



Papers on Selected Topics in Protecting the Tax Base of Developing Countries

Draft Paper No. 1

May 2013

Protecting the Tax Base of Developing Countries: An Overview

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Hugh J. Ault and Brian J. Arnold

1. Introduction

1.1 General background. One of the most significant policy challenges facing developing countries is establishing and maintaining a sustainable source of revenues to fund domestic expenditures. While this problem has many facets, one of the most important is protecting the domestic tax base. In recent years, increasing attention has been paid to the fact that many multinational companies (“MNE”) appear to have been able to pay effective tax rates well below what one would expect from the headline rates in the countries in which they are operating. Several widely publicized cases of low or no taxes on well-known companies highlighted these issues and brought the questions of tax avoidance and evasion into the public political debate. In response to these developments, the OECD began analytical work to try to determine what exactly were the techniques through which corporations were able to dramatically reduce their effective tax rates. This work was supported by the G-20 and the G-8, where the particular problems facing developing countries were emphasized. The results of this work were the OECD Report “Addressing Base Erosion and Profit Shifting” and the subsequent “Action Plan on Base Erosion and Profit Shifting” which are discussed below in more detail. (see 1.4.1)

While the work of the OECD is important, and made substantial efforts to take the viewpoints of developing countries into account in formulating its analysis, it was clear from the beginning that some kind of independent examination of the problems of tax avoidance and the resulting profit shifting and base erosion from the perspective of developing countries was required. This is true for a number of reasons. In the first place, most developing countries are primarily (though not exclusively) concerned with the reduction in source-based taxation, rather than the shifting of the domestic income of locally-owned companies to low or no tax jurisdictions. Secondly, the corporate tax on inward investment typically plays a larger role in total revenue in developing countries than in countries with more developed tax systems. In addition, the potential responses to base erosion and profit shifting are limited to some extent by the administrative capacity of developing country tax administrations.

For all of these reasons, it was clear that work on these questions which focused on the issues and needs of developing countries in particular should be developed. As a result, the United Nations Committee of Experts on International Cooperation established a Subcommittee charged with informing developing country tax officials on these issues and facilitating the input of developing country views and experience into the work of the Committee and in the wider work of the OECD Action Plan. In addition, the UN Financing for Development Office (FfDO) undertook a project to supplement and complement the OECD work by focusing on a number of issues which are of particular interest to developing countries which will include but not be limited to the matters covered by the OECD work.

1.2 Scope of the FfDO work on base erosion and profit shifting.

There is no single cause or explanation for the increasing level of base erosion and profit shifting. The various issues are not new and have been discussed in the past. They involve questions of domestic tax law of individual countries, the interaction between domestic tax systems and the role of tax treaties in facilitating base erosion. Some of these issues are of concern for all countries, while others are of greater importance to some than to others. Thus some of the issues covered in the OECD/G-20 BEPS project discussed below are of interest to both OECD countries and to developing countries and some are primarily the concern of OECD countries. In addition some issues have been identified which are not included in the OECD/G-20 BEPS work but are still important to tax base protection from the perspective of developing countries. Thus the FfDO project has decided to focus its efforts on the following topics:¹

- Neutralizing the Effects of Hybrid Mismatch Arrangements
- Limiting the Deduction of Interest and other Financing Expenses
- Preventing the avoidance of Permanent Establishment status
- Protecting the tax base in the Digital Economy
- Transparency and Disclosure
- Preventing Tax Treaty Abuse
- Preserving the Taxation of Capital Gains by Source Countries
- Taxation of Services

¹ This project does not deal with the base erosion and profit shifting aspects of transfer pricing as those matters are being considered by the UN work on the revision of the UN Practical Manual on Transfer Pricing for Developing Countries.

- Tax Incentives

These issues were the ones which seemed on an initial examination to be of most importance to developing countries. In some situations, the erosion of the tax base results in income avoiding taxation altogether, so-called “double non-taxation.” Typically, these cases involve the interaction of technical tax rules in several countries which combine to have the effect of avoiding the taxing jurisdiction of both countries. In other cases, the base erosion arises from the fact that economic activities which formerly were subject to the local taxing jurisdiction can be restructured, often as the result of advances in technology and communication, into situations where the existing jurisdictional rules no longer reach them. Here, the question is of one of reestablishing the tax base which has been lost and reformulating tax rules to better fit the current structures of business activities. In some cases, countries have intentionally allowed their companies to reduce or avoid tax on their foreign income and in other cases, countries have failed to tax companies doing business in their jurisdiction in order to encourage inward investment. In still other cases, it is a lack of information concerning the overall activities of the corporation which results in the avoidance of tax in the jurisdictions concerned. This is especially the case where third-country intermediary companies are concerned.

Countries can of course deal with some of these issues unilaterally and a number have already begun to do so. But to respond effectively to some of the challenges which base erosion and profits shifting pose, it is essential that actions be taken forward in a coordinated manner. Countries must be more aware both of how their tax systems affect other countries’ systems and how their domestic system is impacted by another country’s tax rules. This is important both for the development of domestic tax legislation and for determining tax treaty policy. These results can only be achieved through increased international dialogue and cooperation.

1.3. Goals and Methodology of the FfDO project on base erosion and profit shifting.

The basic goal of the FfDO project is to complement and supplement the work done in the OECD BEPS project. It will complement the work by providing additional insight into the issues identified in the OECD project when viewed from the perspective of developing countries. It will also supplement the OECD work by considering issues which involve base erosion and profit shifting of particular importance to developing countries which are not included within the OECD focus. In addition, the OECD work has quite short deadlines for its initial assessments and recommendations. It will clearly be a longer term matter for these insights to be evaluated and implemented and here the FfDO outcomes will be relevant. Moreover, the initial focus of the BEPS concerns on double non-taxation and inadequacies of existing rules and principles may open a discussion on more

comprehensive changes in international tax rules. As noted subsequently, the OECD explicitly takes the position that the BEPS project is not intended to alter the fundamental allocation of the international tax base between residence and source countries.

The final outcome of the FfDO project will be a collection of papers on the selected topics listed above. The papers will be developed by individual authors, informed by the OECD work on the topics and a review of the existing literature. Most importantly, it will reflect the input of developing countries both through the Subcommittee-sponsored activities and through the workshops held specifically to catalogue the experience and concerns of developing countries with the overall problem of base erosion and profit shifting.

1.4 History of the OECD/G-20 work on BEPS

1.4.1 Background of the OECD Report “Addressing Base Erosion and Profit Shifting”. In November, 2012, the G-20, meeting in Mexico, in its final communique, “welcomed the work that the OECD is undertaking into the problem of base erosion and profit shifting and look forward to a report about progress of the work at our next meeting.” The G-20 request to the OECD was triggered by well-publicized reports of important multinationals reporting very low effective rates of tax on their worldwide profits. Prior to the G-20 endorsement, the OECD had been examining various related issues in its work on aggressive tax planning, transfer pricing, exchange of information and harmful tax competition. The G-20 requested a “diagnosis” of the extent of and the causes of profit shifting and the accompanying base erosion. The OECD Report was presented to the G-20 Finance Ministers at their meeting in Moscow in February, 2013 where it received an enthusiastic reception: “In the tax area, we welcome the OECD report on addressing base erosion and profit shifting and acknowledge that an important part of fiscal sustainability is securing our revenue bases. We are determined to develop measures to address base erosion and profit shifting, take necessary collective actions and *look forward to the comprehensive action plan the OECD will present to us in July.*”

1.4.2 Content of the OECD Report

The OECD Report identified several “key pressure points” which had been central in the spread of base erosion and profit shifting:

