

# Subcommittee on Base Erosion and Profit Shifting Issues for Developing Countries

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## A. Purpose

This note provides information about the project established by the OECD and G20 to

The Subcommittee is mandated to draw upon its own experience and engage with other relevant bodies, particularly the OECD, with a view to monitoring developments on base erosion and profit shifting issues and communicating on such issues with officials in developing countries (especially the less developed) directly and through regional and inter-regional organisations. This communication will be done with a view to:

helping inform developing countries on such issues;

helping facilitate the input of developing country experiences and views into the on-going UN work, as appropriate; and

helping facilitate the input of developing country experiences and views into the OECD/G20 Action Plan on Base Erosion and Profit Shifting (BEPS).

This paper has been prepared to advance the work of the Subcommittee by providing information on these issues with a view to obtaining the views of developing countries.

As is clear from the mandate, responses will have a dual role of shaping the Subcommittee's input into the OECD/ G20 base erosion and profit shifting work and also



#### D. How does base erosion and profit shifting affect countries?

Base erosion and profit shifting is a global problem because the impact of the tax laws and policies of one country can adversely affect another country's ability to collect tax that should be due to it. This can be an unintended effect, but whether it is intended or not, it has the same budgetary effect on the country losing tax revenue. In turn, this can impede country development.

Historically, countries typically view the setting of domestic and international tax laws as a matter for each sovereign state and in making these decisions too often little or no account is taken of either (i) the impact their laws have on other countries or (ii) the impact that the laws of other countries have on them. Reality has shown that this perspective, which many or even most sovereign states take, can give rise to base erosion and profit shifting concerns.

For instance, if some countries do not effectively tax their own multinationals, this may have a knock-on effect of giving these multinationals incentives to shift profits or minimise their taxable presence in other countries where they operate (and therefore pay no tax anywhere in the world).

In the same way, if countries don't tax businesses operating in their jurisdictions in an effective manner, when they should, the incentive on the multinational to escape taxation in the country where they are headquartered increases.

Another concern that base erosion and profit shifting raises for governments is that it may make local businesses that do face comprehensive taxation uncompetitive in a way that is perceived as unfair.

Ultimately, base erosion and profit shifting

At the same time, a number of countries began investigating the impact of base erosion and profit shifting in their own jurisdiction. Some have already started to explore options for domestic legislation to address some of the problems giving rise to base erosion and profit shifting.

As mentioned above, in October 2013 the United Nations Committee of Experts on International Cooperation in Tax Matters established a Subcommittee on base erosion and profit shifting issues for developing countries.

#### F. Other related initiatives

The base erosion and profit shifting work is only one of the many initiatives currently in progress in response to the current international climate of concern about tax avoidance and tax evasion. The G20, the Global Forum on Transparency and Exchange of Information for Tax Purposes (the Global Forum) and the OECD are leading many of these initiatives. In particular the G-20 has called on the EU pilot on automatic exchange of information covered by the Foreign Account Tax Compliance Act (FATCA) to be developed into a "global standard", and has called on the Global Forum to monitor the global implementation of that standard.

Another development of note has been the modernizing, in 2010, of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, and the opening of that convention to signature by non-OECD or Council of Europe members. The G20 leaders have now called for all countries to sign the convention. The convention has now effectively been signed by 77 jurisdictions, including all G20 and OECD member countries, and all BRIICS countries. The BEPS action plan also calls on the O(a)5(l)tTPShe cBEPCDp1(b)-9(y)on]TJ -



## ANNEX

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Description of OECD action plan on base erosion and profit shifting

### Action 1 – Address the tax challenges of the digital economy

Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services, the characterisation of income derived from new business models, the application of related source rules, and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector.

Output: Report identifying issues raised by the digital economy and possible actions to address them by September 2014

#### Comment

International tax principles have developed from historic business practices that emphasised fixed assets, physical presence and relatively simple business structures. This action point will explore how those rules apply to the digital economy, which commonly relies on intangible assets, little or no physical presence and often complex and highly centralised business structures.

Both direct taxation (income taxes) and indirect taxation (value added or consumption taxes) will be considered and a dedicated task force on the digital economy has been established.

Issues to be examined include, but are not limited to:

## Action 2 – Neutralise the effects of hybrid mismatch arrangements

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Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and

deduction for Globe Co, as it is required to pay tax as a company, and Country Z allows a deduction for the investors as it sees Globe Co as partnership. Globe Co has been able to claim a double -deduction.

This action point will investigate whether changes to the OECD model tax treaty and amendments to domestic rules can be made to counter these arrangements.

### Action 3 – Strengthen CFC rules

Develop recommendations regarding the design of controlled foreign company rules. This work will be coordinated with other work as necessary.

Output: Recommendations regarding the design of domestic rules – September 2015

#### Comment

Controlled foreign company (CFC) rules apply when the residents of one country own a significant interest in a foreign company. These rules typically treat certain types of the foreign company's income (generally this is limited to passive income such as royalties, in(c)7(o)9(u)-2(217 Tw 9.1(dtn /TT1 1 Tf 0.004 Tc -0.006 Tw 9.96 0 0 9.96 72 471 Tm [(i)-11(n)11((c)7(o)9(u)8v1 9.96



Action 4 – Limit base erosion via interest deductions and other financial payments

Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related party and third party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments. The work will evaluate the effect of different types of limitations. In connection with and in support of the foregoing work, transfer pricing guidance will also be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements. The work will be coordinated with the work on hybrids and CFC rules.

