Curbing Illicit Financial Flows from Resource-rich Developing Countries: Improving Natural Resource Governance to Finance the SDGs

Working Paper No. R4D-IFF-WP01-2020

Regulatory Enablers of Profit Shifting

January, 2020

Irene Musselli*
Centre for Development and Environment (CDE) University of Bern

*Note prepared under the Legal Work Package, coordinated by Elisabeth Bürgi Bonanomi

© The Authors. All rights reserved. For more details, visit the project website: https://curbing-iffs.org/
This project is funded through the Swiss Programme for Research on Global Issues for Development (www.r4d.ch) by the Swiss Agency for Development and Cooperation (SDC) and the Swiss National Science Foundation (SNSF).

Corporates profits are routinely diverted from developing countries (relatively high-tax) to more advanced economies (comparatively low-tax), typically through conduit jurisdictions (nil tax). As pointed out in a two-part report to the G20 Development Working Group, this occurs through contractually reallocating risks, and the associated profits, to low taxed affiliates in offshore jurisdictions (supply chain restructuring); it occurs through excessive payments to foreign affiliates in respect of interests, royalties, management and technical fees, and other service charges (base-eroding payments); it occurs through the indirect sale by offshore holding companies of interests in production facilities situated in developing countries (indirect sale of assets); it occurs through the manipulation of transfer prices in respect of traded outputs and inputs (abusive transfer pricing); and by means of routing investment to developing countries through jurisdictions that have advantageous tax treaties with the host state (treaty shopping).[1] These are just some of the most egregious techniques through which multinational enterprises (MNEs) shift profits to low-taxed entities in high-income countries. These techniques leverage debt, location of intangible assets, and transfer prices. They typically involve highly artificial and contrived arrangements whose main objective is to reduce the overall tax liability of the corporate group – what is sometimes termed 'aggressive' or 'abusive tax avoidance'.

Profit shifting is a main obstacle to achieving sustainable and equitable development. The OECD conservatively estimates that as much as US$240 billion every year ─ or around 10 percent of global corporate income tax revenue ─ is lost in tax revenue as a result of corporate tax avoidance.[2] This is in line with IMF data, pointing to an estimated US$200 billion of revenue loss via tax-motivated base erosion and profit shifting (BEPS) for non-OECD countries, corresponding to 1.3 percent of GDP.[3] The poorer countries have the most to lose, since corporate income tax constitutes a large proportion of their total revenue.

We have extensively discussed elsewhere whether these profit shifting practices are legal or illegal and we do not want to duplicate that discussion.[4] The focus of this backgrounder is on the regulatory enablers or drivers of profit shifting: rules and practices that make profit shifting possible, or even incentivise it. While institutional attention is mainly turned to the manifold technical regulatory loopholes and mismatches that MNEs exploit to avoid taxation, it is important to bear in mind that the problem is structural and systemic. As pointed out by some commentators,[5] the enablers of profit shifting stand at the root of the international tax regime; they call into question the basic tenets of that regime. It is important to shed light on these structural enablers, before turning to specific technical loopholes.

---

1 OECD, 'Part 1 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries', OECD, July 2014.

2 Angel Gurría, 'Base Erosion & Profit Shifting', Remarks by Angel Gurría, OECD, Secretary-General, at the APEC Finance Ministers' Meeting (FMM) in Hoi An, Viet Nam, on 21 October 2017, https://www.oecd.org/tax/apec-fmm-base-erosion-and-profit-shifting.htm (accessed 11 November 2019).

3 See Ernesto Crivelli, Ruud A. de Mooij, and Michael Keen, 'Base Erosion, Profit Shifting and Developing Countries', IMF Working Paper No. 15/118, May 2015, https://www.imf.org/en/Publications/WP/Issues/2016/12/31/Base-Erosion-Profit-Shifting-and-Developing-Countries-42973 (visited 11 November 2019).

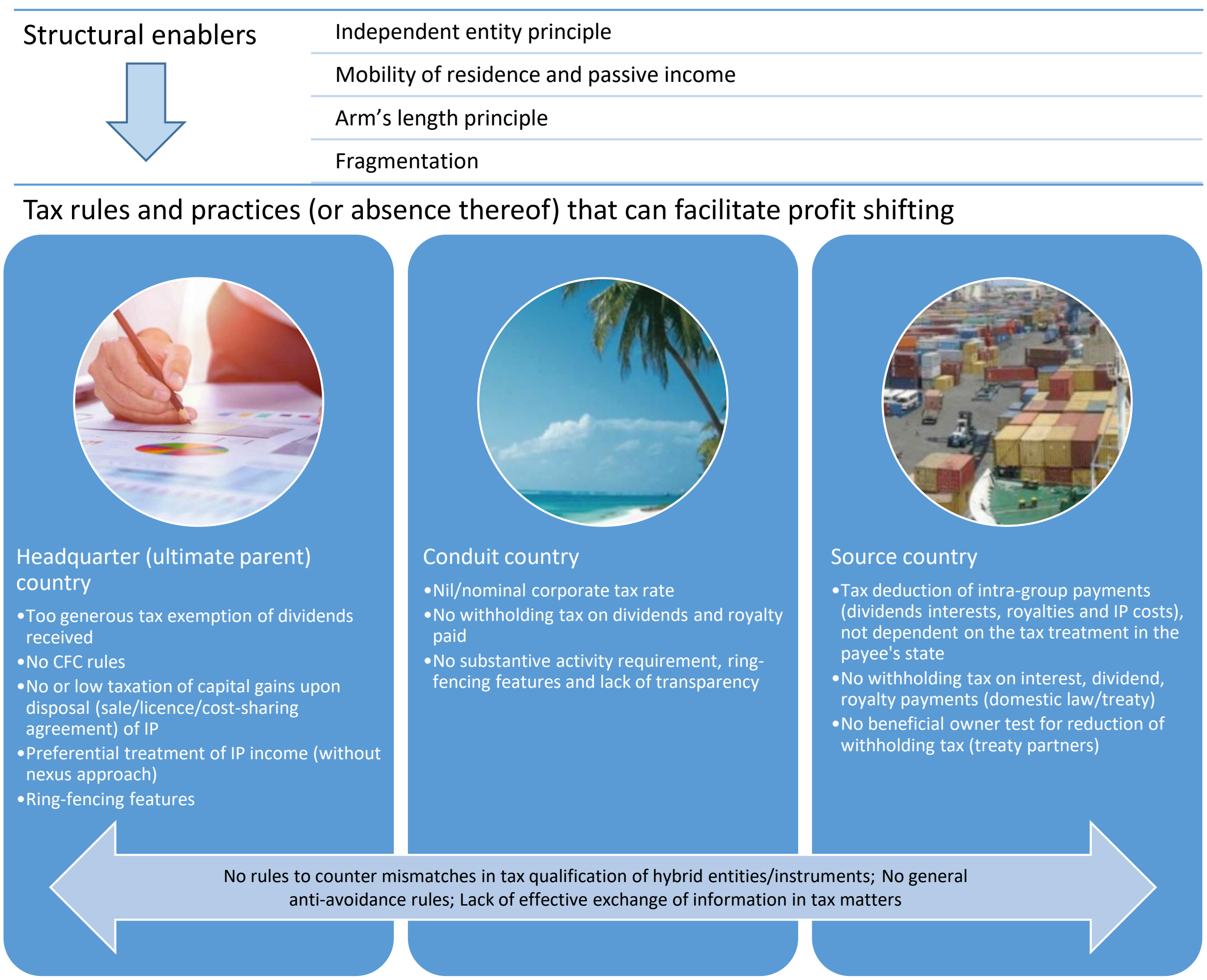
4 Irene Musselli and Elisabeth Bürgi Bonanomi, 'Illicit Financial Flows: Concepts and Definition', *International Development Policy | Revue internationale de politique de développement*, forthcoming 2020.

5 This stance has been adopted and push vigorously by, among others, Sol Picciotto, the BEPS Monitoring Group and the Independent Commission for the Reform of International Corporate Taxation (ICRICT).

Key structural enablers

We can identify a few structural enablers of profit shifting, variously entangled: the independent entity principle and the related arm's length principle, the mobility of residence and passive income, and fragmentation.

Figure 1: Regulatory enablers of base erosion and profit shifting



a) The independent entity principle

Pursuant to the independent entity principle, the constituent entities of a MNE are treated as separate legal persons dealing at arm's length (see below), if separately incorporated. This legal fiction holds even if a subsidiary company is 100 percent owned by its parent. It is a key structural enabler of profit shifting, which would otherwise been blocked: if MNEs were to be taxed as unitary firms, looking at the whole entity, there would be no point in artificially shifting profits to sub-units in low-tax jurisdictions.

b) The (related) arm's length principle

The problem is compounded by complex arm's length rules that have proved particularly difficult to enforce. Under the arm's length principle, prices set between related parties – parent and subsidiary, or affiliates under common control – should approximate the prices that unrelated parties would reach in similar circumstances. The arm's length principle stems from the legal fiction that treats related parties as separate and independent (independent entity principle, above). The OECD

Transfer Pricing Guidelines (TPGs) endorse five methods of establishing arm's length prices. These methods all require individualised fact-intensive analysis of the facts and circumstances of each case. They have come under increased criticism as excessively cumbersome and dysfunctional, and as an incentive for profit shifting.[6]

c) Abuse of the notion of residence and the mobility of passive income

Under the current system, business can quite freely chose the most convenient jurisdiction where to locate corporate residence and therefore where to tax passive income. Passive income is essentially income from dividends, interests, capital gains, and royalties. Under tax rules, passive income is taxed primarily at residence, where the capital was accumulated. Most often, a company is tax resident in the country in which it is registered/incorporated as a legal matter, or where the place of effective management/control is located. In all cases, the place of residence can be easily shifted from one country to another: if a 'formal' residence test applies (place of incorporation), residence is shifted by de-registering and registering elsewhere; if a 'factual' test applies (place of management/effective control), by taking board meetings and strategic decisions in specific locations. Thus residence is essentially under the taxpayer's control, which results in passive income being very mobile (and, for this reason, typically subject to lower taxes than business income and wages). In deciding where to locate the group residence, MNEs shop around ('residence shopping') and choose the most convenient legislation in terms of taxes, accounting rules, directors' liability, etc.