- International mismatches in entity and instrument characterization, so-called hybrid arrangements which take advantage of differences in domestic law to create income which escapes taxation altogether or is taxed at an artificially low rate;
- The use of treaty concepts limiting taxing jurisdiction to prevent the taxation of digital goods and services
- The use of debt financing and other intra-group financial structures
- Various aspects of transfer pricing dealing with risk, intangibles, and the splitting of ownership within a group which allow the separation of economic activities from taxing jurisdiction
- The lack of effective anti-avoidance measures such as General Anti-Avoidance Rules (GAAR), Controlled Foreign Corporation regimes, thin capitalization rules and anti-treaty shopping rules
- The availability of harmful preferential regimes

The Report goes on to examine the techniques which multinational corporations use to exploit these “pressure points” to achieve base erosion and profit shifting. These pressure points can be classified roughly as follows

- minimizing profits taxation in the source country by avoiding source country taxing jurisdiction or through generating deductible payments to related parties,
- Reducing or eliminating withholding tax in the source country by taking advantage of treaty rules and treaty shopping,
- Ensuring low or no taxation in the recipient jurisdiction by shifting profits to subsidiaries in tax havens or low tax jurisdictions,
- ensuring that there is no current taxation in the parent country jurisdiction through avoiding the application of controlled foreign corporation rules;

For the perspective of developing countries, the first two points, minimizing source country tax and avoiding or reducing withholding taxes are clearly the most important. When corporations can use these techniques to exploit the various pressure points in the existing system, the Report identifies a number of important and disturbing consequences. Corporations which can reduce the overall tax burden through low-taxed foreign source income can have a competitive advantage over local corporations which only operate in the domestic market. In addition, the possibility of reducing taxation may lead to an inefficient allocation of economic resources, with investments being undertaken for tax purposes only. Finally, public perceptions that corporations can avoid paying taxes undermines the voluntary compliance of other taxpayers on which the tax system rests.

In addition to the discussion of the substantive reason for base erosion and profit shifting, the Report also deals with the need for transparency and the increased utilization of exchange of information, building on the work of the Global Forum on Transparency and Exchange of information.

As a result of this “diagnosis”, the Report concludes that what is needed is a comprehensive “global action plan” to deal with the many interrelated strands which lead to base erosion and profit shifting. While countries can and will take unilateral action, if those actions are not coordinated, the resulting potential double taxation can generate double taxation. The Report was endorsed by the G-20 at its meeting in February, 2013 and the OECD was instructed to develop the Action Plan . The Action Plan was presented to the G-20 leaders at their meeting in July, 2013 where it was fully endorsed:

“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 minimize 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. We acknowledge that effective taxation of mobile income is one of the key challenges. We look forward to regular reporting on the development of proposals and recommendations to tackle the 15 issues identified in the Action Plan and commit to take the necessary individual and collective action with the paradigm of sovereignty taken into consideration.”

As well, the G-20 supported the OECD’s focus on its ongoing work on transparency and exchange of information, stressing that:

“Developing countries should be able to reap the benefits of a more transparent international tax system, and to enhance their revenue capacity, as mobilizing domestic resources is critical to financing development. We recognize the importance of all countries benefitting from greater tax information exchange”

1.5 The OECD/G-20 Action Plan

1.5.1 Overview of the Action Plan. The OECD/G-20 action plan sets out 15 Actions to be taken to carry out the mandate of the G-20.

- 1) Address the challenges of the digital economy.
- 2) Neutralize the effects of hybrid mismatch arrangements.
- 3) Strengthen the controlled foreign company rules.
- 4) Limit base erosion via interest deductions and other financial payments.
- 5) Counter harmful tax practices more effectively, taking into account transparency and substance.
- 6) Prevent treaty abuse.

- 7) Prevent the artificial avoidance of permanent establishment status.
- 8, 9, and 10) Assure that transfer pricing outcomes are in line with value creation regarding intangibles; risks and capital; and other high-risk transactions.
- 11) Establish methodologies to collect and analyze data on BEPS and the actions to address it.
- 12) Require taxpayers to disclose their aggressive tax planning arrangements.
- 13) Reexamine Transfer pricing documentation.
- 14) Make dispute resolution mechanisms more effective.
- 15) Develop a multilateral instrument to enable interested countries to implement measures developed in the course of the BEPS work and amend bilateral tax treaties.

The items listed in the action plan which are most relevant to developing countries will be discussed in detail in the follows sections of this paper. However, some preliminary observations can be made. The substantive items in the action plan can be grouped into two basic categories. The first category includes transactions and arrangements where the interaction of domestic tax rules create double non-taxation or taxation at low rate. These situations are described as resulting from the lack of “coherence” of existing international tax rules. The Action Plan observes that much attention has been paid in the development of international tax standards to measures intended to avoid double taxation. However, the interaction of rules which allow income to escape tax altogether or to be taxed at a low rate have been for the most part ignored, which has generated a number of techniques which allow for base erosion and profit shifting. These typically involve situations where a country allows a deduction for a payment with the expectation that the payment will be taxed in another jurisdiction but where this is in fact not the case. A similar problem arises where countries treat an organization differently, one viewing it as transparent and taxing the participants and then other viewing it as a taxable entity. Again there is a lack of coherence between the two national tax systems.

A separate set of issues can arise where there is a disconnect between the actual economic activities of a company and the jurisdiction to which current rules may assign the taxing rights to the income which those activities have generated. For example, the interposition of an intermediate or conduit company between the parent company and its operating subsidiary may result in income being attributed to that intermediate company which has no real substance. Similarly, current rules may allow a company to have a substantial economic presence in a jurisdiction without that jurisdiction having a recognized taxing right. This may arise through the increased importance of technological and communications advances which make physical presence in a jurisdiction less

necessary or longer necessary at all. Or it may come about because of the technical requirements of existing rules in domestic tax law or tax treaties as to taxing jurisdiction.

In addition to the importance of reassessing the applicable substantive rules, the Action Plan stress the need for transparency and sharing of information among jurisdictions. Thus, one of the action items calls for the development of better mechanisms for information sharing to implement the substantive rules.

The basic focus in the OECD/G-20 Plan calls for adjustments to current international tax rules which would reduce the ability of companies to generate non-taxed or low-taxed income by modifying existing rules. However, the Plan states that: “[w]hile actions to address BEPS will restore both source and residence taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates, these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income.”

1.5.2. The Role of Developing Countries in the OECD/G-20 Action Plan. At several points, the Action Plan recognizes the special situation of developing countries as regards the issues identified in the Plan. Thus the Plan observes that as a result of base erosion and profit shifting, “[i]n developing countries, the lack of tax revenue leads to critical under-funding of public investment that could help promote economic growth.” As to input from developing countries, the OECD organized various regional meetings to obtain information as to developing country views as to the issues discussed in the Report and the Plan. In addition, the Plan recognizes that “[d]eveloping countries also face issues related to BEPS, though the issues may manifest differently given the specificities of their legal and administrative frameworks. The UN participates in the tax work of the OECD and will certainly provide useful insights regarding the particular concerns of developing countries.” Nonetheless, it is clear that, while developing country interests have been to some extent taken into account, there is a need for an independent examination of the measures which the Action Plan addresses and their suitability and appropriateness to address developing country needs.

2. Analysis of the FfDO topics in the light of the OECD BEPS Action Plan.

As indicated above, some of the problems identified in the OECC/G-20 action plan are of greater urgency to developing countries than others. This is especially the case in the light of the limited administrative resources available and the need in many cases to establish a new legal and administrative framework to deal with the problems of base erosion and profit shifting. The FfDO

project has tentatively selected the following Action Plan items for further analysis for the developing country perspective.

