriate, as evidenced by the very wide application of tobacco and alcohol levies around the world. See Moore and Prichard (2017: 13).

191 See generally Durst (2015).

An important caution, however, is in order: none of these five measures against base erosion is discussed for the first time in this book. All these possible base-protection measures have been known to tax specialists for years, and in some instances they are already applied by countries in practice.

By and large, the fact that these measures are not used more extensively, especially by lower-income countries, does not reflect lack of technical expertise among tax policymakers and administrators. Instead, the barriers to greater protection of the corporate income tax base by lower-income countries are rooted in large measure in the political and economic pressures of tax competition.

For many years, investing multinationals have been eager to accept tax incentives, explicit or tacit, from countries at all levels of development. Governments, particularly those of lower-income countries, have in turn refrained from erecting formidable barriers to profit shifting, apparently fearing the loss of foreign direct investment. The result has been the familiar race to the bottom, with countries relinquishing a very large portion of their corporate tax base to BEPS-style tax planning. Changing this situation will require more than legal and technical capacity in corporate taxation. It also will require mitigation of the pressure of tax competition that led to, and has sustained, the large incidence of profit shifting from lower-income countries.

As discussed above, recent developments may to some extent be reducing the pressure of tax competition on lower-income countries. The reputational concerns of multinationals, for example, and enhanced CFC rules around the world (including, as described in Chapter 4, the new US GILTI tax), may be removing from multinational groups some of the incentive to shift income from lower-income countries. These kinds of developments around the world, however, are likely to result in only limited reduction in pressure for base erosion from lower-income countries. Additional policy actions seem necessary if corporate tax revenue is to be increased substantially closer to desirable levels.

I am convinced by the history of BEPS, and by the apparent continuing pervasiveness of tax competition, that as a political matter lower-income countries will not be able to construct adequate safeguards for their corporate tax base without some conscious assistance from multinational business interests. Today, as well as before the BEPS process, governments are unlikely to make a serious attempt to increase corporate tax revenue if they fear the cost is likely to be the diversion of inbound investment to competing jurisdictions. In particular, as discussed further in the next chapter, I believe that satisfactory progress towards desirable levels of corporate taxation in lower-income countries will require deliberate forbearance by multinational companies from fully exploiting the economic leverage that tax competition affords them. For example, multinational companies and their home-country governments might refrain from opposing, and even seek to facilitate, moderate base protection measures like low-rate ACMTs in countries that are willing to adopt them.

In proposing this kind of forbearance from tax competition, I realise that I am raising important questions relating to the appropriateness of corporate actors basing their behaviour on considerations other than the maximisation of after-tax profits. It is impossible, however, to avoid these issues if the topic of corporate taxation in lower-income countries is to be treated frankly and realistically. The bottom line is that substantial progress towards additional corporate tax revenue in lower-income countries will require mitigation of current pressure of tax competition, and there is no realistic alternative to some degree of corporate forbearance if that mitigation is to be achieved. The next and final chapter of this book will attempt to address this topic, in the course of what I hope is a pragmatic discussion of: (i) the ethical challenges posed by the problem of corporate taxation in lower-income countries; and (ii) the ways both public and private actors might respond productively to these challenges.

Appendix. Descriptions of Some Alternative Corporate Minimum Tax Regimes[192]
(Source: EY *Worldwide Corporate Tax Guide*)

Cambodia

Minimum tax. Minimum tax is a separate annual tax imposed at a rate of 1% of annual turnover inclusive of all taxes, except value added tax (VAT). If the [regular tax] liability exceeds the amount of the minimum tax, the taxpayer is not liable for the minimum tax.

An exemption from the [regular tax] applies to the trigger period plus three years plus the priority period. The maximum trigger period is [a] QIP's [Qualified Investment Project's] first year of profits or the third year after the QIP earns its first revenue, whichever is earlier. The priority period, which is specified in the Finance Law and varies by project, may have a duration of up to three years. The taxpayer is also entitled to an exemption from the minimum tax (see Minimum tax) for as long as it retains its QIP status. QIPs are also eligible for import duty exemption with respect to the importation of production equipment, construction materials, raw materials, intermediate goods, and accessories that serve production.

Cameroon

Tax rates. The regular corporate income tax rate is 30% (plus a 10% additional council tax). For companies operating under the real earnings tax regime, the minimum tax payable is 2% (plus 10% additional council tax) of monthly gross sales (turnover). However, for companies subject to the real earnings tax regime that are in the administered margin sectors, which are the distribution of petroleum, domestic gas, milling, pharmaceutical, and press products, the minimum tax payable is 14% (plus 10% additional council tax) of the gross margin. The minimum tax payable is 5.5% for companies under the simplified tax regime. The minimum tax is creditable against corporate tax due for the current financial year.

Operational phase. Incentives available during the operational phase (10 years for all companies qualifying for the incentives) include exemptions or reductions with respect to minimum tax, corporate tax, customs duties on certain items, and other specified taxes and fees. In addition, companies may carry forward losses to the fifth year following the year in which the losses are incurred.

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192 The material in this Appendix to Chapter 5 is based on the online EY *Worldwide Corporate Tax Guide*, as accessed in November 2017. Reproduced by permission of EYGM Limited from the EY *Corporate Tax Guide*. Copyright 2017 EYGM Limited. All rights reserved.

The descriptions are based on an informal review of the Tax Guide and are presented for illustrative purposes only. The information presented may be out-of-date or otherwise incorrect or incomplete.

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Chad

The minimum tax is paid on a monthly basis at a rate of 1.5% of the turnover of the previous month. The payment must be made by the 15th day of the month following the month of realization of the turnover.

Congo, Democratic Republic of the

The minimum tax payable is 1% of the annual turnover for larger corporations. For small corporations with annual revenues of less than CDF10 million, the corporate income tax is set at CDF50,000. For average-sized corporations with annual revenues between CDF10 million and CDF200 million, the corporate income tax rate is 1% of the annual revenue for sales of goods and 2% for the provision of services.

Congo, Republic of the

The minimum tax payable is 1% of the annual turnover and cannot be less than XAF1 million (or XAF500,000 if turnover is less than XAF10 million a year). A 2% minimum tax is payable by companies that incur tax losses in two consecutive years. It appears that the 2% rate is applied to the sum of gross turnovers and products and benefits realized by the company in the most recent year in which it earned a profit. In general, the 2% tax is not deductible for corporate income tax purposes. However, in the company's first profit-making year after incurring the losses, one half of the 2% tax is deductible.

Côte d'Ivoire

The minimum tax is 0.5% of turnover. For oil-producing, electricity, and water-producing companies, the rate is reduced to 0.1%. The rate is reduced to 0.15% for banks and financial companies and for insurance companies. The minimum tax may not be less than XOF3 million or more than XOF35 million. New corporations are exempt from the minimum tax for their first fiscal year, and mining companies are exempt from the minimum tax during the exploration phase.

Equatorial Guinea

The minimum corporate tax is 3% of annual turnover for the preceding year. The amount of this tax cannot be less than XAF800,000.

Gabon

Tax rates. The standard corporate income tax rate is 30%. However, oil and mining companies are subject to tax at a rate of 35%. A reduced corporate tax rate of 25% applies to a limited number of companies. The minimum corporate tax payable is 1% of annual turnover, but not less than XAF1 million. The base for the calculation of the minimum corporate tax is the global turnover realized during the tax year. An exemption from the minimum corporate tax applies to the following companies:

Companies exempt from corporate income tax, as provided in the general tax code.

New businesses.

Newly incorporated companies or legal entities, for their first two years, regardless of their activities.

Guinea

Tax rates. The regular corporate income tax rate is 35%. Since the issuance of the amended Mining Code in April 2013, the rate for the mining sector is 30% (applicable to mining companies only; not applicable to subcontractors). The annual minimum tax payable is 3% of annual turnover. However, under the 2012 Financial Law, it cannot be less than GNF15 million or more than GNF60 million.

Guyana

Commercial companies, other than insurance companies, and commercial activities of a company carrying on both commercial and non-commercial activities are subject to a minimum tax at a rate of 2% of turnover if the corporation tax calculated as payable for the preceding year was less than 2% of the turnover of the commercial company. If, in any year, the corporation tax payable is calculated to be higher than 2% of turnover, the tax payable is limited to the corporation tax assessed. Consequently, the tax payable by a commercial company or with respect to the commercial activities of a company undertaking both commercial and noncommercial activities is the lower of 2% of turnover or corporation tax at a rate of 40%.

Hungary

Alternative minimum tax. The alternative minimum tax (AMT) is calculated by applying the general rate of 9% to the AMT tax base. In general, the AMT tax base is 2% of total revenues, excluding any revenue attributable to foreign permanent establishments. The AMT tax base must be increased by an amount equal to 50% of additional loans contracted by the company from its shareholders or members during the tax year. If a company’s AMT is higher than the corporate income tax otherwise calculated or the pretax profit, the taxpayer may choose to pay either of the following:

AMT.

Corporate income tax otherwise payable. In this case, the company must fill out a one-page form that provides information regarding certain types of expenses and, in principle, is more likely to be selected for a tax audit.

Madagascar

Tax rates. The standard corporate income tax rate is 20%. In general, the minimum tax is MGA100,000 plus 0.5% of annual turnover (including capital gains) for companies carrying out the following activities:

- Agricultural.
- Craft.
- Mining.
- Industrial.
- Tourism.
- Transport.

This minimum tax equals 0.1% of annual turnover for fuel station filling companies. For companies engaged in other activities, the minimum tax is MGA320,000 plus 0.5% of annual turnover. The minimum tax applies if the company incurs a loss or if the corporate income tax calculated using the 20% rate is less than the minimum tax to be paid as stated above. Individuals or companies performing exclusively public market activities are exempt from minimum tax. Free zones' companies. Free zones' companies are exempt from corporate income tax for the first five years of their activities and are subject to corporate income tax at a rate of 10% for subsequent years. Large mining investments. Mining companies making investments over USD25 million can benefit from legal and tax incentives if they are eligible under a special law called Loi sur les Grands Investissments Miniers (LGIM). They are exempt from minimum tax for five years from the beginning of exploitation. The corporate income tax rates are 10% for owners of mining permits and 25% for the transformation entities.

Mauritania

Tax rates. The regular corporate income tax rate is 25%. The minimum tax (impôt minimum forfaitaire, or IMF) is 2.5% of turnover. However, the tax may not be less than MRO750,000. Profits realized in Mauritania by branches of foreign companies are deemed to be distributed and, consequently, are subject to a branch withholding tax of 10% on after-tax income. The new investment code provides for a preferential tax regime, which is available to companies producing goods or services for export exclusively and companies working exclusively for them.

Morocco

The minimum tax equals the greater of the minimum fixed amount of MAD3,000 and 0.5% of the total of the following items:

- Turnover from sales of delivered goods and services rendered.
- Other exploitation income (for example, directors' fees received when the company acts as an administrator of another company, revenues from buildings that are not used in the company's activities, and profits and transfers of losses with respect to shared operations).

Financial income (excluding financial reversals and transfers of financial expenses).

Subsidies received from the state and third parties. The rate of minimum tax is reduced to 0.25% for sales of petroleum goods, gasoline, butter, oil, sugar, flour, water, and electricity.

The minimum tax applies if it exceeds the corporate income tax resulting from the application of the proportional rates or if the company incurs a loss. New companies are exempt from minimum tax for 36 months after the commencement of business activities. Before January 2016, if minimum tax is applied because of the incurrence of tax losses or because the minimum tax amount exceeded the corporate income tax, the minimum tax could be offset against the corporate income tax due in the following three years. Effective from 1 January 2016, the minimum tax can no longer be offset against corporate income tax. Nonresident contractors may elect an optional method of taxation for construction or assembly work or for work on industrial or technical installations. Under the optional method, an 8% tax is applied to the total contract price including the cost of materials, but excluding VAT.

Nigeria

Minimum tax. Companies are required to pay minimum corporate tax if the minimum tax is greater than their actual tax liability. If a company’s turnover is NGN500,000 or less, the minimum tax is the highest of the following:

0.5% of gross profit.

0.5% of net assets.

0.25% of paid-up capital.

0.25% of turnover of NGN500,000. If turnover is higher than NGN500,000, the minimum tax equals the amount computed in the preceding paragraph plus 0.125% of the turnover exceeding NGN500,000.

The minimum tax does not apply to companies until the fifth year after the commencement of business. Companies engaged in an agricultural trade or business and companies with at least 25% imported equity capital are exempt from the minimum tax requirement.

Pakistan

Minimum tax. Resident companies and nonresident banking companies are subject to a minimum income tax equal to 1% of gross receipts from sales of goods, services rendered, and the execution of contracts, if the corporate tax liability is less than the amount of the minimum tax. The excess of the minimum tax over the corporate tax liability may be carried forward and used to offset the corporate tax liability of the following five tax years.

Senegal

Tax rates. The corporate income tax rate is 30%. The minimum tax (impôt minimum forfaitaire, or IMF) payable equals 0.5% of the turnover for the preceding tax year. The minimum tax may not be less than XOF500,000 or more than XOF5 million.

Tanzania

Alternative minimum tax. Companies reporting tax losses or utilizing loss carryforwards for three consecutive years must pay an alternative minimum tax at a rate of 0.3% on the annual turnover in the third loss year.

Tunisia

The minimum tax payable is 0.2% of annual local turnover and 0.1% of taxable exportation turnover. The 0.2% minimum tax paid in 2014 may be credited against the corporate income tax payable for the next five financial years, but it is not refundable. The 2015 Financial Law eliminates the possibility of deducting the 0.2% minimum tax in the fifth year. Tax benefits, such as exemptions from certain taxes and duties, may be granted to companies established in a Tunisian Free Zone and to companies engaged wholly or partly in exporting.

Chapter 6

BEPS in lower-income countries: a social responsibility perspective

Introduction

The preceding chapters of this book have sought to explore the historical, economic and political background of base erosion and profit shifting in lower-income countries, and to offer suggestions regarding the kind of policy initiatives that might be most effective in enhancing corporate tax revenue in these countries. This sixth and concluding chapter expands the discussion by addressing some questions of an ethical nature. The chapter first addresses whether, as a general matter, the persistence of BEPS in lower-income countries poses a problem of a kind that those involved in the international tax system have an ethical obligation to address. The chapter then considers how major categories of actors in the area of corporate taxation in lower-income countries – including multinational businesses, international organisations like the OECD, UN, IMF and World Bank, and national governments of countries at different levels of economic development – might effectively respond to the ethical challenges that appear to be raised. The discussion will focus on four topics, which I think are of especially high practical importance in the short and medium term. In particular, the discussion below will:

(i) comment on the efforts of multinational businesses, under the rubric of corporate social responsibility (CSR), to articulate standards for socially responsible tax planning;

(ii) argue that intergovernmental organisations in the area of international taxation face an ethical obligation to maintain in-house sources of intellectual challenge to conventional wisdom and the status quo;

(iii) argue that the world's capital-exporting countries face an ethical imperative to collaborate on the enactment of robust controlled foreign corporation (CFC) rules (or similar rules like those that might be modelled on the recent US GILTI rules); and

(iv) argue that the governments of lower-income countries face an urgent ethical imperative to ensure transparency and orderly legal procedure in the award of explicit tax incentives, such as tax holidays; and that governments should give close attention to the maintenance of the data necessary to evaluate the performance of tax administrations in their jurisdictions.

Roots of the ethical challenge

The preceding chapters of this book interpret continuing shortfalls of corporate tax revenue in lower-income countries as both a manifestation of current conditions of poverty and a cause of perpetuation of that poverty. The problem centres on the pressure of tax competition, to which lower-income country governments typically feel especially vulnerable. Wealthier countries, which offer relatively appealing environments for inbound investment, generally can afford to place significant constraints on erosion of their tax bases even in the face of international tax competition. This is evidenced, for example, by the recent tightening of limitations on interest deductions among many relatively wealthy countries, the diverted profits taxes (DVTs) of the United Kingdom and Australia, and by the recently enacted BEAT minimum tax on income from related-party transactions in the US.[193]

Lower-income countries, however, often can offer investors only limited advantages in terms of local business infrastructure and a well-educated workforce. These countries, therefore, often see themselves as required to offer inbound investors very low effective corporate tax rates, either explicitly through tax holidays or other exemptions, or implicitly by leaving their tax bases vulnerable to BEPS-style tax planning. The result is a vicious circle of poverty. The failure to collect corporate tax deprives lower-income countries of revenue that could be used to meet immediate humanitarian needs, and also to improve infrastructure and standards of education that might render the countries less vulnerable to international tax competition in the future.

The role of BEPS in perpetuating poverty in itself raises a moral imperative to try to curtail base erosion and profit shifting. A general social duty to alleviate poverty is widely acknowledged; although the duty can usefully be the subject of philosophical analysis,[194] it seems reasonable to treat it for present purposes as axiomatic. It also can, I think, be taken as axiomatic that one's duty to relieve the suffering of others is enhanced, to the extent that one is in a position as a practical matter to render aid. Therefore, it is reasonable to conclude that those actors who participate most directly in the international corporate tax system – including multinational companies, intergovernmental organisations and national governments – possess especially clear duties to act, within their power, to reduce the incidence of BEPS in lower-income countries.

