

UNCTAD

Investment and Enterprise Division

**Policy action against tax avoidance by MNEs:
existing measures and ongoing discussions**

ANNEX III

**Policy background accompanying the *World Investment Report 2015*,
Chapter V "International Tax and Investment Policy Coherence"**

TABLE OF CONTENTS

A. EXISTING MEASURES AND THEIR EFFECTIVENESS IN DEVELOPING COUNTRIES

B. CURRENT DISCUSSIONS IN THE INTERNATIONAL COMMUNITY

ACKNOWLEDGEMENTS

This background paper has been prepared by a team including Richard Bolwijn, Bruno Casella, and Hasinah Essop, under the guidance of James X. Zhan. The team benefited from comments on selected parts of the work provided by Maikel Evers, Martin Hearson (London School of Economics), Eric Kemmeren (Tilburg School of Economics and Management), and Jan van den Tooren; and from a preliminary review of the draft by Michael Lennard (UN DESA).

Section A. Existing measures and their effectiveness in developing countries

Existing countermeasures against tax avoidance focus mostly on individual levers within the complex structures employed by MNEs. Many countermeasures are not commonly used, or are less effective, in developing countries as they require complex legislation and significant tax collection capabilities.

Table 1. Summary overview of tax avoidance levers and common countermeasures

Enablers	Levers	Common countermeasures
i. Tax rate differentials	<ul style="list-style-type: none"> • Transfer pricing (trade mispricing, intangible asset structures, commissionaire structures) • Excessive debt funding 	<ul style="list-style-type: none"> • Transfer pricing legislation • Thin capitalization and anti-base erosion rules
ii. Legislative mismatches and/or gaps	<ul style="list-style-type: none"> • Hybrids and derivatives • Disguised domestic investments • Deferred repatriation 	<ul style="list-style-type: none"> • Anti-avoidance legislation for hybrids • Anti-round tripping policies or regulations (incl. foreign exchange controls or outward investment policies); beneficial ownership rules • CFC legislation; levy of withholding tax on the earlier of payment or accrual; tax breaks encouraging repatriation
iii. Double taxation treaties	<ul style="list-style-type: none"> • Treaty shopping • Treaty manipulation (triangular structures, circumvention of treaty thresholds) 	<ul style="list-style-type: none"> • Beneficial ownership rules; limitation on benefits and anti-treaty shopping clauses; CFC legislation; general anti-avoidance rules • Residence based taxation of foreign permanent establishments; rules on computing treaty thresholds; anti-avoidance clauses

Source: UNCTAD.

i. Countermeasures against levers exploiting tax rate differentials

Transfer pricing legislation has been introduced by many countries. This legislation essentially requires cross-border transactions between associated entities to take place at arm's length (where the transaction is valued as if it was carried out between independent parties). However, there are still many developing countries that have not yet introduced such measures. Where these measures have been introduced, it proves to be a challenge for developing economies to implement and administer, mostly due to inadequate resources and lack of specialist expertise.

To counter *excessive debt financing* countries tend to introduce so-called thin capitalization rules with limits on the extent of debt funding (for instance, debt-equity ratios) and on the interest rate charged. Some countries manage it through their foreign exchange controls (which controls the flow of currency into and out of the country), whereby foreign loans require registration and approval. Not all developing countries have introduced such rules or controls. Some more developed countries have also introduced anti-base erosion legislation that prevents the conversion of equity to debt without business reasons.

For other levers of tax avoidance, legislative measures are in place with variations across countries, depending on the specific lever. Where issues are not addressed by transfer pricing or other general rules (like anti-avoidance rules), special legislation is sometimes introduced. For instance, a special tax on a specified income stream or industry, or ring-fencing rules where losses are concerned, etc. Developing countries may or may not have these in place, depending largely on the complexity of the legislation.

ii. Countermeasures against levers exploiting legislative mismatches and/or gaps

Hybrids are generally addressed through legislation that contain a reference to the foreign tax treatment and either the income is not exempt where a deduction has been claimed in the foreign jurisdiction or the expense is not deductible where the income is exempt in the foreign jurisdiction. This is specific anti-avoidance legislation and is seldom found in developing countries.