2.1 Neutralizing the Effects of Hybrid Transactions

2.1.1 What are hybrid transactions? In many cases, the same cross-border transaction may be treated differently in two jurisdictions. Domestic tax rules are typically developed without significant consideration given as to how the transaction may be treated in another jurisdiction when a foreign party is involved. This “hybrid” nature of the transaction may result in income escaping taxation in both jurisdictions. As a result, the overall tax revenues which the two countries were expecting from the transaction are reduced. The tax base of one of the countries has been reduced but there has been no corresponding increase in the tax revenue of the other country. The transaction has resulted in “stateless” income which is not taxed in any jurisdiction. In other situations, differences in the treatment of a legal entity can result in the same amount being deducted twice. These “hybrid” results can come about because of differences in domestic law or differences in the application of tax treaties and has been identified as a source of base erosion in the OECD/G-20 Action Plan.

2.1.2 Hybrid instruments and arrangements. One of the most common forms of hybrid transaction involves an instrument which is treated differently in two jurisdictions as regards the payments on the instruments. Typically, the country of the issuer of the instrument treats the instrument as debt and the payments on the debt as deductible interest while the country of the investor treats the instruments as equity and the payments as dividends which qualify for some kind of participation exemption.

Example: Company B resident in Country B issues an instrument to Company A resident in Country A. Under the laws of Country B the instrument is treated as a debt and the payments on the instrument are deductible by Company B. Under the laws of Country A the instrument is treated as a share of stock of Company B and the payments are treated as dividends. Under Country A’s tax system, dividends are given a participation exemption. Thus payments on the instrument escape tax in both jurisdictions.

The same results can obtain where the instrument itself has the same character in the two jurisdictions but has features which are treated differently. For example, an debt instrument may be able to be converted into a stock investment and one country views the conversion privilege separately from the debt aspects of the instrument while the other does not.

In other situations, double nontaxation is the result of differing approaches to determining ownership for tax purposes.

Example: Company A resident in Country A transfers shares to Company B resident in Country B under an arrangement in which Company A agrees to repurchase the shares at some point in the future for a fixed price (a stock “repo”). Under Country A’s tax law, the formal sale is treated as a secured loan and the difference in the two prices is treated as interest that is deductible by Company A. Country B follows the legal form of the transaction and treats Company B as the purchaser of the shares and the payments received on the shares by Company B as dividends. When the shares are repurchased by Company A, Company B may realize a gain. Both the dividends and the gain on the sale of the shares may qualify for the participation exemption under Country B’s tax system.

As a response to these situation of double nontaxation, it would be possible for a country to deny a deduction for any payment which are not taxed in the hands of the foreign recipient. Or it would be possible for a country to deny the participation exemption to any payments which are deducted in the another jurisdiction. In either case it would be necessary for the country modifying its normal treatment of the instrument to have information as to how the payment is being treated in other country. In addition, if both countries react to the situation independently with one country denying the deduction of the interest and the other country denying the participation exemption, there will be a problem in coordinating the two measures and in determining which rule has precedence.

2.1.3 Hybrid entity payments. In some cases, double nontaxation can be involved when two countries treat the legal form of an organization differently. As a result, neither country will assert taxing jurisdiction on some of the income of the enterprise.

Example: Company A, a resident of Country A, owns all the shares of Company B, a resident of Country B which in turn owns all of the shares of Sub B which is also resident in Country B. Company B and SubB can consolidate their income and losses for purposes of Country B tax. Country B treats Company B as a legal entity but Country A ignores the separate existence of Company B. Company B borrows from a bank and pays interest on the loan. Under the tax rules of Country A, the interest payments to the bank are deducted in Country A as part of the expenses of Company A; the separate existence of Company B is ignored. Under the tax rules of Country B, Company B is entitled to a deduction for the interest paid to the bank and can offset that deduction against the income of SubB through consolidation. Thus, the interest expense has been deducted twice in circumstances in which a corresponding income inclusion by Country A is not possible.

2.1.4 Hybrid entity receipts(“reverse” hybrids).

Payments **to** a hybrid entity can also result in double nontaxation. This occurs because the jurisdiction viewing the organization as an entity allows payments to be deducted while the jurisdiction of the investor does not tax the payments because, from its perspective, it has no taxing jurisdiction over the receipt of the payments as they are received by a separate entity.

2.1.5. Tax Treaty Aspects of Hybrid Entities.

Hybrid entities can be used to obtain the benefits of the allocative rules in tax treaties in circumstances where it is unlikely that the parties to the treaty intended such benefits to be available.

Example: Organization P of Country P is owned by X1 and X2, residents of Country X. Organization P is treated as an entity by Country S but is fiscally transparent under the laws of Country P. The tax treaty between Country P and Country S prevents Country S's taxing rights on royalty payments. Thus from Country S's perspective, payments to Organization P would in principle be entitled to treaty benefits. However, from Country P's point of view, the relevant taxpayers are X1 and X2 over which it has no taxing jurisdiction. In these circumstances it would be inappropriate for Country S to be required to reduce its tax on royalties received by Organization P.

In this example, under the OECD Model Convention, if Organization P was a partnership under the laws of Country P so that under the laws of Country P, the income of the Organization is allocated to X1 and X2, Country S would not be required to reduce its taxes. A similar approach could be applied to all situations in which there is a conflict in the classification of an organization.

2.2 Limiting the Deduction of Interest and other Financing Expenses

2.2.1 General The use of borrowing ("leverage") was identified in both the OECD Report and in Action Plan Item 4 as a technique which facilitated base erosion and profit splitting. The issue comes up because most jurisdictions recognize interest expense on borrowing (the "rental" cost of money) as a deductible expense. When applied to corporations, this basic rule encourages the use of debt financing rather than equity financing for corporate structures since interest deductions reduce the tax base while distributions of corporate profits in the form of dividends do not. In addition, it gives an incentive to "load" debt into companies operating in high tax countries and arrange for the interest payments to be received by an entity in a low or no tax jurisdiction. This problem is especially true where the loan is provided by the shareholder or a related finance company organized in a low tax jurisdiction. Furthermore, not only can the amount of the loan be excessive, but there is also an incentive to have an excessively high interest rate on the loan. From the point of view of developing countries, where inward investment is financed through debt, this can result in serious problems of base erosion and profits shifting.

Example A: Company P has no external debt. It has provided capital to Company F, organized in a tax haven which functions as a financing vehicle to all of its operating subsidiaries, including Company DC which is resident in Country DC, a developing country. Company DC has paid in capital of 250 and is able to borrow 1,000 from Company F, deducting the 100 of interest expense in Country DC which entirely eliminates the profits of 100 of Company DC.

As this example shows, there are a number of connected issues involved in determining the appropriate treatment of cross border interest. First of all, since there is no external debt anywhere in the Company P group, the only effect of allowing the interest deduction is to shift profits from Company DC to Company F. That is, the combination of the deduction in Country DC and the exemption from tax of the interest receipt has resulted in part of the profits of Company DC and the Company P Group from being taxed anywhere. If Company P had instead financed the investment in Country DC through a direct equity investment, Company DC would have been taxed on the profits which would be transferred to Company P as a dividend which might be subject to withholding tax by Country DC. And from an economic point, money is fungible. Apart from tax consequences, Company P is generally indifferent to whether the internally derived funds are represented by a loan or an equity investment.

Issues with respect to the interest deduction can also arise even when the borrowing does not involve a related party. Though the borrowing is from an unrelated party, there will still be an incentive to locate the borrowing where it will be most advantageous from a tax point of view which can have a base eroding aspect.

Example B: Company P, a resident of Country P, pays tax at a rate of 20% in Country P and wishes to make an investment in Country DC which has a tax rate of 40%. It has determined that it will need to finance this investment by external financing. It can structure the investment in Country DC so that all of the financing expense falls in Country DC and is deducted there while the interest receipts are taxed in Country P or in a third country.

2.2.2 Possible restrictions on interest and similar financing expenses.

2.2.2.2 Recharacterization of debt as equity. If the financing instrument takes the legal form of a loan, it would be nonetheless possible for tax purposes to treat the instrument as an equity investment and disallow the deduction of the purported interest expense. This might be the approach if the debt is subordinated to other debt or if the “interest” payments are dependent on profits, giving the financing the economic character of equity, despite its formal status as debt.

2.2.2.3 Thin capitalization rules. A number of countries have so-called “thin capitalization” rules which deny the interest deduction where the amount of debt in relation to equity capital exceeds certain ratios. Thus in Example A above, where the borrowing was 4 times the amount of the equity capital, all or a part of the interest deduction in Country DC could be disallowed if it has thin capitalization rules that deny the deduction of interest on a corporation’s debt to the extent it exceeds, say, 2 or 3 times its equity. In some cases, only related party debt is included but, in other situations, all loans are taken into account in determining if the interest expense is deductible.

2.2.2.4 Earnings stripping rules. Instead of focusing on the amount of debt, it is also possible to restrict the amount of the current interest deduction by focusing on the amount of the interest expense relative to the company's income. Thus, in Example A, where the profits of 100 were completely eliminated by the interest deduction of 100, it would be possible to limit the interest deduction to, say, 30% of the before-tax earnings and thus disallow 70 of the interest deduction in the current year. It might be possible to allow the interest expense to be "carried forward" to subsequent years in which the taxpayer has additional profits and less interest expenses. Again, it might be possible to limit the "earnings stripping rules" to related party interest or to apply them to all interest on all borrowings.

2.2.2.5. Transfer pricing aspects. In some cases, the interest deduction can be limited by applying "arm's length" transfer pricing principles. For example, the interest deduction might be disallowed if the taxpayer cannot establish that a third party lender, for example, a bank, would have made the loan in similar conditions. Similarly, the loan could be respected as such, but the amount of deductible interest could be limited to what an "arm's length" rate of interest would have been.

2.2.2.6. Allocation of worldwide interest expense. From an economic point of view, money is fungible, that is, borrowing for one purpose or in one country means that the taxpayer can continue holding other assets or investments in other countries. Suppose, for example, that the taxpayer holds asset A and wishes to acquire asset B. To make this acquisition, the taxpayer could either borrow funds to finance the purchase or could "disinvest" in asset A to purchase asset B. Viewed from this perspective, if the taxpayer borrows to acquire asset B, the interest expense can be viewed as related to both asset A and asset B. In the same way, the borrowing in Example B in Country DC to finance the acquisition there could also be seen to be related to the assets which Company P holds in Country P. If one takes this approach, the proper allocation of the interest among the countries involved would involve some kind of allocation based on the assets, income or activities in each country.

2.2.3. Developing country perspectives. In establishing rules to prevent interest deductions from causing base erosion, developing countries must balance the need to attract investment against the necessity of protecting the tax base. In addition, considerations of practical implementation must be taken into account. For example, an approach based on worldwide apportionment would require substantial information from other jurisdictions to be available. A focus on only related party loans in the context of thin capitalization rules, on the other hand, would prevent less administrative challenges. However, it would be subject to taxpayer manipulation which could undercut its effectiveness.

2.3 Preventing the Avoidance of PE status. One way in which a developing country's tax base can be eroded is for the taxpayer to arrange its operations in a manner which technically avoids the rules for the assertion of taxing jurisdiction. One of the basic principles of the domestic law of many countries and of tax treaties based on both the UN and OECD Models is that the source country's right to tax business activities requires the existence of a Permanent Establishment ("PE") in the country. In some situations, it has been possible for taxpayers to arrange their affairs to avoid the definition of PE while at the same time having a substantial penetration in the jurisdiction which might be seen to justify taxation by that country. These issues are related to the PE issues discussed here, the taxation of the digital economy, discussed in the materials in Section 4, and the materials on the taxation of services, discussed in Section 8.

2.3.1 Commissionaire arrangements. In recent years, a number of companies have reorganized their international structures. This process has involved centralizing a number of functions dealing with intangibles, product promotion, inventory management and the like in individual companies, often located in low tax jurisdictions and converting sales subsidiaries who previously handled all aspects of the purchase and sale of goods in the source country, into so-called "low risk" distributors. In many cases these business restructurings had the effect of reducing substantially the amount of revenue attributed to the source jurisdiction. Under the prior structure where the "full-fledged" subsidiary bought the goods from a related party and sold them in the source jurisdiction, the full amount of the sales profit would be taxed in the source country. However, where the operations are rearranged with the local company only acting as an sales agent, it is possible to argue that only a small sales commission would be taxable in the source state. This position relies on the requirement of Article 5(5) of the OECD and UN Model Conventions which requires that, for a PE to be present in these circumstances, the agent must have "authority to conclude contracts" in the name of the related person supplying the goods. This requirement has been interpreted to require that the authority must include the legal authority to bind the supplier, that is, at the end of the contract negotiations, the agent must have the legal authority to create binding obligations on the supplier for a PE to exist, regardless of the extent of the agent's activity in the market jurisdiction.

Under the laws of many countries, the agency relationship can be structured as a so-called "commissionaire" under which the agent concludes contracts which are only binding on the agent itself and do not create any obligations on the part of the supplier, even though it is clear that the supplier will be supplying the goods on the terms agreed to by the agent. In such a case, the only amount taxable in the country of sale would be the "low risk" sales commission and not the real profit on the sale of the goods which would be attributed to the supplier who in these circumstance would

not technically have a PE in the country of sale. The OECD Action Plan No. 6 proposes to examine this kind of “artificial” avoidance of PE status and make it clear that the source country’s taxing right extends to the underlying sales profit when significant sales activities are undertaken by the agent in the market country, regardless of the legal technicalities.

2.3.2 Preparatory and auxiliary services. Article 5(4) of the UN Model , like the OECD Model, lists a number of activities which are described in the Commentary to be “preparatory or auxiliary” and which do not result in the creation of a PE. The basic idea is that the taxpayer should be able to establish itself in the territory and carry on activities which are not central to the earning of its profits without any taxation in the market country. This is the case even if many or all of the enumerated activities are carried on and even if they are carried on over a long period of time. Concern has been expressed that by manipulating and combining the various functions, taxpayers can establish a substantial presence in the market jurisdiction which contributes to the profitability of the enterprise without the activities resulting in a PE under the existing rules.

2.4 Protecting the Tax Base in the Digital Economy

2.4.1 General. Information and communications technology (“ICT”) have significantly changed the ways that companies can do business globally. ICT raises a number of related problems from the point of view of base erosion and profit shifting. First of all, through technological advances, it has become possible to have significant market penetration in a country without creating a taxable presence in the form of a PE. As a result, countries are deprived of revenues from the traditional sale of goods which they would have normally been entitled to tax historically under existing rules regarding taxing jurisdiction. Second, new forms of income have been created in the business models using ICT. For example, it is possible to collect data about consumer preferences and other information from the market jurisdiction through the monitoring of digital traffic which can then be sold to third parties to aid them in their marketing strategies. In addition, the ability to deliver goods and services using ICT raises questions concerning the nature of income resulting from the provision of the goods/services. For example, payments might be considered royalties subject to tax on a withholding basis or might be treated as business profits taxable only in the presence of a PE. Finally, the flexibility provided by ICT allows multinational enterprises to centralize their functions in certain jurisdictions, often in tax havens, which then provides a vehicle for base eroding payments for the market jurisdiction. The OECD/G-20 Action Plan Item 1 undertakes to identify the issues involved in the taxation of the digital economy, including the application of indirect taxes to such activities. These issues are of particular importance to developing countries where there is a significance

expansion of access to digital services and the attendant possibility of the use of ICT to exploit the local market.

2.4.2 Avoiding taxable presence and possible responses. ICT makes it possible to avoid a traditional taxable presence in the jurisdiction. In the simplest case, a distribution model which relied on a local sales office can be replaced by a website selling the product for direct delivery thus eliminating all of the sales income from the domestic tax base. Similarly, a local presence might be maintained but through ICT many of the functions formerly performed by the local presence can be transformed into functions performed offshore.

In these circumstances, it might be possible to reevaluate the traditional presence tests in the light of the technological developments. For example, the types of activities which traditionally have not constituted a PE might perform a different function where the sales into the jurisdiction are done on-line. Thus the existence of a warehouse, which often does not constitute a PE (though see UN Model Convention, Article 5(4)(a)) might be evaluated differently in this context. Similarly, activities in the jurisdiction which would not normally lead to the existence of a dependent agent might be needed to be evaluated differently where the sales take place on-line. Similarly, the collection of information through a fixed place has traditionally been viewed as not constituting in itself a PE. But the extensive ability to collect and utilize digital information, where is it the primary revenue source of the business, may require a different result to adequately protect the tax base of the source country.

2.4.3. Income characterization. Apart from the issue of taxable presence, the existence of ICT has raised issues as to the appropriate characterization of particular items of income which result from digital access to the goods or services involved. Thus, for example is a streamed song the delivery of a good, a service or something else and can it be given a geographic source?

2.4.4 Base erosion. One of the indirect effects of ICT is to facilitate structures which enable base eroding payments at the expense of the market jurisdiction. These issues are analyzed in the prior Sections dealing with hybrid mismatch, interest deductions, the section below dealing with treaty abuse and in the parallel work being done on the UN Manual of Practical Aspects of Transfer Pricing.

2.5 Transparency and Disclosure

2.5.1 General. In order to assess the extent of possible base erosion and profits shifting, it is essential that tax authorities in developing countries have access to information about the nature and structure

of activities of taxpayers carrying on business or investing in their jurisdiction. This requires both transparency with respect to the way in which the taxpayer's activities are structured and disclosure of the necessary information. The information involved may be detailed information as to particular transactions, for example, the determination of transfer pricing or more general, higher-level information which allows the tax authorities to view the overall structure of the taxpayer's global business and in particular, the use made of tax haven vehicles as part of a tax avoidance scheme. The OECD/G-20 Action Plan has several items which are relevant in this connection.

2.5.2. Transfer pricing documentation. Both the OECD Transfer Pricing Guidelines and the UN Practical Manual on Transfer Pricing contain substantial guidance on the structure and application of transfer pricing documentation. Action Plan Item No. 13 mandates that the existing rules on transfer pricing documentation should be re-examined

2.5.3 Country-by-Country ("CbC") reporting.

2.5.3.1 General. Currently it is very difficult for developing countries to obtain information about the global activities of MNEs operating in their jurisdiction, where their profits are reported and where and how much tax they pay. This information would allow the developing country tax administrations to assess whether the income reported and the taxes paid in their jurisdiction appeared to be appropriate in the light of the MNE's global activities. It would allow them to identify, for example, where base-eroding payments were ending up or whether the "low risk" return shown by a local distributor was appropriate in light of the residual profit being reported elsewhere. The OECD/G-20 Action Plan in Item 13 proposes a requirement that MNE's provide CbC information in the context of transfer pricing documentation, but it is clear that the importance of CbC reporting goes well beyond transfer pricing issues as it provides insight into the relations between the various parts of the MNE and whether the income and tax allocations in the group broadly seem to make sense. CbC information can be useful as a risk assessment tool to help the tax administration to make decisions as to where it should allocate its auditing and investigative resources. This is particularly important given the lack of resources faced by most developing country tax administrations.

2.5.3.2. Technical issues in country-by-country ("CbC") reporting. Since the purpose of CbC reporting is to give a broad overall view of an MNE's activities, income and tax position, the necessary information should be at a fairly high level. This is of particular importance to developing countries as they generally would have limited capacity to deal with vast quantities of data. The OECD Discussion Draft on Transfer Pricing Documentation and CbC Reporting initially contained some 17 different items to be reported in a CbC template but subsequently, indications are that the

items to be reported will be reduced to revenue, profit before tax, cash taxes and accrued taxes in the current year stated capital and retained earnings, number of employees, and tangible property. A related issue is whether the information should be reported on an entity-by-entity basis or if aggregates for the country would be more suitable given the purposes of CbC. As to how the information should be reported, it is anticipated that the MNE would be required to maintain a “master file” which consolidates all of the data and each local operation would have access to the information in the master file which could be obtained by the local taxing authority. The principal function of CbC reporting is to aid tax administrations in properly assessing tax but there have been proposals to make the information required in the CbC process a matter of public record.

2.5.4. Disclosure of aggressive tax planning schemes. It is often impossible for tax administrations to obtain information on aggressive tax planning strategies which lead to base erosion and profit shifting simply through subsequent audits of taxpayers’ activities. Many countries have had experience with administrative provisions which require taxpayers to disclose in advance certain transactions which have been determined to be aggressive or abusive. Action Plan Item No. 12 anticipates developing recommendations as to how such provisions could be structured, stressing in particular the advantages of developing common approaches to these issues and to the sharing of experience between tax administrations.

2.5.5. Mechanisms for obtaining information from other countries. In evaluating the exposure to base erosion and profit shifting, it is important that tax administrations can obtain information from other jurisdictions. The issues involved in the exchange of information under tax treaties is discussed extensively in the UN Handbook on the Administration of Double Tax Treaties, Chapter IX. The Global Forum on Transparency and Exchange of Information has done extensive work on developing the standards for exchange and monitoring of countries’ success in implementing effective exchange of information. In addition, increased use of the Convention on Mutual Administrative Assistance in Tax Matters, currently signed by over 60 countries, has provided an additional means of obtaining information needed by tax administrations.

2.6 Preventing Treaty Abuse

2.6.1. General Treaties offer a number of advantages to taxpayers, particularly with regard to the reduction of source based taxation. While those rules are important to carry out a basic purpose of the treaties to encourage cross-border investment, there are circumstances where those rules can be used to create advantages which were not intended by the treaty partners. These situations can be characterized as “improper use of tax treaties” and countries are concerned with limiting such “treaty abuse” and denying treaty benefits in those cases. Both the OECD Report and the Action Plan recognize the importance of preventing the granting of treaty benefits in inappropriate circumstances.

On the other hand, to deny treaty benefits in cases where they are appropriate undercuts the basic purpose of entering into the treaty in the first place and creates uncertainty for taxpayers. Thus the determination of when a particular situation constitutes a “treaty abuse” depends on balancing a number of factors. In determining in specific situations whether there is an abuse or improper use of a treaty, the United Nations Committee of Experts endorses the following “guiding principle.”

“A guiding principle is that the benefits of a double taxation convention should not be available where the main purpose for entering into certain transactions or arrangements was to secure a more favorable tax position and obtaining that more favorable tax treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.
(Paragraph 24 of the Commentary on Article 1 of the UN Model Convention)

2.6.2. Techniques to prevent treaty abuse. There are a number of techniques to deal with treaty abuse including:

- Domestic legislative specific and general anti-abuse rules
- Judicially developed doctrines
- Specific anti-abuse rules found in treaties
- General anti-abuse rules (‘GAAR’) in treaties
- Purposive interpretation of tax treaty provisions

Which technique or combination of techniques is most appropriate will depend on the basic legal structure of the country involved and the nature of the transaction. The following material examines the various techniques and then discusses how they could be applied to some commonly occurring situations.