Another option to address expensive debt is an earnings stripping rule. Such a rule allows interest deductions only up to a certain fraction of earnings. Since the rule is based on interest deductions, not amount of debt, it can counter both excessive amounts of debt (like thin capitalization rules) and expensive debt (like transfer pricing rules). There are drawbacks, however. For example, an interest stripping rule could result in interest denial if a company's earnings fall due to an economic downturn, even if the company does not have excessive amounts of debt.

Action 5 – Counter harmful tax practices more effectively, taking into account transparency and substance

Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.

Output: Finalise review of member country regimes – September 2014; Strategy to expand participation to non-OECD members – September 2015; revision of existing criteria – December 2015

Comment

Countries compete to attract foreign investment into their economies. This competition may include lowering tax rates, providing incentives, exempting certain forms of income or granting tax holidays.

This action will consider how, given that nations have the sovereign right to set their own tax rules, the effects of this tax competition can be countered. Part of the work related to this action is focused on a review of the OECD member countries to identify which nationals have preferential regimes and engagement with non-OECD members on the framework developed to assess these regimes.

Other work will look at improving transparency so that the impacts and effects of preferential regimes can be more easily identified, and developing a common set of rules that countries could base tax policy decisions on. One such rule could be requiring substantial activity to be carried out in a jurisdiction before a business becomes eligible for tax incentives.



Action 7 – Prevent the artificial avoidance of PE status

Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions. Work on these issues will also address related profit attribution issues.

Output: Changes to the OECD Model Tax Convention – September 2015

Comment

A foreign enterprise can operate and earn profits in a country by performing its activities directly through a branch in its own name rather than operating through a local subsidiary. In these cases the question of whether the country in which the activities take place can tax that enterprise depends on whether the enterprise has a “permanent establishment

Permanent establishment (PE) is a term used to describe the threshold beyond which a

on whether the foreign enterprise has established a fixed place of business through which the business of the enterprise is carried on. Other fact3(e)1( dt 4)-11(c)-2(a)1(n)-23(e)1-11(e)o1(o)-12(fe1(c)-2

it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation. This work will be coordinated with the work on interest expense deductions and other financial payments.

#### Action 10 – Other high-risk transactions

Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: (i) clarify the circumstances in which transactions can be recharacterised; (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses.

Output: Initial changes to the OECD Transfer Pricing Guidelines and possibly to the OECD

Model Tax Convention – September 2014; remaining changes to the OECD Transfer

Pricing Guidelines and possibly to the OECD MDo8( )31(l)1(y3(o)9(1do-2(o8( )3( )1(h))TJ -0.0051(l)j 0.0o8( h))TJ -0. -0.

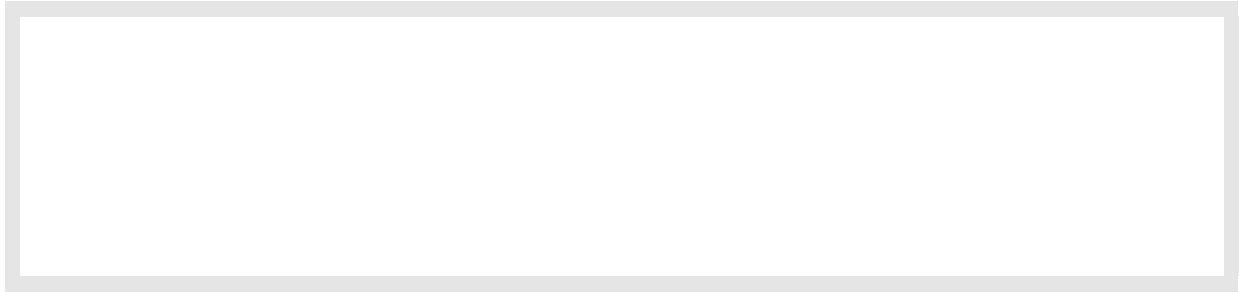
intangibles are aligned with economic activity; how to deal with hard to value intangibles, for instance partially developed technologies; and cost contribution arrangements.

An MNE has two companies (Company A and Company B) in two different countries (Country Y and Country Z respectively). Country Y is a high tax jurisdiction, Country Z is a low tax jurisdiction. Company A designs, manufactures and retails a brand of products. When Company A develops a new product line it sells the patent for that product to Company B. Company A then pays Company B an annual royalty which has the effect of shifting profit out of the high tax jurisdiction and into the low tax jurisdiction.

Another common strategy is for MNEs to provide capital from, or assign risk to, a low tax jurisdiction. This allows profits to be shifted from one jurisdiction to another through interest payments or guarantee fees. These transactions are problematic as there is often no change to the MNEs overall capital position or risk exposure as a result of the transfer and yet there is a substantial change in the MNEs tax position. Action point 9 will consider how these transactions can be better aligned with the MNE's economic activity.

may loan Company A funds and strip profits out through interest deductions (see Action 4 for an expanded example). Note that while Company B had

Output: Recommendations regarding data to be collected and methodologies to analyse them – September 2015



### Action 13 - Re-examine transfer pricing documentation

Develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNE's provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.

Output: Changes to OECD Transfer Pricing Guidelines and recommendations regarding the design of domestic rules – September 2014

#### Comment

This action point will consider whether a global template can be developed for transfer pricing documentation. This template will include a high level view of the MNE's global activity, commonly known as country-by-country reporting, and detailed information on the MNE's activity in the local jurisdiction.



## Action 15 – Develop a multilateral instrument

Analyse the tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties. On the basis of this analysis, interested Parties will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy an