The OECD BEPS Project and Developing Countries

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Aim of the Article

G20/OECD “base erosion and profit shifting“(BEPS) project
- Launched in 2013
- Initiated and shaped by developed economies
- Endorsement of a 15-point BEPS action plan in 2015
- Many developing countries (DCs) joined in implementation phase

Aim of this article: discuss implications of BEPS project for DCs
- Trade-offs related to international tax avoidance and anti-avoidance laws
- Legal and administrative changes implied by BEPS actions
  → Relevant & suitable for DCs?
- Broader stance: BEPS actions in light of a wider range of policy options
Many developing countries struggle with small **tax-to-GDP-ratios**
- Hampers the provision of much-needed public goods and services
- Key issue how "governments [can] go from raising around 10% of GDP in taxes to raising around 40%" (Besley and Persson (2013)).

**Determinants of lack of tax capacity**
- Political, social & cultural determinants
- Economic factors, mainly high prevalence of small-scale informal businesses
  - Large firms are important revenue contributors
- Many DCs, nevertheless, feel that they **lose significant tax revenues through profit shifting** of large firms to low-tax economies.
Profit Shifting from DCs: Quantitative Evidence

- **Systematic academic evidence** on profit shifting from DCs still **scarce**.
- Much of related **literature set in industrialized countries**.
  - Macro studies: Increasing fraction of MNE-income earned outside home economies, and in foreign tax haven economies (e.g. Zucman (2014)).
  - Firm-level analyses: MNEs shift profits by ...
    - ... mispricing of intra-firm trade (e.g. Davies et al. (2018), Liu and Schmidt-Eisenlohr (2017))
    - ... distortions of intra-firm debt (e.g. Schindler et al. (2011), Büttner et al. (2013))
    - ... strategic location of valuable intellectual property (e.g. Riedel and Karkinsky (2012), Griffith et al. (2014))
  - BEPS considered to be quantitatively relevant phenomenon.

- **Profit shifting in developing countries**
  - Fuest et al. (2011), Crivelli et al. (2017), Johannesen et al. (2017) and Wier (2018): **shifting activities larger than in developed economies**
  - Important shifting channels
    - Debt shifting (Fuest et al. (2011) and OECD (2014))
    - Overcharging of management services and royalties (OECD (2014))
    - Other areas: treaty shopping activities (OECD (2014)) and avoidance of permanent establishment status (IMF (2014))
Heterogeneity in profit shifting across firms

- Size of the business (group)
  (Dharmapala (2014), Davies et al. (2018) and Wier (2018))
- Industry affiliation
  (Barrios and d’Andria (2016))
- Intra-group size of tax rate differentials
  (Dowd et al. (2017))
Governments responded by introducing anti-avoidance legislations
- transfer pricing rules
- thin capitalization and earnings stripping rules
- controlled foreign company legislation

Empirical evidence from developed country contexts suggests that these laws limit income shifting to low-tax economies
- Riedel et al. (2016), Beer and Loeprik (2015): transfer pricing legislations
- Büttner et al. (2012) and Blouin et al. (2014): thin-capitalization rules
- Ruf and Weichenrieder (2013): CFC legislations
DCs implemented various unilateral anti-avoidance policies. Many, moreover, joined the OECD’s BEPS process after 2015. DCs, however, face a number of challenges w.r.t. these laws

- **High resource burdens on tax authorities**
  - Particularly true for transfer pricing provisions (complexity and lack of comparables data)
  - Potentially large opportunity costs
  - Without resource committment: Anti-avoidance laws less effective in channeling the behaviour of MNEs

- **Foster corruptive behaviour**
  - Weak governance institutions & corruption in tax authorities
  - High levels of complexities of anti-avoidance laws → Discretion to tax administrators → Corruption

- **Negative investment effects**
  - Higher effective tax burdens
  - Increased compliance costs
  - More uncertainty
Empirical evidence on investment effects
- Büttner et al. (2018) and Merlo et al. (2016) for thin-cap rules
- Liu and de Mooji (2018) for transfer pricing rules

Welfare effects (e.g. Hale and Xu (2016)): FDI associated with...
- ... higher worker productivity and wages
- ... higher levels of employment
- ... positive spillovers from to domestic economy (wages and productivity)
- ... more tax revenues

Lax anti-avoidance provisions: strategic policy instrument to attract footloose MNEs (Peralta et al. (2006))

Many DCs operate in environments with fierce competition for FDI
- Strong decline in corporate tax rates of developing economies and emergence of various investment incentives
- Klemm and van Parys (2012): evidence for strategic interactions in regional governments’ tax policy choices
Governments incentives to grant low effective taxes to footlose and large MNEs
Riedel (2018) and Egger et al. (2018)
→ Effective tax gaps between MNEs and NEs not shifting but tax discrimination

DCs may lose revenues because of administrative incentives and strategies

- Tørsløv et al. (2017): audit capacity channeled to maximize revenue
  - In transfer pricing domain: audit high-tax country trade as...
  - ... arm’s length price for low-tax country trade well backed up by firms

- Becker and Davies (2014): observed transfer prices is outcome of a bargaining game between firm and tax authorities
  - Determinants: bargaining power of authorities and efforts provision
  - Both may be low for DC → May lose tax base
  - High-capacity countries: incentives to channel audits to DC trade
Nature of the OECD BEPS project

At start: some indication that the BEPS project may engage with certain fundamental international tax principles

As project gathered pace: emphasis on the existing detailed rules

15 BEPS action points within three specific themes...

1. ... to ensure the coherence of the international tax system
2. ... to realign taxation and substance
3. ... to boost transparency

BEPS agenda designed to plug various gaps in the existing rules
Relevance and Suitability of BEPS Output for DCs

- BEPS package of anti-avoidance measures clearly of relevance for DCs
- However, focus of the various BEPS action points concerned with highly structured and sophisticated tax planning as seen in developed countries
- Different set of priorities on the part of the DCs
- Criticism: BEPS agenda has been shaped by interests of developed countries DCs not properly consulted before BEPS Action Plan agenda was finalised.

Two questions:
- How relevant are BEPS action items for DCs?
- How suitable are the proposed BEPS measures for DCs?
Relevance of BEPS for DCs

- **Action points of limited relevance to DCs**
  - Digital economy (Action 1)
  - Hybrid mismatch arrangements (Action 2)
  - CFC rules (Action 3)
  - Some of the work on risk and capital (Actions 8-10)
  - Disclosure of aggressive tax schemes (Action 12)

- **Action points of relevance for DCs**
  - Limiting interest deductibility (Action 4)
  - Prevention of treaty abuse (Action 6)
  - Artificial avoidance of PE status (Action 7)
  - Much of the transfer pricing work (Actions 8-10)
  - Transfer price documentation incl. country-by-country reports (Action 13)
Suitability of BEPS actions for DCs

Even if action points are relevant, BEPS solution may not be suitable.

1. Capacity issues
   - DC typically constrained in relation to people resources or 'capacity' to administer the tax system
   - BEPS action points take little account of resource issues.
   - Regarding transfer pricing measures: 'explosion of complexity'. Report for Actions 8-10: 200 pages; Action 13: 70 pages; 2017 version of Transfer Pricing Guidelines: 600 pages (+ 50%)
   - New transfer pricing measures often onerous to apply → E.g. new approach to base transfer pricing more than before on actual conduct
   - Opportunity cost of focussing limited resources on BEPS measures
Suitability of BEPS for DCs

2. **Tax technical position within the tax authority or tax system**
   - International tax laws in DCs lags behind those of developed countries.
   - Issues are raised w.r.t. anti-treaty abuse measures, such as the PPT.
   - DCs often lack knowledge of technical international tax law and treaty principles to efficiently interpret and administer tax treaties.
   - Suggestions to use tax treaties with radically-reduced technical provisions and which deal with a small number of highly-relevant issues alone.

3. **Encourage inward investment**
   - Possible conflict between protecting DC’s tax base and attracting FDI
   - Even if resources were available to introduce and police an anti-avoidance measure, a developing country may choose not to use it
Work Carried out Following the BEPS Project

- Significant volume of output and high level of focus of the OECD (and also of other international organisations) on DCs.

- **OECD - Inclusive Framework**
  - Implement and monitor the BEPS package of measures
  - Minimum standards (relating to harmful tax practices, treaty abuse, transfer pricing documentation and dispute resolution)
  - Putting in place a framework for other parts of the BEPS package
  - Developments of toolkits for low-capacity DCs

- **Output from the Platform for Collaboration on Tax (OECD, UN, IMF, WB)**
  - Output includes publications to help DCs implement BEPS measures e.g. toolkits on accessing comparables data and the taxation of offshore indirect transfers, Handbook on Effective Tax Risk Assessment

- Other important developments: ongoing work of the United Nations Tax Committee, IMF, Tax Inspectors Without Borders (TIWB) initiative, regional tax organisations such as ATAF
OECD’s BEPS package: not a tailor-made action plan for DCs

So why did developing countries join?

One hope: get access to administrative capacity building measures

Were not disappointed on that point.

High-profile developing country issues such as tax losses due to indirect transfers of assets; the taxation of cross-border services; and issues related to tax incentives; etc, were considered after 2015.

Various issues nevertheless remain.
Scarce administrative resources: Less complex measures to curtail profit shifting

- **Withholding taxes on interest and royalty payments**
  - Most MNEs accused of avoiding taxes: use intra-group licensing and interest payments to shift profits
  - Levy withholding taxes on interest and royalty payments
  - Nullifies many debt and IP based international tax planning strategies.
  - Tax credit in the residence country to avoid double taxation
  - Fuest et al. (2013): ”it is surprising for us that neither the European Commission nor the OECD considers this option. In our view the levy of withholding taxes by source countries [...] [is] an appropriate measure to ensure that multinationals pay a fair share of taxes in countries where they operate” (Fuest et al. (2013), p. 15).
Wider use of safe harbours for transfer pricing purposes

- Complexity in anti-avoidance laws mainly relates to the complexity of TP laws
- Any possibility to facilitate administration and compliance of assistance.
- Benefits from using safe harbors (e.g. Hofmann and Riedel (2018)):
  1. No need to undertake transfer pricing studies or permit simplified procedures
     - Foster tax simplicity
     - Eliminate tax uncertainty for taxpayers
     - Corporate investment may increase.
  2. Target freed tax audit resources on high-risk cases → reduce profit-shifting
- On the downside
  - Benefits from safe harbours may be unequally distributed among MNEs
  - Non-linear corporate tax scheme or application of safe harbours to homogenous subgroups (Hofmann and Riedel, 2018)
- Platform for Collaboration on Tax: Toolkit on technical assistance in transfer pricing → addresses transfer pricing safe harbours.
Exempt small and medium-sized MNEs from anti-avoidance provisions

▶ Follows from the empirical evidence: profit relocation a quantitatively relevant phenomenon among a rather small group of large MNEs
▶ Among small and medium-sized entities, costs related to compliance with anti-shifting laws, distortions of real activity and administrative burdens are not (to a limited extent) offset by mitigation of profit shifting
▶ May make it optimal to exempt these entities from the provisions.

Strengthen Regional Coordination and Limit International Tax Competition

▶ Fundamental dilemma faced by DCs: balance the countervailing objectives of raising revenues from mobile MNEs and attract FDI.
▶ Countries might forgo implementation and enforcement of anti-avoidance laws
▶ Evidence for regional tax competition
▶ Regional cooperation on tax matters that help to limit this type of regional competition may thus be a way forward.
▶ Regional coordination, may in the medium term also create opportunities to move to international tax rules which are easier to administer than current ones

International Organisations to Adopt Advisory Role to Developing Countries
DCs not necessarily have the same priorities w.r.t. BEPS as developed countries.

They were not involved in setting the agenda of the OECD’s BEPS project.

Some BEPS issue of little relevance and limited suitability and some of developing country issues not addressed.

Appreciable efforts by the OECD to engage developing countries in the BEPS work as it proceeded.

Capacity building measures have to be applauded.

Various options for assisting the position of developing countries, incl. use of simpler law, the use of safe harbours, the use of targeted exemptions, participation in regional co-ordination initiatives, and the like.

Provide technical assistance targeted to particular countries.