2.6.2.1 Specific and general anti-abuse rules in domestic legislation and their relation to treaties.

Where a domestic anti-abuse rule would appear to limit the applicability of a treaty benefit, several results are possible depending on the circumstances. In some situations, a closer examination of the treaty may indicate that the status of the domestic rule has already been taken into account and is made explicitly applicable in the treaty context. In other situations, a domestic rule may apply to

determine or recharacterize the facts on which the domestic tax liability is based. In this situation, there is no conflict between the treaty and domestic law and domestic law can apply without any limitation by the treaty. Depending on the situation in the country, domestic judicial doctrines such as business purpose, substance-over-form and sham transaction may also be factors in determining the facts on which tax liability is based and do not present a conflict. Nonetheless, in some limited circumstances, treaty rules may prevail over certain domestic anti-avoidance principles where there is a conflict between them. When this result occurs, under the general principle that tax treaties prevail over domestic law in the event of a conflict, it will usually be necessary to rely on other techniques, for example, a specific anti-avoidance rule included in the treaty discussed below.

2.6.2.2 Specific treaty anti-avoidance rules. Existing treaties contain a number of specific rules which are aimed at denying treaty benefits in particular situations that have been identified as abusive. The use of “beneficial ownership” rules can restrict treaty benefits where the recipient of the income is not the “true owner” of the income and is only functioning as a conduit or nominee. The “special relationship” provisions of interest and royalties articles allow the tax authorities to reclassify certain payments which are not made at arm’s length. Special provisions are often used which are aimed at personal services companies used by entertainers and athletes to avoid source country tax. Similarly, special provisions in Article 13 of both the UN and OECD Models allow countries to tax gains from the sale of shares of real estate holding companies to prevent the use of such companies to avoid taxation on gains on the underlying real estate.. To deal with situations where a company claiming the treaty benefit does not have substantial connections with the country of which it is a resident, some treaties contain a so-called “limitation of benefits” clause which requires that the company have certain ownership and income connections to the country

2.6.2.3 Treaty General Anti-Avoidance Rules (“GAAR”)

Some treaties deal with the problem of treaty abuse by having an explicit general anti-abuse rule in the treaty. The UN Commentary on Article 1, paragraph 36 suggests one possible version.

“Benefits provided for by this Convention shall not be available where it may reasonably be considered that a main purpose for entering into transactions or arrangements has been to obtain these benefit and obtaining the benefits in these circumstances would be contrary to the object and purpose of the relevant provisions of this Convention.”

While a treaty GAAR can be a useful tool, too broad an application of a GAAR can create in some circumstances create undesirable legal uncertainty and impede investment. In addition, the existence

of a GAAR in some treaties but not others can make the application of other techniques in treaties lacking a GAAR more difficult.

2.5.2.4 Limiting treaty abuse through treaty interpretation Artificial arrangements which have been structured to attempt to take advantage of treaty benefits can sometimes be dealt with through an appropriate approach to treaty interpretation. Under Article 31 of the Vienna Convention on the Law of Treaties, treaties are to be interpreted in good faith and in the light of the object and purpose of the treaty. Viewed from this perspective, structures without a business purpose or lacking in substance can be ignored in applying the treaty even where the treaty does not have a GAAR. The effectiveness of this approach depends on the general approach of the courts in the relevant country to legislative and treaty interpretation.

2.6.3. Example of possible inappropriate use of treaties; “Treaty shopping.” One common form of improper treaty use involves so-called “treaty shopping.” In these situations, the taxpayer interposes an intermediary company (I) between the source country (S) and the residence country (R) to take advantage of the treaty benefits of the treaty between the intermediary country and the source country. The taxpayer “shops” to find a treaty between the source country and the intermediary country which has the lowest tax “price” in terms of treaty benefits.

Example: Company R, organized in Country R, is entitled to receive royalties from Company S, a company organized in Country S. Under the R-S treaty, royalty payments from Company S to Company R are subject to withholding tax. To avoid this result, the taxpayer forms Company I in Country I and transfers its right to receive the royalties to Company I. The I-S treaty reduces or eliminates the Country S withholding tax. In Country I, Company I may not be subject to tax on the income it receives (though still qualifying as a treaty “resident”). Payments by Company I to Company R would not be subject to Country I tax as the I-R treaty has eliminated the Country I withholding tax. As a result of the treaty shopping structure, income originating in Country S has ended up in Country R without the imposition of any Country S tax.

Various techniques could be used to prevent the inappropriate use of the I-S treaty in this case. If Country S had a domestic GAAR which would be applicable in this case, it might be possible to ignore the existence of Company I and treat the transaction as if the royalty had been paid directly to Company R. The same result could be reached if the I-S treaty had a GAAR which could be applicable in this case since a main purpose of the structure is tax avoidance. Treaty benefits could also be denied under a limitation of benefits article in the treaty which denies benefits where there is foreign ownership of the entity claiming treaty benefits and that entity has no substantial business operations in its country of residence.

2.7 Preserving the Taxation of Capital Gains by Source Countries

2.7.1 General. Foreign direct investment in developing countries can be structured as a locally organized subsidiary or as the branch of a foreign corporation. In both cases the shares of the corporation may be held by an off-shore holding company. If the operating assets in the country are sold whether they are owned by the foreign corporation or a local subsidiary, the country will typically have the right to tax the capital gain on the assets, both under its domestic law and under a tax treaty. Similarly, if dividends are paid by a domestic corporation, a withholding tax would generally be applicable to the dividends. However, if instead of selling the assets directly, the foreign investor sells the shares of the domestic subsidiary or the shares of the foreign subsidiary with branch operation in the country, it may often be possible to avoid any tax in the source country. A similar result would apply if the shares were held by a holding company and the shares of the holding company were sold. Thus the gain which is attributable to the underlying assets which has accrued in the source country would escape taxation by the source country. This gain may represent appreciation in the underlying assets or retained earnings which would have been taxed to the shareholder if distributed to a shareholder as a dividend. These elements of gain will escape taxation by the source country if the shares are sold unless the domestic law of the source country has a special provision to reach such gains. Even if the domestic law has the appropriate provisions, tax treaty provisions may in some circumstances prevent the taxation of the gain.

2.7.2. Domestic law provisions.

2.7.2.1. Shares in domestic companies. The structure of the capital gains provisions as they apply to the sale of shares of domestic companies differ substantially from country to country. Some do not apply to any sales of domestic shares by non-residents, some tax the sale if the corporation holds certain assets, for example, real or immovable property located in the country and others may assert a source-based claim if the non-resident owns a specified percentage of shares in the domestic corporation regardless of the asset composition. Additionally, some countries tax the sale of shares only if the transaction is viewed as a matter of tax avoidance; for example, the transfer of property the direct sale of which would have been taxable, to a corporation, is followed by the sale of the shares of the corporation. The basic decision of how far to extend source-based taxation to the sale of domestic corporation sales involves a balancing of the desire to attract foreign investment and the importance of the taxation of the gains for the domestic tax base.

2.7.3.1. Administrative issues. If the decision is made to tax the sale of shares in domestic corporations by non-residents in some cases, there are a number of administrative issues to consider. There are several ways to enforce the tax. The seller may be required to report the gain and pay the tax in the same way it would if the gain were attributable to assets located directly in the country.

This approach may be difficult to enforce, especially if there is no requirement under local law for the sale of shares to be reported by the domestic corporation. In addition, tax might be collected by a withholding tax obligation on the purchaser to withhold and remit the appropriate amount of tax. Additional administrative issues are involved if the decision is made only to tax the sale of the sales in cases where there is a tax avoidance element.