Disguised domestic investments (whereby an entity invests in a subsidiary in its own jurisdiction via an offshore intermediary so as to access certain tax and non-tax benefits) are controlled through policies or regulations that prohibit or limit round-tripped investments. In some cases, for outward investments, details of the investment and of the shareholders must be submitted for approval, although these policies and regulations are not common in developing countries. Tax treaties also contain a clause limiting the benefits of the treaty to beneficial owners only (broadly defined as the shareholder having the full right to use and enjoy dividends on the shares); i.e. beneficial ownership is a condition for a reduced withholding tax rate to apply. This beneficial ownership clause can be a measure against disguised domestic investments if adequately implemented. Some of the older treaties may not have this clause and would need to be renegotiated.

Deferred repatriation is a US-specific case. In the US, a tax break on repatriation was offered in 2005 (Homeland Investment Act) in order to encourage the repatriation of offshore-retained earnings. For most other countries, the issue of deferred repatriation is usually addressed through controlled foreign company (CFC) legislation, where profits of foreign subsidiaries are taxed under certain circumstances irrespective of whether repatriation takes place or not. CFC legislation – which has its own set of fairness issues – is not common in developing countries, and it may only be relevant for developing countries that have sufficient outward investments to warrant introducing and administering such legislation. Where deferred payment of income streams like interest, royalties, service fees and dividends is concerned, this is mitigated through the levy of withholding taxes on accrual rather than on payment (or the earlier of the two events).

iii. Countermeasures against levers exploiting double taxation treaties

The body of double taxation treaties conceived as a mean to protect global players from double taxation may give rise to opportunities of "*double non-taxation*". The practice of *treaty shopping* refers to the improper use of tax treaties whereby an entity in one jurisdiction uses an entity (referred to as an 'intermediary') in another jurisdiction principally to access treaty benefits, like reduced withholding taxes or reduced or no capital gains tax. It can also involve the transfer (migration) of tax residence of an entity. Specific clauses are added to treaties like the beneficial ownership clause, a limitation of benefits clause and anti-treaty shopping clauses to prevent the abuse of tax treaties. The beneficial ownership clause is fairly common, however it is not often adequately implemented. Very few treaties of developing countries contain additional clauses. General anti-avoidance rules contained in domestic legislation are also used as a measure to address treaty shopping.

For outward investments, tax legislation that contains CFC provisions (where certain income attributable to the intermediary or conduit is taxed in the hands of the ultimate shareholder) is used to reduce the

incentive for using low tax jurisdictions. CFC legislation is usually complex and detailed, making it difficult for many developing countries to introduce and administer it. It may only be relevant for developing countries that have sufficient outward investments to warrant such legislation.

Measures to address other opportunities are also in place in many countries, like exit charges on migration of the tax residency of an entity; treating the place of effective management as the place of tax residence, or referring to the tax residence under the tax treaty to prevent mismatches in the tax residence definition; etc. These measures are sometimes present in developing countries.

Treaty manipulation can occur through the triangular use of treaties where three tax jurisdictions are involved, usually the two Contracting States and a permanent establishment or foreign branch in a third State (or another State of dual residence) to which the income is attributable. It can also occur when temporary arrangements are entered into in order to circumvent a treaty threshold, like the minimum shareholding requirements to qualify for a reduced dividend withholding tax rate; or the creation of a permanent establishment.

Triangular structures in respect of permanent establishment or foreign branch structures are addressed in the recipient State by taxing the income of permanent establishments / foreign branches and providing a credit for the foreign taxes suffered. The circumvention of treaty thresholds is partly addressed through tax legislation that contains specific rules on computing thresholds for treaty purposes (for example, rules on how to compute the value of shares). It is also can also be addressed through anti-avoidance provisions in treaties (specific clauses on temporary manipulation of the articles, for instance, a minimum holding period requirement).

Section B. Current discussions in the international community

The scope of ongoing discussions in the international community, most notably in the context of the OECD Action Plan on BEPS for the G20, but also involving other international organizations, NGOs and wider stakeholders, is centered on tax and accounting rules, company law, and transparency and information exchange, with limited attention to investment policy.

In-depth discussions and investigations are ongoing within the international community, led by the OECD and based on their Action Plan for the G20, but involving also other international organizations, NGOs and wider stakeholders. Numerous proposals are being made on future measures that can be introduced to address the increasing occurrence of BEPS. [Table 2](#) summarizes the current debate around BEPS, starting from the OECD Action Plan and bringing together various other inputs that have been proposed (mainly by NGOs).

