



The OECD's BEPS Process and Developing Countries – a Way Forward

By Krishen Mehta, December 2014

The OECD's Base Erosion and Profit Shifting (BEPS) project [launched](#) in July 2013 project is the fruit of considerable public outrage over an international tax system that seems increasingly to be allowing multinational corporations (MNCs) to take the benefits from societies in which they operate, but then escape paying their fair share of tax contribution towards those benefits.

The BEPS process seeks to address a fundamental reality - that a number of large corporations are more profitable today because of the OECD's so-called "arm's length principle" (see box) and all the dysfunctions that come with it. Can something be done to resolve this fundamental issue?

Box: the Arm's Length Principle

The arm's length principle (or arm's length method) is a means of assessing transactions across borders between different affiliates within the same multinational corporate structure. It asserts that the "transfer price" of such a transaction should be the same as if the two related parties were in fact independent of each other and not part of the same corporate structure. This method or principle is a central pillar of the international corporate tax system, and the premise that the "arm's length price" is 'independent' has also made it a central pillar of a number of multinational corporations' tax avoidance strategies.

By seeking to put into place 'Action Plans' that can help create a more level playing field for both developed and developing countries, the OECD has embarked on an important exercise. It remains to be seen whether the architecture of the arm's length principle will be challenged, or whether it will end up being sustained with just a few adjustments here and there. One hopes for the former, but one needs to be prepared for the latter.

Joseph Andrus, who was head of the OECD's transfer pricing unit when the BEPS process was launched, made an insightful comment on February 13, 2013 when the process was germinating. He said:

"Whatever it is we are doing isn't producing accurate results if it turns out that 75 percent of the world's income, under the current transfer pricing system, is reflected as being earned in Singapore, Switzerland, the Cayman Islands, and Bermuda."

This in itself is an important admission about the need and urgency for change.

Yet real change will be tough. The OECD is a club of rich countries, and its member states will be under constant pressure from their large corporations to maintain the status quo, or to make only modest adjustments to how the tax pie is allocated between the "residence" countries (where large multinationals are resident; usually rich OECD countries), and the "source" countries (which are the source of multinational corporations' profits; very often developing countries.)

This will create tensions with developing countries, which on the one hand want to participate in the BEPS process and its promise of producing remedies for the shortcomings in the international tax system, and on the other hand feel the pressure to assert their own fiscal sovereignty, conscious that a club of rich countries may be seeking to protect primarily its own membership first.

One wonders therefore if there a middle ground that could be a win-win for developing countries while the BEPS process is unfolding. Perhaps there is.

I would argue that without impeding or running counter to the BEPS process in any way, there is a lot that developing countries can do to protect their interests.

Here are ten approaches to consider.

1. Implement strict **General Anti Avoidance Rules (GAAR)**. This way, any impermissible tax avoidance structures, where the main purpose is to obtain tax benefits, would be subject to challenge. GAARs are framed to minimise tax avoidance for example, by reallocating profits to tax havens. Under these rules the tax benefits of transactions or arrangements can be denied if they do not have any commercial substance or consideration other than achieving the underlying tax benefit itself.

2. Tax authorities can do more **audits of service fees and royalty payments** that are made by MNC's to related parties. China is [leading by example](#) by doing selective audits for years 2004 to 2013, paying particular attention to companies in tax havens and to related parties in other overseas jurisdictions that have few or no functions.

3. Ensure that domestic law and tax treaties follow the "**source rule**" for **royalties, management expense, interest expense, and other payments**. To illustrate how this works, take royalties as an example. Suppose an MNC uses intellectual property (IP) in a business carried out in a developing country. The MNC's subsidiary in the developing country pays a royalty to that MNC, thus stripping (taxable) profits out of the developing country and shifting them to the MNC's country of residence. Under conventional arrangements, this will reduce the company's tax bill in the developing country. To tackle this, the developing country can treat the royalty payment as foreign-source income by the MNC, and subject it to local withholding taxes in the developing country. The royalty payment would then be subject to withholding taxes. Domestic law should insist on this, and the tax treaties should follow that legal interpretation. Developing countries need to ensure that 'nil withholding tax' does not apply in any circumstance. Countries should be willing to renegotiate tax treaties, if need be, to ensure that this objective is in place.

4. Strengthen the home country's resources on **Advance Pricing Agreements** (APAs), so that more of these agreements can be expedited and signed. An APA is an agreement between a company and the taxing authority on an appropriate transfer pricing methodology to be followed for some set of transactions at issue over a fixed period of time. Agreements such as these give certainty to MNCs but also give certainty to governments on the taxes that would be payable. India is considering rolling over existing transfer pricing litigation (under the arm's length principle) into APAs once they have been signed: essentially, if there is any litigation pending for those years, and is similar in nature to the APA that is negotiated, then those cases would be closed along the APA guidelines.

5. Implement **Safe Harbours**, which put caps on allowable tax deductions (see [point 4 here for](#) further explanation.) For example, in the IT sector, safe harbors have been introduced in many countries at cost plus 25 percent. This means that in this sector, the targeted profit margin (or safe harbor) is fixed at 25 percent, and is taxed as such. Both parties agree to it in advance, and no litigation by the tax authorities would take place, nor would there be any audits. The tax revenue is protected and the developing country and the company both get the certainty of income tax being paid on that profit margin. The developing country gains when the profit margin is less than 25 percent, and the company gains when it is more. These safe harbors can also apply to service fees, interest expense, management fees, and other inter-company charges. For example, a management fee of 2% could be agreed to as a safe harbor, and that would become a cap on the maximum amount that the company could charge. Any profit shifting through the MNC charging its subsidiaries in developing countries excessive management fees can thus be avoided.

6. Adopt a wider use of the **profit split method** in determining source country taxation. Basically, this method adds up the profit from a group of transactions for all related parties, then divides these profits among those related parties according to certain proxy measures of genuine economic activity. These measures include headcount, sales, functions performed, risk borne, and assets employed by each party. (This could be considered as a very restricted, transaction-level version of Unitary Taxation.)

7. Developing countries **should expect sound transfer pricing documentation from MNC's**. They could be asked to file information returns on all transactions above a certain amount. This further puts pressure on companies to ensure that the arm's length principle is not being misused for tax avoidance purposes.

8. Countries can **start implementing policies consistent with the spirit and intent of BEPS** through both legislative and enforcement activity, **without waiting** for the final recommendations to be agreed. Some countries are already doing so. For example, new tax laws in France and Mexico have included several BEPS-related changes including restrictions on the deduction of financing costs. This can serve as an important model for other countries.

9. Developing countries need to also **evaluate carefully their informal economy**, especially the sector driven by domestic corporations that keep a major portion of their taxable income outside of the formal sector through trade mispricing or other means. If the primary objective of BEPS is to tax "where the economic activities take place", then developing countries also have an obligation to look inwards, to look at their own domestic companies, and ensure that tax evasion is not taking place. Suppose that a country has a significant portion of its exports being re-invoiced through Dubai, Singapore, or Mauritius. In such case, the country is deprived of the tax revenue on the profits, and the funds often 'round-trip' back as black money or foreign direct investment. It is important to rein in this 'parallel' economy, so that domestic tax resources can be better mobilized.

10. Invest not only in **better training for tax administrators, but also share or publicise successful best practices with other developing countries**. We can learn from each other, and we should. A good case in point is China's current challenge to companies with respect to all management fees that are charged by headquarter companies, thereby stripping profits out of China. These fees are being viewed by Chinese tax authorities as a stewardship cost that is necessary to protect and support the investment in China, and a cost that should therefore not be charged to the overseas subsidiary. There is nothing to constrain other countries from taking a similar approach on these kinds of charges that reduce the reportable profits that foreign MNCs have in their subsidiaries in developing countries.

In conclusion, one can say with reasonable accuracy that the tide is shifting demonstrably towards greater tax justice, more than ever before. Without tax

justice, the poorest and most vulnerable countries cannot fund their development priorities, or manage their budget deficits effectively.

BEPS has provided some hope to developing countries for a fairer allocation of tax revenues consistent with the performance of economic activity. Hopefully it will meet the vision that is intended. But the call for action inherent in BEPS should also be a call for action within the developing countries to make back-up plans that can strengthen their own tax base for development. This does not mean fiscal arbitrariness. It simply means doing what is best for themselves within the legally accepted practices that other countries also follow.

Let us be smart about our tax policies and not wait for others to frame them for us.

Krishen Mehta is a former partner with a big 4 firm and served in their Tokyo, London, and NY offices. He is a global justice fellow at Yale University, and a Senior Advisor to the Tax Justice Network. The views expressed here are his own.