A related issue is what impact the sale of the shares should have on the tax status of the underlying assets in the domestic corporation. If the sale of the shares is taxable but no adjustment is made in the tax cost of the underlying assets, a second tax would be due on the same economic gain when the assets were sold. Whether or not this pattern of taxation is appropriate will depend on the general structure of corporate-shareholder taxation in the country.

2.7.4 Shares of a foreign corporation. Assuming the decision is made to tax the sale of shares of domestic corporation in certain circumstances, a separate question is how to treat the sale of shares in a foreign corporation which owns the shares of the domestic corporation. There are significant administrative difficulties in implementing a tax on such a transfer as a general matter, both in terms of obtaining the necessary information to assess the tax and implementing effective methods for collection. In any event, it may be desirable to have a provision which taxes such sales where the transaction can be viewed as involving tax avoidance; for example, where the transfer of the shares of the domestic corporation to a foreign corporation is followed by the immediate sale of the foreign shares or in situations where the foreign corporation is merely a shell corporation.

2.7.5 Treaty Aspects. If the decision is made to tax the capital gains on the sale of shares in domestic or foreign corporations, it is important to consider the extent to which that right should be preserved in tax treaties. Many treaties limit the right to tax gains on the sale of shares to shares in companies which have substantial local real estate holdings. The United Nations Model in Article 13.5 provides for source state taxing rights where the percentage ownership of the shares in a domestic corporation exceeds a certain amount regardless of the nature of the underlying assets. In addition, as discussed in Section 2.5, treaty anti-abuse rules may be applicable to protect the source-based taxing claim on the sale of shares of either domestic or foreign corporations.

2.8 Services

2.8.1 General

The use of services to erode the tax base of developing countries is a serious issue that involves several types of services and the provisions of both domestic law and tax treaties. The provisions of the domestic law of developing countries dealing with income from services vary enormously. Some countries impose tax on virtually all business services provided by nonresidents in the country or to residents of the country; other countries impose tax only if a nonresident has a PE or fixed base in the country. Some countries impose tax on income from services by way of a final gross-based withholding tax while other countries tax income from services on a net basis.

It is relatively easy for multinational enterprises operating in a developing country through a subsidiary resident there to reduce the tax payable to that country through payments for services rendered to that company by other nonresident group companies. The payments will generally be deductible in computing the income of the company resident in the source country but may not be taxable by the developing country in the hands of the nonresident service provider. Even if payments for services performed by the nonresident company are taxable under the domestic tax law of the developing country, an applicable tax treaty along the lines of the UN Model would in many circumstances prevent the country from taxing such payments unless the nonresident has a PE or fixed base in the country.

The UN Model contains several provisions dealing with various types of services. Some types of services – for example, insurance, government service, pensions, and services of directors and top-level managerial officials – do not provide serious opportunities for the erosion of the tax base of developing countries. These services are not dealt with in this overview. As discussed below, the UN Committee of Experts has decided to include a new article dealing with income from certain “technical services” in the UN Model.

2.8.2 Employment Income

In general, under both domestic law and the provisions of the UN Model, employment income derived by nonresidents is taxable by a country only if the employment services are performed or exercised in the country. Under Article 15 of the UN Model a source country is prevented from taxing a nonresident on income from employment exercised in the source country if the nonresident is employed by a nonresident employer that does not have a PE or fixed base in the source country, or if it has a PE or fixed base, the

employee's remuneration is not deductible in computing the profits attributable to the PE or fixed base, and the nonresident employee is not present in the source country for 183 days or more in any 12-month period.

The broad scope of source country taxation of income from employment earned by nonresident employees suggests that opportunities for tax avoidance of source country tax are limited. Where a nonresident employee's remuneration for employment services (performed in the source country) is deductible by the employer in computing income subject to tax by the source country, the nonresident employee is usually subject to tax on that remuneration by the source country. The employee's remuneration will usually be deductible if the employer is a resident or a nonresident carrying on business in the source country through a PE or a fixed base located in the source country. In these circumstances, the employer is usually required to withhold the tax on behalf of the employee from the remuneration.

Nevertheless, a developing country's tax base may be eroded if a nonresident employer avoids having a PE or fixed base in the source country or if a nonresident individual can alter his or her legal status from employment to independent contractor. A nonresident employee of a nonresident employer without a PE or fixed base in the source country is taxable only if the nonresident employee is present in the source country for more than 183 days. If a nonresident is an independent contractor, Article 7 or 14 of the UN Model will limit the source country's right to tax to situations in which the nonresident has a PE or a fixed base in the source country and the income is attributable to the PE or fixed base or the nonresident stays in the source country for 183 days or more in any 12-month period. In contrast, a nonresident employee of a resident employer or a nonresident employer with a PE or fixed base in the source country is taxable on any income from employment exercised in the source country.

2.8.3 Entertainment and Athletic Services

Some entertainers and athletes can make large sums of money in a short period of time. Developing countries that wish to tax income derived by nonresident entertainers and athletes must ensure that the provisions of their domestic law and tax treaties, such as Article 17 of the UN Model, allow them to tax such income irrespective of the legal structure of the arrangements. Article 17 allows the country in which entertainment or sports activities take place to tax the income from those activities. Countries must also have provisions in place to deal with techniques used by nonresident entertainers and athletes to avoid source country tax. Common avoidance schemes in this regard involve the assignment of income by a nonresident entertainer or athlete to another person, usually related to the taxpayer, or the use of an entity of which the nonresident entertainer or athlete is a shareholder and employee. Article 17 of the UN Model allows the imposition of tax in these circumstances.

2.8.4 Business Services

Under the provisions of Article 7 and 14 residents of one state are taxable on their income from services by the other state only if the residents carry on business through a PE or fixed base in the other country. Under Article 5(3)(b) a nonresident is deemed to have a PE if it provides services in the other state for 183 days or more in any 12-month period. Similarly, a nonresident is subject to tax on income from professional or independent services if the nonresident stays in the other state for more than 183 days in any 12-month period. The rules in Article 7 and 14 do not apply to special types of income from services such as international shipping and air transportation, entertainment and athletic activities and employment.

The tax base of developing countries can be eroded through the performance of services by nonresidents in two major ways. First, if a nonresident service provider does not have any PE or fixed base in the developing country, any income from services may not be taxable by the developing country under its domestic law or under the provisions of an applicable tax treaty. Moreover, even if the nonresident service provider has a PE or fixed base in the developing country, that country cannot tax income from services that is not attributable to

the PE or fixed base. Second, if the services are provided outside the developing country but are deductible in computing the payer's income for purposes of the developing country's tax, the developing country may be unable to tax the income under its domestic law or under the provisions of an applicable tax treaty. If the nonresident service provider has a PE or fixed base in the developing country, the income attributable to the PE or fixed base under the provisions of Article 7 or 14 of the UN Model may include foreign source income if, for example, the remuneration of the employees performing the services is deductible in computing the profits of the PE or fixed base. Nevertheless, unless the domestic law of the developing country includes such foreign source income in the income of a nonresident, the fact that an applicable tax treaty allows the country to tax will be of no effect.

As discussed in section 2. , there are several ways in which taxpayers can structure their affairs to avoid having a PE or fixed base in a country. In some situations nonresident service providers can provide services in a developing country at various locations in the country without any one place being used for more than 6 months. Or a nonresident service provider may attempt to avoid having a PE or fixed base by using the fixed place of business of a client or a related enterprise. Although the Commentary on Article 5 of the UN Model indicates that a PE may exist in this situation,² it is necessary for the tax administration of the developing country to have the necessary information gathering resources to discover the facts required to show that there is a PE or fixed base. In other situations a nonresident can avoid having a PE or fixed base by fragmenting its activities among related enterprises. A nonresident can also avoid having a PE under Article 5(3)(b) by using related nonresident enterprises to carry out connected projects. Under Article 5(3)(b) any services performed for the same or a connected project are aggregated for purposes of counting the number of days on which services are provided in the source country. There is no rule, however, to take into

² Paragraph of the Commentary on Article 5 of the UN Model quoting paragraph 4 of the Commentary on Article 5 of the OECD Model.

account services provided by related enterprises with respect to the same or connected projects. The same concern applies to construction projects under Article 5(3)(a) of the UN Model. Specific anti-avoidance rules in domestic law or tax treaties might be useful in this regard although the application of such rules requires effective information gathering by the tax administration of the developing country.

A multinational enterprise with a group company carrying on business in a developing country may use another group company resident in a low-tax country to provide various services to the company in the developing country. These services, which often include legal, accounting, management and technical services,³ may not require employees of the nonresident service provider to be present in the developing country for long periods of time. It is difficult for developing countries to counteract this type of tax planning even with effective anti-avoidance rules in place. Some countries have insisted on a shorter period than 183 days to minimize the limitation on their ability to tax.

2.8.5 Technical Services

Some developing countries have special rules in their domestic law and tax treaties for income from technical services. Under these rules such services are subject to a final gross-based withholding tax at a flat rate and the resident payer for the services is required to withhold from the payments to the nonresident service provider. The types of services to which the rules apply often include managerial, technical and consulting services but these are not defined precisely.

The current UN Model does not contain any specific provisions dealing with income from technical services. As noted above, in general, income from business services is covered by Article 7 or 14 of the UN Model and is taxable only if the nonresident has a PE or a fixed base or spends a significant amount of time in the source country. The high threshold for the imposition of source

³ The treatment of technical services is discussed in more detail below.

country tax on income business services means that it is relatively easy for nonresidents to provide technical services to customers in a source country without becoming subject to source country tax. Since the payments for the services are usually deductible by the payers (either residents of the source country or nonresidents with a PE or fixed base in the source country), fees for technical services present a serious problem of base erosion for the source country.

The erosion of the source country's tax base by payments for technical services and the inability of the source country to tax such payments has led some countries to add specific provisions to their domestic laws and their tax treaties to allow them to tax payments for technical services on a gross basis.⁴ A 2011 survey by the IBFD found that 134 of the 1600 tax treaties concluded between 1997 and 2011 contained a separate article dealing with fees for technical services.⁵ Several other treaties extended the provisions of Article 12 dealing with royalties to include certain technical services. Under the separate articles, income from technical services are treated like royalties. Source country tax is allowed on a gross basis at a fixed rate but is limited to fees for technical services “arising” in the source country which usually means that the services must be performed in the source country. As noted above, typically these separate articles dealing with fees for technical services refer to “managerial, technical or consultancy services” without defining that expression.

The UN Committee of Experts has been working since 2008 on the provisions of the UN Model dealing with the taxation of income from services. In 2013 the Committee decided to work on a new article to be added to the UN Model to allow source countries to tax income from technical services on a basis similar to the taxation of royalties (i.e. on a gross basis at a limited rate without any threshold requirement even if the services are provided outside the source country). If a new article with these features is added to the UN Model and developing countries are successful in negotiating the inclusion of the new article in their tax treaties, such countries will be able to protect their domestic tax base from erosion through payments to nonresidents for technical services.

2.9 Tax Incentives

2.9.1 General

⁴. In some cases, the definition of royalties is amended to include technical fees; in other cases, a separate article dealing with technical fees is added to a tax treaty. See S.B. Law, "Technical Service Fees in Recent Treaties", *Bulletin for International Taxation* 5 (2010), pp. 250-52.

⁵ Supra note 56.

Tax incentives are widely used by both developing and developed countries to attract foreign investment. Although it seems likely that multinational enterprises use tax incentives to erode the tax base of both developing and developed countries, developing countries may be more susceptible to such base erosion because of a greater need for foreign investment and less capacity for the effective administration of tax incentives.

Tax incentives for foreign investment can be divided into two major categories:

- 1) incentives that directly reduce the cost to a nonresident of an investment in the source country (for example, a tax holiday or reduced tax rates); and
- 2) incentives that indirectly reduce the cost to a nonresident of an investment in the source country (for example, the lax enforcement of thin capitalization or transfer pricing rules by the source country).

The key issue for developing countries is how to design and administer tax incentives for foreign investment in order to maximize their effectiveness.

2.9.2 Cost/Benefit Analysis of Tax Incentives

The ostensible benefit of granting tax incentives for foreign investment is increased foreign investment and the consequential economic benefits for the source country. Often these benefits are simply assumed to occur and rarely are attempts made to quantify them prior to the granting of the incentive. The benefits of tax incentives must be weighed against their costs which include:

- foregone tax revenues
- the costs of administration and enforcement
- the possible misallocation of economic resources
- opportunities for corruption.

The costs of tax incentives can be minimized if developing countries follow best practices in designing, implementing, administering and evaluating their tax incentive programs.

2.9.3 The Role of Tax Sparing

If a company resident in a developed country makes a direct investment in a developing country that qualifies for a tax incentive in the form of a tax holiday, the tax given up by the developing country will be replaced by the tax imposed by the developed country (assuming that it taxes the worldwide income of its residents). As a result, the developing country's tax holiday is

ineffective because it provides no benefit to the nonresident investor. Instead of paying tax to the developing country and claiming a credit for that tax against the tax payable to the developed country, the investor pays tax only to the developed country. To avoid this result many developing countries insist on “tax sparing” provisions in their tax treaties with developed countries. Under these tax sparing provisions, the developed country, the country in which the investor is resident, generally agrees to provide a credit for the tax that would have been paid to the developing country (i.e. the tax that was spared) in the absence of the tax incentive.

The importance of tax sparing is sometimes exaggerated. In general, tax sparing is a problem only where a nonresident invests in a developing country through a branch. If the investment is made through a subsidiary established in the developing country, the residence country does not generally impose tax when profits are earned by the subsidiary and many developed countries exempt dividends from foreign subsidiaries. Even if the investment is made in branch form, tax sparing is not a problem with respect to several developed countries that exempt profits earned through a foreign branch.

Tax sparing provisions in bilateral tax treaties are often subject to abuse and may result in an unanticipated increase in the cost of a developing country’s tax incentives without any increase in foreign investment.

2.9.4 Possible Effects of the BEPS Project on Tax Incentives

It is impossible to predict the effect of the OECD’s BEPS project on tax incentives offered by developing countries. One possibility is that the BEPS project will make doing business in developed countries more expensive because of increased tax burdens resulting from the reduction or elimination of base erosion and profit shifting. If so, the tax incentives offered by developing countries may become more attractive for multinational enterprises. This assumes, of course, that multinational enterprises cannot easily strip profits out of developing countries. If they can do so, the tax incentives offered by developing countries will be less important. Another more likely possibility is that several of the BEPS action points may provide developing countries as well as developed countries with additional tools to improve the administration and enforcement of their tax incentives.

3. Conclusions The protection of the domestic tax base against base erosion and profit shifting is an important part of the work necessary for developing countries to attain revenue sustainability. Capacity development in this area is essential to move toward this goal. In this connection, the OECD/G-20 work has much to offer to developing countries in terms of identifying issues and suggesting possible techniques to deal with these problems. However, it is important to keep in mind

the special needs and perspective of developing countries regarding these issues. These involve among others the state of development of the tax system, the administrative resources available to deal with these matters, the nature of the trade and commercial relations with trading partners and regional considerations. Each country must evaluate its own situation to identify its particular issues and determine the most appropriate techniques to insure a sound tax base. The following materials are intended to assist in this task.