Table 2. Overview of the OECD Action Plan and other proposals

Enabling factor	Specific levers	OECD Action Plan	Other contributions
i. Tax rate differentials	<ul style="list-style-type: none"> Transfer pricing (trade mispricing, intangible asset structures, commissionaire structures) Excessive debt funding 	<ul style="list-style-type: none"> Addressing the challenge of the digital economy [Action 1]; Prevent the artificial avoidance of PE status [Action 7]; Assure that transfer pricing outcomes are in line with value creation [Actions 8,9,10]; Re-examine transfer pricing documentation [Action 13] Limit base erosion via interest deductions and other financial payments [Action 4] 	<ul style="list-style-type: none"> Adapting transfer pricing methods for developing countries (through collaboration with regional communities, synergies with customs system, price filter matrices, developing a comparables database) Introduce or strengthen thin capitalization rules and approval process of foreign loans
ii. Legislative mismatches and/or gaps	<ul style="list-style-type: none"> Hybrids and derivatives Disguised domestic investments Deferred repatriation 	<ul style="list-style-type: none"> Neutralize the effects of hybrid mismatch arrangements [Action 2] ... Strengthen CFC rules [Action 3] 	<ul style="list-style-type: none"> Introduce specific legislation for hybrids and derivatives Introduce rules to manage and limit round-tripped investments
iii. Double taxation treaties	<ul style="list-style-type: none"> Treaty shopping and treaty manipulation (triangular structures, circumvention of treaty thresholds) 	<ul style="list-style-type: none"> Prevent treaty abuse [Action 6] 	<ul style="list-style-type: none"> Introduce domestic 'beneficial ownership' definitions and anti-treaty shopping / anti-avoidance legislation; align withholding tax rates with other countries (for instance within regional communities) and between treaties. Introduce general anti-avoidance rules.
iv. Other areas	<ul style="list-style-type: none"> (BEPS process implementation, Transparency, Tax co-operation) 	<ul style="list-style-type: none"> Counter harmful tax practices more effectively, taking into account transparency and substance [Action 5] Establish methodologies to collect and analyse data on BEPS and the actions to address it [Action 11] and develop a multilateral instrument [Action 15] Require taxpayers to disclose their aggressive tax planning arrangements [Action 12] Make dispute resolution mechanisms more effective [Action 14] 	<ul style="list-style-type: none"> Address harmful tax regimes and shift from tax competition to tax co-operation Include developing economies in the BEPS process and strengthen the role of the United Nations in the BEPS project Increase transparency and disclosure requirements

Source: UNCTAD.

i. Discussions on how to counter tax avoidance enabled by tax rate differentials

The OECD has included in its Action Plan on BEPS the development of transfer pricing rules that will specifically address the areas of concern like contractually agreed risks to inappropriately allocate returns and aligning returns with value creation. It will also address transfer pricing documentation. Specific rules

for intangibles and the transfer thereof will be developed. The digitalised economy, which is to a large extent linked to intangible assets, will be dealt with separately and holistically. Other areas like the artificial avoidance of a permanent establishment, profit attribution, CFC rules and debt funding rules are also included in the Action Plan.

NGOs and other organizations have emphasized the need for improved transfer pricing methods, especially for developing economies. Price filter matrices and a database of *comparables* specifically for developing economies are amongst the suggestions. Some of these organizations have gone further to advocate for an alternative approach to the arm's length principle such as a unitary tax system or global formulary apportionment.¹ However, while it has been noted that alternative approaches like moving toward the taxation of assets, sales and employees may assist in achieving a more fair taxation system, these require detailed analyses and a long-term development of an entirely new international taxation system. A shorter term solution may be that of addressing the gaps and opportunities for improvement in the current system. Collaboration with regional communities (like AMU, EAC, CELAC), considering potential synergies with the customs system and similar approaches could assist in achieving this.² In terms of other tax avoidance areas, specific recommendations have been made by the international community on the valuation of intangible assets, deferred repatriation and the tightening of thin capitalization rules.³ For intangible assets, appropriate limits on royalty fees should be considered as well as regulating payments to pure SPEs. Proper thin capitalization rules, not always in place in developing economies, also appear to be a key start to addressing excessive debt funding and excessive interest rates. Specific approval for foreign loan funding can also be considered. Other proposals like the monitoring of commissionaire structures may also be beneficial.

ii. Discussions on how to counter tax avoidance enabled by legislative mismatches and /or gaps

Specific papers and discussions on hybrids have been released by the OECD and the UN. Hybrids have also been included in the OECD Action Plan. Treaty provisions and domestic rules that address hybrids will be recommended, for instance denying exemption where the amount is deductible in another jurisdiction and vice versa. Tie-breaker rules for situations where both jurisdictions wish to apply the denial rules will also be recommended.

There are certain views within the international community that consistent rules be adopted by countries for the treatment of entities and instruments. This does require global co-operation and may not be achievable. The consensus in the international community is however in line with the OECD's approach on introducing special rules for derivatives and hybrids. Rules on managing and limiting round-tripped investments by the host country are also considered as advantageous to developing countries.

iii. Discussions on how to counter tax avoidance enabled by double taxation treaties

Model treaty provisions will be developed as part of the OECD Action Plan in order to prevent the granting of treaty benefits in inappropriate circumstances and situations of double non-taxation. Policy considerations for countries planning to enter treaties will also be identified. Further work on 'beneficial ownership' is also expected from the OECD.

The international community has reiterated the need to have specific provisions in treaties to address triangular structures where third States are involved. In addition, it may be worthwhile for developing

¹See OXFAM (2013).

² The OECD, World Bank and the UN Committee of Experts on International Cooperation in Tax Matters are currently in discussion with the World Customs Organization on arm's length pricing issues.

³See Gravelle JC (2013).

countries to consider domestic legislation that will assist with treaty shopping and treaty manipulation.⁴ Suggestions of a 'look-through' approach where SPEs are concerned have also been made, whereby they are treated as tax resident in the shareholder country.⁵ A domestic equivalent of beneficial ownership or SPE definitions and anti-avoidance legislation may be other options.

Introducing general anti-avoidance rules is viewed as a good approach to address this category of tax avoidance as well as other categories (or enabling factors). The extent to which rules can "affect" treaty obligations is a live issue addressed in the UN and OECD Models (Article 1 Commentaries), seeking to find the proper scope for domestic laws consistent with international obligations and the need for investor certainty. The balance of general and specific anti-avoidance measures is an important issue that directly confronts the balance between revenue and a more certain investment climate.

Additional potential solutions include aligning domestic withholding tax rates to what is considered to be the acceptable norm or range for that income stream or industry. Discussions with other countries, especially those within the same regional communities, may assist in this process. Reduced withholding tax rates within treaties could also be kept within a reasonable range (i.e. avoiding situations where treaty rates differ vastly from each other).

Withholding taxes and denial of deductions for some interest (e.g. paid to affiliates in offshore locations – unless taxpayer information as to substance and value creation in that jurisdiction is shared) is deserving of further discussion. There is a need for developing countries to preserve appropriate rights under treaties.

Other aspects of preserving source state taxing rights under treaties, such a lower time and geography thresholds for permanent establishment, or not requiring it (e.g. for "technical services") are important issues. The correct allocation of taxing rights to avoid double taxation remains a key concern for developing countries.

iv. Discussions on other relevant areas

The OECD Action Plan also addresses harmful tax practices, transparency, information exchange, solving treaty-related disputes and the monitoring of BEPS. Included in the transparency initiative is country-by-country reporting and disclosures of aggressive tax planning. The Action Plan also considers the potential for a multilateral instrument to be developed in order to speed up the implementation of BEPS measures in treaties.

NGOs and other international organizations have placed significance on harmful tax regimes. A shift from tax competition to tax co-operation is favored. There is also strong support within the international community on information exchange between countries, additional transparency measures like the country-by-country reporting and public disclosure of beneficial ownership. Initiatives like the EITI Standard have been given credit, which could be expanded in order to help ascertain whether sufficient taxes have been paid (in light of production / extraction and sales quantities). Another suggestion is that disclosures by all companies with foreign ownership should be made compulsory through either accounting / company law practices or through tax measures. Other key messages are the inclusive approach towards developing economies and additional assistance to developing economies (training, resourcing, technical and practical assistance).⁶

⁴See UN/ITC (2013).

⁵See UN (2011).

⁶ See for example OXFAM (2013); ActionAid (2013); Christian Aid (2013).