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193 See Chapter 4.

194 For an important survey of the large body of philosophical inquiry regarding the source and extent of a moral duty to redress poverty, see Sen (2009). For a more recent survey of the philosophical literature in the specific context of international taxation, see Dagan (2018: 185-212).

Ethical duties of multinational businesses: corporate social responsibility

The early polarisation of the BEPS debate

As described in Chapter 1, the early objections to international profit shifting, as voiced by NGOs and others following the 2008 financial crisis, often took a pejorative tone towards multinational companies and rhetoric tended to become polarised. Several events in the UK illustrate the polarisation. First, late in 2012, in the course of a UK parliamentary hearing, MP Margaret Hodge responded to the insistence of corporate executives that their BEPS-style tax planning was legally permissible under the laws of affected countries. Ms. Hodge replied, ‘We are not accusing you of being illegal, we are accusing you of being immoral’ (BBC 2012).

Then, in 2013 Starbucks was faced with substantial public hostility in the UK for apparently having paid no corporate income tax in the country for several years.[195] As a result, in a highly publicised move Starbucks committed itself to making voluntary tax payments to the UK of up to £20 million during 2013 and 2014, regardless of whether the company was legally obligated to do so. This episode was met by alarm among many tax practitioners and commentators as it raised the prospect of a tax system based, not on the boundaries of law, but on the vagaries of popular political pressure.[196]

These events promoted a kind of all-or-nothing dialogue concerning whether it is appropriate for companies to refrain from taking favourable tax positions, even when those positions are legally permissible under the laws of the countries that would be affected. On one hand it was argued that a company’s fiduciary obligation to its shareholders generally requires the company to take the most favourable tax position legally available to it. Against this, it was argued that a company acts immorally by participating in tax planning corresponding to the BEPS pattern, even if the company believes that the planning is legally permissible in the countries that will be affected.

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195 See generally Christians (2013).

196 Professor Allison Christians wrote at the time: ‘Activists have shown that they cannot be dispensed with by platitudes about legal compliance. They have flagged higher tax payments as a major component of multinationals’ global social license to operate, even if they have not yet articulated the precise amount to be paid. What is certain is that the price for Starbucks’s social license to operate is above that apparently required by current law. The same appears to be true for many other multinationals that provide popular services and products around the world. If governments don’t make tax reform changes that meet the demands of activists, multinationals face the very real risk of a conflicting plurality of legal requirements and extralegal standards. For multinationals, that makes for an uncertain future: one in effect shaped by activist vigilantism’ (Christians 2013).

This argument proved largely unproductive as it involved an oversimplification of the company's fiduciary obligation. It is true that, as a general matter, a corporation is required in its decision-making to act in the shareholders' interest, and in some circumstances doing so might involve taking advantage of legally available routes towards tax reduction. But the corporation's fiduciary obligation to its shareholders does not require that every business decision taken by the corporation must be designed to maximise the shareholders' short-term pecuniary interests. Instead, the corporation is free to forgo opportunities for short-term advantage if doing so will promote the interests of the shareholders in the long term.

Therefore, if corporate management believes that engaging in a particular instance of BEPS-style tax planning may ultimately cause harm to the corporation, for example, by damaging the company's reputation, by violating management's own standards of ethically permissible behaviour, or both, the company is free to decide not to engage in the planning.[197] Indeed, if the company's management believes that it is in the company's best interest, all things considered, to refrain from engaging in a particular tax-advantaged transaction, then management can be said to face a fiduciary duty to refrain.

Corporate social responsibility

This kind of reasoning has become well-accepted around the world over the past half-century in areas of corporate activity other than taxation. In the areas, for example, of labour protection and environmental regulation, lower-income countries have sometimes been perceived as unable to enforce reasonable, minimal levels of protection. One result of this circumstance has been the CSR movement, under which businesses engaging in cross-border activities adopt voluntary codes of conduct requiring the maintenance of, say, particular standards of employee or environmental protection, even if governments are not successfully enforcing those standards.[198] At the heart of CSR is the principle that a company's obligation to its shareholders is to promote the company's interests as broadly defined, and that this obligation does not in every instance require maximisation of the company's short-term financial results. Instead, corporate management may validly take actions that are designed to increase the wellbeing of employees, customers and others affected by their activities, even if there is no identifiable financial pay-off for doing so.

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197 See Farrer & Co. LLP (2013), (concluding that there is no fiduciary obligation to minimise tax liabilities); William Underhill (2013) (disagreeing with elements of the Farrer & Co. opinion, but agreeing there is no duty to minimise liabilities if other elements of corporate welfare would be adversely affected). See generally Chafee and Davis-Nozemack (2017).

198 For background on CSR, see Crane et al. (2008) and Carroll (2008), both in *The Oxford Handbook of Corporate Social Responsibility*. For a useful and comprehensive reflection on CSR in the developing country context, see Ruggie (2013).

The notion of CSR has been criticised as counterproductively confusing the different social obligations of the public and private sectors. Arguably, overall social well-being is best served when society's rules of behaviour are set through formal political processes, and when business limits its role to maximising economic value-added within the bounds of those rules.[199] Proponents of CSR acknowledge the validity of this concern, and concede that it is difficult to reconcile the concept of CSR rigorously with conceptual models of the public-private distinction.[200] Nevertheless, it is argued that in practice if companies operated only according to the standard of the law's minimal requirements, without taking additional voluntary initiatives, serious damage would be inflicted on individuals in a wide range of areas. As a matter of pragmatism if not of social theory, the principle of CSR has become well accepted within the international business community.

The post-crisis years have witnessed numerous discussions of the potential role of CSR in defining companies' ethical obligations towards the persistence of BEPS.[201] In February 2018, a group of business leaders and multinational companies calling itself 'the B Team' published a plan for implementing the principles of CSR in the context of international taxation.[202] The principles espoused by the group include: (i) accepting tax incentives in countries only under conditions of transparency and regular legal process;[203] (ii) refraining from using corporate structures that do not promote a non-tax business purpose;[204] and (iii) engaging only in tax planning that is more likely than not to be upheld as legally permissible.[205] In addition, the signatories

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199 See e.g. Friedman (1970): '[T]he doctrine of "social responsibility" taken seriously would extend the scope of the political mechanism to every human activity. It does not differ in philosophy from the most explicitly collective doctrine. It differs only by professing to believe that collectivist ends can be attained without collectivist means. That is why, in my book Capitalism and Freedom, I have called it a "fundamentally subversive doctrine" in a free society, and have said that in such a society, "there is one and only one social responsibility of business - to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud".

200 CSR therefore has been called 'an essentially contested topic' (Crane et al. (2008: 5) quoting Moon et al. (2005).

201 See e.g. Christian Aid et al. (2015). See generally Desai and Dharmapala (2006); Avi-Yonah (2014); Chafee and Davis-Nozemack (2017: 1474-1479).

202 The B Team (2018). Companies participating in the B Team include Allianz, BHP, Maersk, Natura, Repsol, Safaricom, Shell, Unilever and Vodafone. In explaining the new document, Bob Collymore, CEO of Safaricom, said: 'Taxes don't just build schools and transport systems. They also create the conditions for responsible investment and sustainable growth, which will be key to meeting the UN Sustainable Development Goals. We need to build a new business consensus around responsible tax practice, and communicate that clearly and proactively' The B Team 2018: 2).

203 The B Team (2018: 4): 'Where we claim tax incentives offered by government authorities, we seek to ensure that they are transparent and consistent with statutory or regulatory frameworks'.

204 The B Team (2018: 4): 'We will only use business structures that are driven by commercial considerations, are aligned with business activity and which have genuine substance. We do not seek abusive tax results'.

205 The B Team (2018: 4): 'We aim for certainty on tax positions, but where tax law is unclear or subject to interpretation, we evaluate the likelihood and where appropriate seek an external opinion, to ensure that our position would, more likely than not, be upheld'. This language is included as subsidiary to the B-Team's Principle 2: 'We comply with the tax legislation of the countries in which we operate and pay the right amount of tax at the right time, in the countries where we create value'.

agree not to use tax haven entities to separate the taxation of income from the business activities that generate it.[206]

Substantively, the B-Team principles depend heavily on tests like economic substance and business purpose, the subjectivity of which historically has contributed to the development of BEPS. As discussed in Chapter 3, these and similarly subjective tests remain important in international tax law, and the B-Team drafters had no real choice but to refer to these tests in stating their commitment to complying with applicable laws. Presumably, however, the B-Team's commitment to a more-likely-than-not test in tax planning will involve restraint in pushing the boundaries of the subjective legal tests.

The B-Team principles are notable for their frank use of the term tax haven,[207] language that often is avoided in discussions among tax specialists. This choice of words suggests that the B-Team document is intended for reading by consumers and other members of the general public, as well as by tax specialists. Indeed, the B-Team principles can be seen in part as an appeal to public opinion – the drafters have offered criteria for judging multinationals' tax behaviour that they hope members of the public will accept as sound. To facilitate public scrutiny, the B-Team principles promise to provide 'regular information to our stakeholders, including investors, policy makers, employees, civil society and the general public, about our approach to tax and taxes paid'.[208] The drafters promise that the information will include indications of the companies' tax payments in different countries where they conduct business,[209] as well as information on tax incentives received by the companies.[210] It remains to be seen how comprehensive and detailed the various disclosures will be in practice. Nevertheless, the B-Team principles seem to provide a framework on which might over time be built a durable system for transparency and public accountability with respect to companies' international tax planning practices.

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206 The B Team (2018: 5): 'We do not use so-called 'tax havens' in order to avoid taxes on activities which take place elsewhere. Entities which are based in low or nil-rate jurisdictions exist for substantive and commercial reasons'. The B-Team lists this commitment as a component of the general principle that '[w]e will only use business structures that are driven by commercial considerations, are aligned with business activity and which have genuine substance. We do not seek abusive tax results'.

207 Note 13 above.

208 B-Team principles (The B Team 2018: 8).

209 The participating companies commit to releasing '[a]nnual information that explains our overall effective tax rate and gives information on the taxes we pay at a country level, together with information on our economic activity' (The B Team (2018: 8).

210 The participating companies agree to provide '[i]nformation on financially-material tax incentives (e.g. tax holidays), where appropriate, including an outline of the incentive requirements and when it expires' (The B Team 2018: 8).

The possibility of CSR-based lobbying

An intriguing element of the B-Team principles is a commitment to 'engage constructively in national and international dialogue with governments, business groups and civil society to support the development of effective tax systems, legislation and administration' (The B Team 2018: 8). This is to include the offering of 'constructive input to industry groups, governments and other external bodies (e.g. OECD and the EU) and engag[ing] with civil society on tax issues in order to contribute to the development of future tax legislation and practice' (The B Team 2018: 8).

Conceivably, these principles could be applied by groups of companies, perhaps working through large international bodies like the Business and Industry Advisory Committee (BIAC) or the International Chamber of Commerce (ICC), to advocate that lower-income countries adopt as best practice base-protection measures that many countries appear reluctant to adopt for fear of tax competition. For example, BIAC or the ICC might issue a statement to the effect that the organisation views EBITDA-based interest deduction limitations, conforming to Action 4 of the OECD's BEPS recommendations,[211] as appropriate for countries at all levels of economic development, and as consistent with a welcoming stance towards inbound investment.

Of course, these kinds of lobbying efforts by business groups might not in themselves provide lower-income country governments with the confidence needed to enact effective base-protection legislation. Nevertheless, these efforts, when combined with advocacy from other groups, including, for example, the OECD, UN and international lending agencies, could help to bring about an environment in which the adoption of specified base-protection measures is accepted as best practice among lower-income countries, just as the OECD's EBITDA-based interest limitations have recently been embraced by many of the world's wealthier countries.[212]

CSR and explicit tax incentives

The B-Team's list of ethical commitments is also noteworthy for its inclusion of a promise to seek to ensure that any explicit tax incentives, like tax

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211 See Chapter 4.

212 I use EBITDA-based interest limitations as an example of a measure for which businesses might lobby, because these limitations today seem to be relatively non-controversial among businesses and tax specialists. Depending on the development of consensus over time, it might be possible for businesses to support other base-protection measures for use in lower-income countries, e.g. simplified means of identifying appropriate comparables for use in applying transfer pricing methods (see Chapters 4 and 5). It is conceivable as well that businesses might have a role in promoting more ambitious base-protection regimes, like the alternative corporate minimum tax discussed in Chapter 5.

holidays, are offered transparently and in accordance with statutory or regulatory frameworks.[213] The B-Team document also commits to public disclosure of financially material tax incentives that a company receives.[214]

Transparency with respect to explicit tax incentives is crucial to raising the likelihood that reductions in base erosion and profit shifting in a country will in fact result in net increases in tax revenue. Implicit tax reductions that governments provide investors by tolerating BEPS, and explicit tax incentives like tax holidays, are at least to some extent substitutes for one another. If the substitution is perfect – that is, if a given reduction in BEPS results in an equivalent or even greater increase in the allowance of explicit incentives – then reducing BEPS will not increase tax revenue on a net basis. The discussion in Chapter 2, however, posits that the granting of explicit incentives is likely to be more constrained by local political oversight than the implicit allowance of tax incentives by tolerating BEPS-style planning. Therefore, increases in revenue through the curtailment of BEPS are unlikely to be offset fully by increases in explicit incentives.

This desirable effect can prevail, however, only if the issuance of explicit tax incentives is in fact subject to reasonably effective political constraints. This requires transparency in the granting of explicit incentives, including transparent statutory and regulatory procedures for evaluating requests for exemptions, and for monitoring compliance with the conditions (like maintaining specified levels of employment) that might be attached to exemptions. To promote this transparency, it is important that CSR efforts include a commitment to participate in tax incentive regimes only under conditions of transparency, and with clear legal authorisation.[215]

Ethical obligations of international organisations

Inevitability of interpretive communities

There can, I think, be little denying that around complex and important areas of economic regulation like taxation, communities of insiders (sometimes called interpretive communities) tend to coalesce, with a natural tendency

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213 The B-Team principles include this commitment: 'Where we claim tax incentives offered by government authorities, we seek to ensure that they are transparent and consistent with statutory or regulatory frameworks' (The B Team 2018: 7).

214 The B-Team report calls for disclosure by companies of '[i]nformation on financially-material tax incentives (e.g. tax holidays), where appropriate, including an outline of the incentive requirements and when it expires' (The B Team 2018: 8). A B-Team spokesperson explains that the modifier 'where appropriate' is used to address situations where the terms of agreements require confidentiality.

215 There seems to be broad consensus on this point among both businesses and civil society groups. See generally ActionAid et al. (2018).

towards retention of the legal and regulatory status quo.[216] The disproportionate influence of established interpretive communities on legal and regulatory decision-making, often called capture, is inevitable in connection with a high-stakes legal and administrative system like that of international taxation.[217]

One reason for the coalescing of interpretive communities is that the effects of regulation tend to be concentrated on relatively small groups of actors. Specifically in the area of international taxation, corporate taxpayers have much more concentrated interests in the lawmaking process than members of the general public. As a broad matter, taxpayers can be expected to have a bias towards retention of those existing legal structures that facilitate tax avoidance, especially if the legal structures are relatively non-transparent.

Moreover, taxpayers are not the only parties likely to display a political bias towards the retention of existing legal structures. Tax advisers, government officials and experts in international organisations like the OECD and UN have all accumulated human capital based on their expertise with respect to current legal structures. To say this is not to impugn policymakers' commitment to objectivity in their work. The bias of interpretive communities, to the extent it is present, may be largely unconscious. Moreover, interpretive communities are not always monolithic, and not all members generally necessarily will act in role with respect to every policy question. Nevertheless, as a longtime observer of (and sometimes participant in) legislative and regulatory processes in taxation, there seems to me little doubt that communities of insiders tend to coalesce around complex and important areas of economic regulation like taxation, with some degree of overall bias towards the retention of existing legal and regulatory structures.

Measures to promote transparency and critical review

The inherent vulnerability of regulatory bodies to bias towards the status quo places upon them a social responsibility of transparency in their operations and voluntary exposure to critical review. This means, I believe, that technical research performed by the OECD, the UN Tax Committee and other international organisations should be conducted transparently, in consultation with outside experts. It is important, in particular, that deficiencies in current rules and procedures be frankly identified and discussed publicly. The fact that base erosion and profit shifting were basically unknown to the public prior to the 2008 financial crisis testifies to the historical insufficiency of

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216 e.g. see Picciotto (2015) (referring to interpretive community in field of international corporate taxation); see also Langbein (2010).

217 The classic academic statement of the theory of regulatory capture is found in Stigler (1971).

transparent self-critical discourse within the OECD and other international organisations involved in setting rules for international taxation.

The need for a high degree of transparency also counsels, I believe, for both external and internal checks and balances on the OECD. With respect to external checks and balances, although it should not be expected for the UN to supplant the OECD's lead role in international tax policymaking, it should be seen as essential that the UN Tax Committee be provided with an enhanced budget, and ideally upgraded to an intergovernmental organisation, to afford the Committee strengthened political standing.

A strengthened UN tax committee should not be expected routinely to take positions contrary to those of the OECD. As discussed at many points in this book, developing and industrialised countries have numerous interests in common with respect to taxation, so that a UN-OECD relationship should not be adversarial on many points. Also, there are likely to be some biases towards the status quo in both organisations. It therefore would be unrealistic to envision the UN as performing a fully-fledged watchdog role with respect to the OECD. Nevertheless, there may be natural competitive tension between the two organisations as centres of thought leadership, and in an area as predictably controversial as international taxation it seems imprudent to allow any single intergovernmental organisation a monopoly over authoritative analysis. The UN therefore can be expected to play a critical, albeit imperfect, role as a counterweight to the OECD.

The OECD also should consider whether it is possible to build into its own organisational structure what would amount to an independent evaluation office, charged specifically with reviewing the performance of various aspects of OECD tax guidance in actual operation around the world, including the *Transfer Pricing Guidelines*. To promote independence, this office would report, not to the head of the Committee on Fiscal Affairs who oversees the Guidelines, but instead to a senior official elsewhere in the OECD Secretariat. The work product of this office would be available to the public. The presence of this office might lead on occasion to disruptive controversy within the OECD, but the scrutiny the office affords should lead over time to more satisfactorily performing policy instruments (including better-functioning *Transfer Pricing Guidelines*).

In sum, there are many predictable forces that can lead to bias, within regulatory bodies like the OECD towards the retention of current legal and administrative structures. The OECD and other organisations engaged in formulating rules for international taxation face a social responsibility to anticipate the possibility of this bias, and to build into their procedures the means for ensuring transparency in their research and deliberations, as well as internal and external sources of criticism and review.

Continuing role for NGOs and the press

The implementation of new checks and balances within policymaking bodies should not be seen as substituting for the role of non-governmental organisations and journalists, as in effect watchdogs on international tax policymaking. The leading role played by NGOs and the press in initiating the recent BEPS efforts is in itself testimony to the cruciality of truly independent sources of commentary and criticism. The OECD, UN and other policymaking bodies should continue their longstanding practice of soliciting comment from, and otherwise engaging with, NGOs and the press, even when the engagement adds contentiousness to the policymaking process.

Ethical responsibilities of national governments

Introduction

The OECD is not a legislative body – its role is limited to recommending the use of particular policy instruments as best practice, with the decision whether to adopt the recommended measures left in the hands of national governments. The analysis of BEPS in lower-income countries in the first five chapters of this book suggests several initiatives that should, I think, be recognised as especially pressing ethical obligations on the part of national governments. These include:

(i) a renewed attempt by capital-exporting countries, probably through the OECD, to agree upon standards for effective controlled foreign corporation (CFC) rules or similar measures;

(ii) in all countries, the establishment of a high degree of transparency and the articulation of clear legislative and administrative procedures with respect to the granting and oversight of explicit tax exemptions like tax holidays; and

(iii) the stepping-up of efforts by national governments, including those of lower-income countries, to generate and maintain data of the kind necessary to evaluate the effectiveness and integrity of tax administration, including tax enforcement, in their jurisdiction.

CFC rules and similar legislation

As explained in Chapters 3 and 4, by adopting strong CFC rules or similar legislation, governments can remove from their multinationals some of the financial incentive to engage in BEPS-style tax planning around the world, including in lower-income countries. A robust global network of CFC or similar rules therefore might result in significant reductions in the incidence of profit shifting from lower-income countries.

At the outset of the BEPS process, it appeared that the OECD might be heading for a strong statement in favour of a global network of CFC rules in BEPS Action 3.[218] Apparently, however, political consensus could not be raised in favour of that position, and the final report on Action 3 contains only mild language pointing to the potential benefits of an effective global network of rules, without offering specific recommendations. The failure to agree on international standards for CFC rules must be seen, I believe, as a missed opportunity among the OECD countries to take one of the most feasible initiatives available to reduce global demand for profit shifting from the world's lower-income countries.

The OECD should, as a matter of social responsibility, resume efforts to reach international agreement on standards for CFC rules or similar legislation, ideally through the processes of the Inclusive Framework so that the views of both capital-exporting and capital-importing countries are represented. The model rules adopted should be capable, as a practical matter, of significantly reducing demand for BEPS planning around the world. Therefore, for example, the rules should not depend heavily on subjective tests like business purpose or economic substance for their implementation, but instead should target for taxation all income that is shifted to countries with corporate tax rates below specified levels.[219] Success in this effort would send a strong signal of global commitment to redressing the problem of profit shifting from countries at all levels of economic development.

Although in several parts of the world, as described in Chapters 4 and 5, some strengthening of CFC rules has occurred (e.g. through the new US GILTI rules), the political barriers facing multilateral agreement on effective CFC or similar rules should not be underestimated. Strengthened CFC rules in effect result in a redistribution of resources from multinational companies, which tend to be based in capital-exporting jurisdictions, to the governments of capital-importing countries (including lower-income countries) where the multinationals conduct business. This kind of redistribution might in itself raise political resistance in some countries to strengthened CFC rules. Indeed, political resistance of this kind may account in part for the often weak state of CFC rules around the world today. It remains to be seen whether a re-invigorated effort to establish effective global norms for CFC rules, motivated explicitly by concerns of social responsibility with respect to capital-importing countries, might lead to more substantial results than were

218 See Chapter 4.

219 See the discussion of CFC rules in Chapters 3 and 4.

reached in the BEPS Action 3 Report. Efforts in this direction, however, seem clearly indicated as a means of removing incentives to taxpayers for profit shifting from all countries, including lower-income countries.

Transparency with respect to explicit tax incentives

An especially urgent need is for governments of countries at all levels of economic development to afford a high level of transparency to the evaluation and granting of explicit tax incentives, like tax holidays. As discussed above,[220] if efforts to control BEPS are to result in significant revenue increases for lower-income countries, it is essential that there be effective political controls on the issuance of explicit tax incentives, so that revenue gained from the curtailment of BEPS is not simply offset by additional governmental largesse in the allowance of explicit incentives.

It is evident that many countries today do not have in place the kinds of transparent procedural mechanisms that are necessary to afford effective political control over the granting of incentives.[221] Governments should act promptly to enact clear standards for transparency, and legislative and regulatory process, in the granting and oversight of tax incentives. This work ideally should occur under the auspices of regional tax organisations in order to mitigate to some extent the pressure of tax competition. The use of regional organisations would also facilitate efficient assistance from international organisations or other sources of technical support.

It is important to be realistic about the prospects of curtailing explicit tax incentives in lower-income countries. The pressure of tax competition is almost certain to remain influential in those countries, and even with a high degree of transparency and clear political and administrative processes, governments will continue to grant incentives. Moreover, tax incentives typically have strong supportive constituencies within countries. Politicians and others often perceive they can achieve popular acclaim if they are seen as attracting new investment and employment. Also, there surely are some instances in which the granting of tax incentives involves rent-seeking opportunities that beneficiaries will not want to give up.

Nevertheless, achieving greater control over the issuance of explicit incentives is essential to the process of raising additional corporate tax revenue. It is to be hoped, moreover, that greater transparency will result not only in limitations on the volume of incentives, but also improvements in the

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[220] Notes 22-24 and accompanying text.

[221] See IMF (2015).

economic efficiency of those incentives that are provided.[222] In any event, until effective political brakes can be applied to the granting of additional explicit tax incentives, efforts to increase corporate tax revenue in lower-income countries through reducing the incidence of BEPS will remain seriously impeded.

Transparency with respect to tax administration

The BEPS recommendations already envision enhancements to transparency in international tax policymaking – particularly in the report on BEPS Action 11,[223] which addresses the topic of measuring changes in the extent of base erosion and profit shifting over time. Action 11 recommends that national governments and the OECD maintain data on changes over time in the quantitative extent of BEPS, including items like the volume of royalty income accumulated in zero- and low-tax jurisdictions, and the ratio of taxpayers' interest deductions to their income. The information needed to perform these analyses is to come from a variety of sources, including (i) detailed revenue data, generally based on filed tax returns, which is compiled by national governments and international organisations; and (ii) additional data that is expected to become available in the future, especially from the country-by-country transfer pricing documentation that governments are now beginning to require from taxpayers under BEPS Action 13 (OECD 2015d: 249 ff). The kind of information envisioned, on changes over time in the incidence of BEPS, should prove valuable in assessing the effectiveness of countries' efforts to curtail BEPS.

The Action 11 recommendations, however, generally do not address a particular category of information that is, I believe, essential for well-informed lawmaking in international taxation – detailed information on the extent and outcome of tax audits of local affiliates of multinational groups. Studies conducted over the years in the US by the Treasury Department and the oversight office of Congress, comparing the claims made by examiners in transfer pricing audits with the adjustments ultimately upheld after administrative and judicial appeal, illustrate the kind of studies that I believe would be useful.[224] It is only by direct observation of the performance of enforcement activities that the efficacy of important components of the tax law, like transfer pricing methods and limitations on the deduction of interest, can be satisfactorily evaluated. In addition, monitoring of the conduct of particular tax audits and other enforcement-related contacts with taxpayers is necessary in order to ensure employee integrity.

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[222] For discussion of the relative efficiency of different kinds of incentives, see IMF (2015)

[223] See OECD (2015c).

[224] See the discussion of these studies in Chapter 3.

Not all countries currently maintain, or are likely in the foreseeable future to begin maintaining, the detailed records of tax examinations and other administrative actions that are necessary to maintain and evaluate tax enforcement programmes effectively. Nevertheless, the goal of additional transparency with respect to audits – particularly through the collection and evaluation of case-specific data – seems essential to significant progress in the control of BEPS, and indeed to the basic integrity of the tax system, in all countries. Governments of countries with currently limited data availability should take prompt steps to build capacity in this area, with technical and ideally financial assistance from international organisations and national tax authorities with well-developed data systems.

Conclusion

This book has interpreted the persistence of BEPS in lower-income countries in large part as a manifestation of the continuing strong pressure of tax competition, which affects lower-income countries especially intensively. The pressure of tax competition will not dissipate overnight. Significant improvement is likely to be possible only gradually through a combination of factors. These include the reduction of international demand for profit shifting, both through taxpayer restraint and CFC rules and similar measures; a stiffening of political resolve in lower-income countries to enact base-protection measures, perhaps through regionally coordinated action; greater political control over the granting of explicit tax incentives; and upgraded processes of tax enforcement and administration. Through actions and policies likes these, it may become possible for lower-income countries to raise the revenue needed to build both economic and educational infrastructure, thus reducing their vulnerability to international tax competition.

This chapter has argued that various actors in the international tax community – multinational companies, intergovernmental organisations and national governments – all face social responsibilities in assisting lower-income countries to break the cycle of tax competition. Much of this book has explored the technical challenges that must be met if lower-income countries are to substantially increase the revenue that they raise from corporate income tax. The main barriers to success in this effort, however, are not technical in nature. They instead have to do with the resolve of the various parties who are in a position to decide whether to expend the material and political capital needed to reduce the pressure of severe tax competition on lower-income countries. It is only with the necessary commitment of knowledgeable and concerned actors, expressed through both political processes and corporate initiative, that substantial reduction of base erosion and profit shifting in lower-income countries will prove realistic.

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