d) Fragmentation

Finally, profit shifting is enabled by a highly fragmented and inconsistent tax regime. In tax matters, there is no equivalent of the World Trade Organization: there is no coordinated set of multilateral rues, nor a binding dispute settlement system for cross-border tax disputes. Instead, "current arrangements that define and divide the international corporate tax base have evolved over the last century or so with little explicit coordination".[7] This has resulted in a highly fragmented legal landscape, fraught with regulatory loopholes and mismatches, on which tax avoidance thrives.

A host of regulatory gaps and loopholes

Altogether, the structural features outlined above enable and promote profit shifting. They create opportunities for regulatory arbitrage and tax abuse. They are at the root of the many technical loopholes and mismatches that MNEs exploit to avoid taxes. The G20/OECD BEPS project has identified a host of key regulatory gaps and loopholes that create opportunities for tax arbitrate and abuse – including mismatches in tax classifications across countries, profit shifting into controlled foreign companies, excessive interest deductions, ring-fencing, lack of substantial requirements and lack of transparency, unilateral tax rulings, treaty shopping, artificial avoidance of permanent establishment status in tax treaties, and abusive transfer pricing. With the adoption of the BEPS package, OECD and G20 countries set out 15 actions to address aggressive tax avoidance and harmful tax practices. A study on aggressive tax planning structures and indicators commissioned by the European Commission has listed thirty-tree tax rules and practices (or lack thereof) that can

[6] In this direction, Sol Picciotto, 'Simplified Transfer Pricing Methods: An Overview and Analysis', ICTD Working Paper 86 (Brighton: International Centre for Tax and Development, 2018); Veronika Solilová and Danuše Nerudová, 'Sixth Method as a Simplified Measurement for SMEs?', 10(3) European Financial and Accounting Journal 45 (2015); Alexander Ezenagu, 'Safe Harbour Regimes in Transfer Pricing: An African Perspective', ICTD Working Paper 100 (Brighton: International Centre for Tax and Development, 2019).
[7] IMF, 'Spillovers in International Corporate Taxation' IMF Policy Paper (Washington, D.C.: IMF), 2014, at 7.

facilitate aggressive tax planning.[8] They go beyond the regulatory loopholes and mismatches identified in the BEPS project and also include some generic characteristics of a tax system that may still facilitate aggressive tax avoidance. For example, tax deductions for interest payments to foreign affiliated companies, absence of withholding taxes on interest payments, lack of thin capitalization rules or lack of other interest limitation rules, altogether are capable of facilitating structures where the tax base of a host country is eroded by means of financing costs.

Current reforms: opportunities and challenges

Profit shifting points to dysfunctions of the law that need to be addressed.

Responses so far have been relatively fragmented. At the multilateral level, the BEPS project has led to a patchwork of specific anti-avoidance measures – often qualified by carve-outs, thresholds and reservations. These measures close important loopholes but only marginally tackle the root of the problem – the structural enablers of tax avoidance. At the unilateral level, a few countries have adopted far-reaching tax reforms that pierce the corporate veil of separate legal entities and treat MNEs as unitary firms, departing from key tenets of the ancient tax regime. Yet, these remain unilateral and uncoordinated actions.

The international community seems to have reached a new critical reform momentum under the OECD/G20 Inclusive Framework on BEPS, under the Programme of Work on digitalization.[9] For the first time, the OECD-sponsored machinery is re-considering the basic tenets of the international tax regime. Under Pillar 1 of the Programme of Work, Members of the Inclusive Framework have agreed to consider proposals that "would lead to solutions that go beyond the arm's length principle".[10] Under pillar 2, countries are considering far-reaching measures that would counter profit shifting to entities subject to no or very low taxation – stopping a harmful race to the bottom in tax competition. While the reform route is promising, there are risks ahead: that, through the negotiating process, potentially far-reaching measures are diluted by means of carve-outs, thresholds and reservations; and that a diluted reform package is traded-off in exchange for a moratorium on potentially far-reaching unilateral or sub-regional measures, or versus the acceptance of terms to which developing counties are hostile, such as mandatory arbitration. The coming year will clarify in which direction reform is heading.

[8] European Commission, 'Study on Structures of Aggressive Tax Planning and Indicators: Final Report', Working Paper 61, Taxation Papers (Brussels: European Commission, 2015).
[9] OECD, 'Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy', OECD/G20 Inclusive Framework on BEPS (OECD, Paris: 2019), www.oecd.org/tax/beps/programme-of -work-to-develop-a-consensus-solution-to-the- tax-challenges-arising-from-the-digitalisation-of -the-economy.htm.
[10] January 2019 Policy Note Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note, as approved by the Inclusive Framework on BEPS on 23 January 2019, OECD 2019, accessible http://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf.