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Low Tax Jurisdictions and Preferential Regimes

Policy Gaps in Developing Economies

Jonathan Leigh Pemberton
Jan Loeprick

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Abstract

This paper reviews recent international initiatives and domestic policy developments aimed at helping countries to protect their tax base against erosion by individuals and companies that allocate assets to or route income via low tax jurisdictions. The paper highlights the benefits and limitations of existing policy instruments from the perspective of capital-importing developing economies. Focusing on two common policy gaps for developing economies, options are explored for (i) introducing necessary charging provisions to ensure effective taxation of individuals, and (ii) an anti-diversion rule tailored to reflect developing economy contexts and administrative constraints. These proposals include a possible definition of excess profits in low tax jurisdictions and options for distribution keys to reallocate profits to countries where there is "real" economic substance and activity. The measures discussed could also address the diversion of profits to entities benefitting from preferential regimes in countries with high nominal tax rates.

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Low Tax Jurisdictions and Preferential Regimes: Policy Gaps in Developing Economies

Jonathan Leigh Pemberton and Jan Loeprick

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1. Introduction[1]

The lengths to which some large multinational corporations (MNEs) and wealthy individuals go to shelter their income from taxation has attracted increasing public attention. While international tax avoidance and evasion are not new phenomena, a combination of factors have given these issues greater prominence in public discourse. Perhaps the most important of these has been the financial crisis, which coincided with press stories about the ways in which some banks had facilitated tax evasion by their clients.[2]

Public interest in the issue of international tax avoidance and evasion has been surprisingly sustained, given the technical complexities of the subject. In part this has been the result of further revelations about tax avoidance and evasion, including the so-called "Mossack Fonseca papers" and "Paradise papers" stories pursued by the International Consortium of Investigative Journalists.[3]

Press coverage does not always make a clear distinction between tax evasion, which is illegal, and tax avoidance, which is not. Although the proposals in this paper address tax compliance issues arising from both tax avoidance and evasion, the distinction between the two is an important one. While MNEs will arrange their affairs to minimize their tax liabilities, increased scrutiny of their internal governance and "good corporate citizenship" mean that they will change their behavior in response to changes in the law. Nonetheless, for developing economies the underlying problem of tax avoidance is real enough. A growing body of evidence, comprehensively analyzed by Beer and others (2018) indicates that MNEs do indeed minimize their tax obligations, shifting profits from high to low-tax jurisdictions, which is estimated to result in a global net effect of reducing corporate tax revenue by 2.6 percent. UNCTAD (2015) estimates that 30% of global cross-border corporate investment stocks have been routed through off-shore hubs. The estimated annual tax revenue losses for developing countries amount to approximately $100 billion. The OECD (2015) estimates global CIT revenue losses between US$100 billion and US$240 billion annually at 2014 levels and Crevelli et al (2016) provide evidence that international tax base and rate spillovers are a relatively larger concern for developing countries.

Individuals, in particular at the upper end of the wealth distribution, sometimes evade taxes by hiding income and assets offshore. Clearly individuals engaging in this kind of behavior do not respect the law and will only become more compliant if there is a realistic possibility of discovery and enforcement. Estimates of the amounts that have been transferred offshore have been based on a number of different sources. Drawing on anomalies in portfolio liabilities and assets reported globally, the amount of assets in offshore jurisdictions has been assessed at around 10% of global GDP (Zucman 2013; Pellegrini et al. 2016, Alstadsaeter et al. 2017). These estimates are supported by anecdotes on the use of offshore structures for tax evasion

[1] The authors would like to thank Anne Brockmeyer, Colin Clavey, Jessie Coleman, Michael Durst, Chris Morgan, Marijn Verhoeven, and three anonymous reviewers from the IMF's Fiscal Affairs Department for providing helpful comments. The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors and should not be attributed to the World Bank Group, its executive directors, or the countries which they represent.

[2] Prominent among these was coverage of revelations by the whistleblower Bradley Birkenfeld about the Swiss Bank, UBS. UBS would eventually reach a deferred prosecution agreement with the United States' Department of Justice.

[3] See: https://www.icij.org/.

and money laundering by high net worth individuals ("Swiss/Liechtenstein leaks", "Mossack Fonseca Papers").

International concern about potential weaknesses in the way international standards developed in the early part of the last century interact with modern ways of doing business is not new.[4] Similarly, governments in many countries had long-standing concerns about banking secrecy and the use of offshore financial centers for tax evasion. But the financial crisis gave these concerns new prominence and new urgency.

The first sign of a renewed determination to tackle cross-border evasion and avoidance came in April 2009, when the G20 meeting in London declared that the "era of banking secrecy is over".[5] This led to several countries withdrawing their reservations to the exchange of information on request article contained in model double taxation agreements. The Global Forum on Transparency and Exchange of Information (the Global Forum) was restructured to strengthen implementation of the international standard on exchange of information, through a process of peer review. Subsequently, the standard itself was enhanced to encompass automatic exchange of information about financial accounts.[6,7] That new standard was codified as the "Common reporting Standard" (CRS) and supported by a Model Competent Authority Agreement.[8]

The introduction of the CRS is a major development.[9] It is notable that the CRS requires information to be exchanged that includes details of the beneficial owners of entities, including trusts, that might otherwise be used to disguise the true ownership of financial accounts.[10] This is enhancing the ability of governments in both developed and developing countries to detect funds that have been lodged in undisclosed offshore accounts for the purposes of tax evasion and other criminal reasons.[11] Some behavioral changes in individuals' use of offshore jurisdictions can already be observed. De Simone et al. (2018), for instance, assess the effects of the Foreign Account Tax Compliance Act (FATCA), which increased reporting

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[4] For example, the OECD started consultations with businesses about the transfer pricing implications of business restructuring in 2005: http://www.oecd.org/tax/transfer-pricing/45690216.pdf, page 4.

[5] The leaders' declaration can be accessed here: https://www.g20.org/en/g20/timeline.

[6] This development was modeled on legislation in the United States that was enacted in response to the revelations of tax evasion by US citizens involving secrecy jurisdictions. The Foreign Accounts Tax Compliance Act (FATCA) was signed into law in 2010 and came into effect in 2014. Alongside the legislation, the United States entered into agreements with other governments, based on two alternative models, which enabled the reporting process to take place by way of exchange of information between governments. See: https://www.irs.gov/businesses/corporations/fatca-governments.

[7] G20 Finance Ministers and Central Bank Governors endorsed automatic exchange of information as part of an expected new standard in April 2013. http://en.g20russia.ru/events_financial_track/20130418/780961081.html.

[8] http://www.oecd.org/ctp/exchange-of-tax-information/standard-for-automatic-exchange-of-financial-account-information-for-tax-matters-9789264216525-en.htm.

[9] Automatic exchanges of information have already taken place between 45 jurisdictions. http://www.oecd.org/tax/OECD-Secretary-General-tax-report-G20-Finance-Ministers-Argentina-March-2018.pdf.

[10] The standard uses the term "controlling persons" but this is explicitly linked to the concept of beneficial ownership, as described in Recommendation 10 of the Financial Action Task Force Recommendations: http://www.fatf-gafi.org/publications/fatfrecommendations/documents/fatf-recommendations.html.

[11] The Global Forum now has 154 members who are committed to the international standard on exchange of information. In 2018, 4,500 successful bilateral exchanges took place between 86 jurisdictions under the new AEOI Standard. There is an ongoing program of technical assistance to help all members to meet the AEOI standard. For more information see: http://www.oecd.org/tax/transparency/AEOI-Implementation-Report-2018.pdf.

requirements for offshore accounts.[12] They find a significant response in the location of individuals' investment assets and a decline of US$56.6 billion-US$78 billion in worldwide investment out of tax havens. Looking at policy initiatives in the US since 2009, including FATCA, Johannesen et al. (2017) report that around 60,000 individuals disclosed offshore accounts amounting to a value of around US$120 billion. But the long-term effect on the role and use of tax havens in the global economy is unclear. The stock of wealth held offshore since 2001 remains relatively constant (Alstadsaeter et al. 2018).[13]

Alongside these efforts to tackle cross-border tax evasion, the international community has also been working to address the tax avoidance opportunities that have arisen as business practices have diverged from the assumptions underlying the international tax system. In response to a call from the G20 Finance Ministers, in 2013 the OECD published an action plan to address Base Erosion and Profit Shifting (BEPS) by multinational enterprises (MNEs).[14] At the heart of this action plan were steps to ensure that taxing rights are better aligned with the location of the underlying activity that gives rise to the profits of MNEs.

There is some evidence of the effectiveness of the measures included in this BEPS initiative, in particular the role of anti-abuse measures in curbing observable profit shifting. Introducing effective transfer pricing (TP) regimes and related measures (thin capitalization), for instance, has been shown to reduce observable profit shifting (Beer and Loeprick 2015). However, these effects cannot be observed in all relevant areas of base erosion.[15] Importantly, when it comes to the allocation of significant returns to entities in low-tax jurisdictions, the BEPS guidance aims at clarifying the requirements for acceptable remuneration, in particular with respect to the risks actually borne by an entity. In essence, risks allocated contractually to entities need to correspond to the underlying functional profiles and the effective control of risks by those entities. Overall, the BEPS process adds complexity to tax policy and administration. Ongoing innovation and the introduction of additional and sometimes simple(r) anti-avoidance tools at the country level demonstrates that the BEPS measures are just an interim step in the continuing evolution of the international tax policy framework. This is especially true for developing economies that are more constrained by limited capacity in their tax administrations,[16] and is reinforced in ongoing discussions in the context of the OECD's Inclusive Framework on BEPS.[17] Options for further reform can be distinguished into two broad categories. First there are proposals to introduce further anti-avoidance rules that are targeting specific risk areas and tend to be simpler to administer than an assessment of compliance with the Arm's Length

[12] FATCA requires foreign financial institutions to automatically submit client information to the US Internal Revenue Service (IRS). De Simone et al. (2018) also find evidence suggesting a post-FATCA switch in investment strategies to less regulated markets, namely real estate and art markets.

[13] Looking at Tax Information Exchange Agreements, Menkhoff and Miethe (2017), also find a gradual decline in the effect of TIEAs on outbound income flows.

[14] The immediate result of the BEPS project was the publication in 2015 of final reports covering all 15 actions. The focus has now switched to implementation of the BEPS recommendations, including the creation of a Multilateral Instrument that allows countries to upgrade their network of taxation treaties in a single process. See: https://www.oecd.org/ctp/BEPSActionPlan.pdf. As at 21 December 2018, 85 jurisdictions had signed the MLI.

[15] At the same time, aggressive and poorly targeted enforcement efforts may also damage countries' investment climates. Buettner et al. (2017) and De Mooij and Liu (2018) document, for instance, negative effects of introducing thin capitalization rules and transfer pricing on FDI.

[16] This is one of the reasons for the creation of the Platform for Collaboration on Tax by the IMF, OECD, UN and WBG http://www.worldbank.org/en/programs/platform-for-tax-collaboration.

[17] A recently published policy paper (OECD 2019) explicitly recognizes that current tax challenges include "risks remaining after BEPS for highly mobile income producing factors which still can be shifted to low-tax environments". The draft also acknowledges that "any solution needs to be administrable by tax administrations and taxpayers alike and take account of the different levels of development and capacity of members".

Principle. The BEPS discussion recognized the need to supplement enhanced transfer pricing regimes with more mechanical measures and recommendations, including a ceiling on interest deductions (BEPS Action 4). And, many countries are going further, the United States, for instance, recently introduced formulaic rules to capture intangible returns (Global Intangible Low-Taxed Income - GILTI).[18] Second are proposals aiming at more fundamental reform, including a possible shift towards more destination-based taxes or the introduction of regional or global formulary apportionment, with sales as the main allocation factor.[19] This paper falls into the first category with the objective of helping to address two gaps in the current international tax architecture that risk preventing effective taxation of individual and corporate profits that should be part of the tax base of developing economies.[20]

The first gap arises because countries lack the policy tools to take full advantage of the progress made in respect of exchange of information. Many countries should already have or will soon have access to information that will enable them to detect and correct tax evasion involving offshore financial centers and undeclared assets. However, having the information is a necessary but not a sufficient step towards securing the tax revenue due on these undisclosed assets and income. Where ownership structures are straightforward, existing charging provisions in a country's tax code may be sufficient. But it is commonplace for offshore holdings to be held via complex and opaque legal arrangements, designed to disguise the true ownership and side-step mainstream tax charges. Most developed economies have introduced legislation that addresses these situations, but this is often not (yet) the case in developing economies.[21] Section 2 of this paper explores this issue in more depth and suggests a possible solution.

Secondly, an important gap persists with respect to aggressive corporate tax avoidance, which, while legal, is still a serious problem for developing economies seeking to grow their tax base as part of a program of domestic resource mobilization. Here the goal of the BEPS project is to ensure that taxing rights over profits are better aligned with the location of the underlying activity giving rise to those profits. This was a particular focus of Actions 8 to 10 of the initiative, which concerned transfer pricing. But there are limits to what can be achieved through transfer pricing. This was acknowledged in the BEPS discussion and Action 3 of the initiative considered how effective Controlled Foreign Company (CFC) regimes could provide additional safeguards.[22] It is not clear, however, that CFC rules are as effective as they once were. [23] Australia and the UK have recently decided that they need to address profit diversion more directly. It is even less clear how CFC rules are relevant to developing economies, which are mostly capital importing and have relatively few MNEs with domestic parents. Section 3 of this paper addresses this issue and proposes a policy response.

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[18] To target excess returns, a minimum tax of 10.5% is applied to foreign income exceeding 10 percent of tangible assets. As the excess is defined mathematically, it does not necessarily represent a return from intangibles.

[19] See Auerbach, A. (2017): Demystifying the Destination Based Cash-Flow Tax.

[20] The proposed mechanism for addressing ongoing base erosion by MNEs could also be considered in the context of more fundamental changes to the profit allocation rules that are contemplated in the Inclusive Framework's recent Policy Note (OECD 2019).

[21] Examples from Australia, France and the UK are discussed in section 2.

[22] https://read.oecd-ilibrary.org/taxation/designing-effective-controlled-foreign-company-rules-action-3-2015-final-report_9789264241152-en#page17.

[23] For example, unless all economies adopt CFC rules, they can easily be side-stepped by changing the domicile of the ultimate parent of an international group of economies. This issue is explored further in section 3.

Both sections 2 and 3 are aimed at contributing to a discussion on appropriate responses and tools. To illustrate how these ideas might be put into effect, draft model provisions are included as annexes to this paper.

2. Attributing Income Received Offshore to Resident Individuals

Tax policies that address the risks posed by wealthy individuals who control significant assets at home and abroad but use offshore structures to manage their holdings and minimize their taxes matter for developing economies.[24] This typically involves multiple entities in a variety of offshore jurisdictions. Trusts are often used because they are very flexible, which is also one of the reasons why trusts are used for entirely legitimate purposes, such as the management of the affairs of individuals who lack the capacity to make decisions for themselves. The formal documentation of a trust does not always disclose the true purpose of the trust arrangement. In some cases, the trust deed may suggest that there is a charitable purpose by mentioning a well-known charity as one of the potential beneficiaries. In reality, the trustees in the offshore jurisdiction will often manage the trust's assets in accordance with the instructions of the person who actually controls the trust. Using structures that include a mix of corporations and trusts established in different countries may make it harder to detect the true owner. It can also make it hard to establish a charge to tax if the tax legislation does not permit the tax authority to look through the structures and attach a liability to the true owner.

So, the desired tax policy outcome is the ability to attribute to resident individuals income and capital gains accruing to entities they control but that are held through complex and opaque structures in offshore jurisdictions. In the absence of an effective income tax charge on these types of structures, there is a clear incentive to use them to legally avoid a domestic charge to tax. Introducing a charging provision will bring this income back within the tax base of the jurisdiction concerned. However, the use of these structures is not confined to legal tax avoidance. It is common for it to be associated with deliberate tax evasion and other criminal activity, including corruption. One of the ancillary benefits of an effective charging provision, coupled with increasing international exchange of information, is that it should help deter corruption, which often involves cash payments into offshore accounts. The link between tax evasion and other criminal activity including corruption is well established.[25] Having an effective charge to tax on income diverted into offshore structures is therefore a necessary part of the wider fight against corruption and other forms of criminality. It is the policy corollary to the improved access to information about such structures that is resulting from the Common Reporting Standard and increased international cooperation between tax administrations and between tax administrations and other arms of law enforcement.

Anglo-Saxon jurisdictions (US, UK and Australia) have enacted specific rules, particularly targeting trusts. Typically, a charge may arise on the settlor (person putting wealth into the trust) and/or the beneficiaries. To be effective, charging provisions should not be limited to trusts but should apply generally to arrangements that may be exploited to exclude income from a charge to tax. So, for example, the UK has provisions known as the "settlements

[24] The leaked data contained in the Mossack Fonseca and Paradise Papers illustrate the lengths some tax avoiders and evaders will go to disguise their ownership of assets and minimize their taxes. As discussed in Alstadsaeter et al. (2018) several developing economies that feature prominently among the countries that generated a lot of shell companies relative to the size of their economy also have high offshore wealth-to-GDP ratios. Similar observations apply to corrupt officials who commonly rely on corporate vehicles to conceal their identities. These include shell companies in offshore jurisdictions, trusts and foundations (WBG 2011).
[25] For a recent discussion of the close relationship between tax crimes and corruption see OECD-WBG (2018).

legislation", which apply to trusts but also to a wide range of other situations involving individuals, companies and partnerships. The overall purpose of the legislation is to tackle arrangements that are intended to divert income from one person to another who is either not liable to tax at all, or liable at a lower rate. To achieve this, the term settlement is defined widely so that a "settlement" includes any "disposition, trust, covenant, agreement, arrangement or transfer of assets".[26] The legislation applies equally to domestic and offshore arrangements. However, the very breadth of the legislation, which dates back to the 1930s, does give rise to some difficulties of interpretation. Case law has established that to be caught a transaction has to involve an element of "bounty". This requires a case by case examination of the arrangements in question and the application of the settlements legislation is technically demanding.[27] This type of approach to the taxation of offshore arrangements, based on a broadly defined scope that requires careful interpretation based on a case by case analysis, does not seem well-suited to the needs of developing countries. The UK has separate anti-avoidance legislation that targets transfers of assets abroad and that can impose a liability on the transferor, or the transferee, but these provisions are also complex and involve a motive test.[28]

Countries that have a civil code tradition often have rules that address the use of entities that perform similar functions to trusts (foundations for example) but may not address trusts directly, because the concept is not recognized by the civil code. Whether or not trusts are recognized by domestic law, citizens of civil code countries can and do make use of them. Recognizing that fact, the French government introduced specific legislation in 2011 to bring trusts within the scope of its income, wealth and inheritance taxes and imposed new reporting obligations. Interestingly, the charge to income tax only arises when a trust makes a distribution. However, if excess income can be accumulated offshore tax free, that is a facility that can be taken advantage of. In 2015 Belgium introduced a regime that goes further, the so-called "Cayman Tax". The regime takes a more direct approach by attributing the income of certain foreign legal structures to their Belgium resident founders. This looks to be a more effective approach, as it ensures that the Belgium resident is taxed as if the foreign structure did not exist. However, there were limits to the scope of the regime in its original form, as it only directly addressed the first tier of ownership. It seems possible to side-step the charge by having the first legal structure create a second, subordinate structure, which actually receives the income. Ideally, a charge to tax should be able to penetrate multiple layers of ownership in a complex offshore structure. Belgium amended its regime in late 2017 to address multiple layers of ownership.

An effective charging provision needs to be clear in its purpose, which is to tax resident individuals on income and gains accruing to offshore structures they control. The charge to tax should not be contingent on there being a distribution of the income and gains to the ultimate owner, unless there is a good policy reason for that being the case, pension funds being an obvious example. Stating the purpose of the legislation very clearly reduces difficulties of interpretation that can make anti-avoidance provisions technically demanding to apply. The legislation also needs to be capable of dealing with the variety of structures and entities that are employed in offshore tax avoidance and evasion. The core issue is the definition of who is the "true owner" of the assets and income in question.

[26] United Kingdom Income Tax (Trading and Other Income) Act 2005, Section 620.
[27] For a recent discussion of the legislation and the concept of "bounty" see the decision in the case of Jones v. Garnett: https://publications.parliament.uk/pa/ld200607/ldjudgmt/jd070725/jones%20-1.htm.
[28] The legislation is found in Part 13, Chapter 2 of Income Taxes Act 2007.

As part of the Common Reporting Standard, the OECD developed a definition of Controlling Persons that is designed to identify the ultimate beneficial owner of financial accounts for reporting purposes. As this is part of an international standard and supported by explanatory material that is intended to aid interpretation and implementation, this appears to be a good starting point for a model charging provision that could help countries realize their policy goals in this area. Annex 1 to this paper comprises draft model legislation that attempts to illustrate how this might be done.

The draft provision is flexible in its scope, which can be narrowed or extended using the definition of what constitutes a low rate of taxation. Policy makers can also consider different definitions of what constitutes a controlling interest, although 25% is a commonly used threshold.[29] It is perfectly possible to have a lower threshold, or to apply the charge if a person is able directly, or indirectly to exercise ultimate effective control over any portion of the income of an offshore entity.[30] The provision makes explicit reference to trusts but also applies to arrangements not involving trusts. The proposal is targeted at passive income, so it will not discourage direct investment in real activity, which has been routed through an offshore center. The draft provisions also include a series of exclusions from the charge, designed to leave out of scope entities that are unlikely to give rise to a tax risk, such as pension funds and genuine charities.

Whether or not the proposed approach in Annex 1 is the best means to impose a charge on offshore structures, there is no good policy reason not to have an effective charging provision of some sort. There are often practical obstacles to reform in jurisdictions where those individuals who are making use of offshore structures also exercise considerable political influence. Even more so, improving tax compliance by high net worth individuals is an important element for successful domestic resource mobilization in these countries.

3. Diverted Profits Provisions for Developing Economies

This section briefly discusses why it is generally accepted that transfer pricing rules need to be supplemented by some form of additional defense against profit shifting, or diversion. This has tended to take the form of a controlled foreign company (CFC) regime. The second part of the section describes how CFC rules work and some of the shortcomings of an approach that focuses on control, particularly when viewed from the perspective of a developing economy that will generally be capital importing. The section then considers an alternative approach that has been adopted by Australia and the United Kingdom, in the form of a specific tax on diverted profits. This is followed by a discussion of how the thinking underlying these diverted profits taxes could be adapted to meet the needs of developing economies in a way that strikes a balance between the need to attract foreign investment and the need to have a rule that is relatively straightforward to apply. Recognizing that developing economies are a diverse group, the section concludes with a discussion of two alternative mechanisms for securing the corporate tax base by means of mechanical rules.

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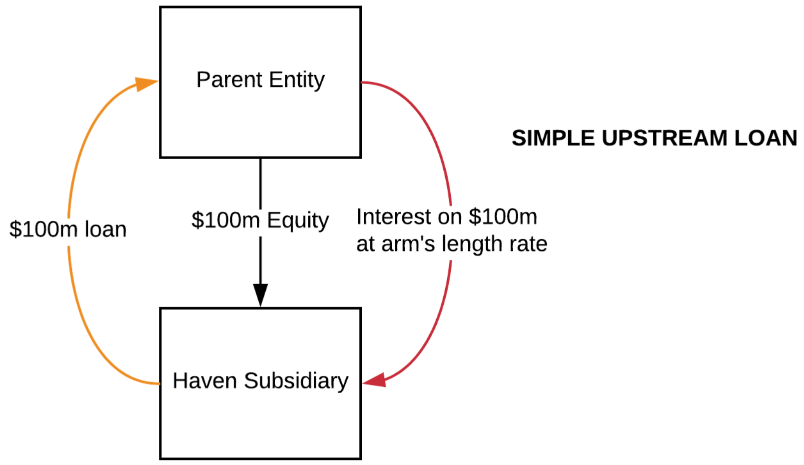
[29] See for example the discussion of the concept of controlling persons in the commentary on Section VIII of the CRS.

[30] For example, the United States has provisions that target income from investments made through foreign entities, defined as Passive Foreign Investment Companies, and these apply to any level of investment in such companies.

Backing up transfer pricing rules

A central outcome of recent policy discussions on tackling cross-border tax avoidance is an update of transfer pricing guidelines issued by the OECD and the UN. The aim is to improve the correlation between taxation and value creation. At the same time, it is recognized that countries may need to complement those rules with additional defenses. That is because not all mechanisms for diverting profits to low tax territories are susceptible to challenge under transfer pricing rules. The most obvious example is the so-called "money-box" company. Simplifying somewhat, a money-box company is a subsidiary located in a tax haven that is funded by way of an injection of equity capital by its parent. That capital can then be invested to make a tax-free return, or typically be lent back to the parent on arm's length terms. The pricing of the loan does not offend transfer pricing principles but clearly the overall result of the transaction is to strip profits from the home country into the tax-haven. The diagram below illustrates this simple example.



The very simple money-box example described above could be challenged on various grounds but, in practice, aggressive tax planners will have inserted the funding arrangements into more complex business structures that are proof against substance over form provisions that might be used to attack a simple money-box. And finance is not the only mechanism that can be used to divert profits to a haven entity, without infringing transfer pricing rules. Some MNEs have been adept in structuring the ownership of intellectual property so that profits attributable to patents, brands and other intangibles are recognized in territories where they are subject to low or no taxation. Dischinger and Riedel (2011), for instance, find that intangible asset holdings are distorted towards low-tax subsidiaries in MNEs. Changes to the transfer pricing guidelines made as part of the BEPS project are intended to address this type of planning, but the issues of fact and law involved are complex. Consequently, many countries have developed separate legislation designed to counter the diversion of profits to tax haven subsidiaries. These are generally known as Controlled Foreign Company rules (CFC).

It is questionable, however, whether CFC rules effectively address the profit-shifting risks faced by capital importing countries. Consequently, an alternative approach that is more commensurate with the administrative capacity in developing countries may be required.

Controlled foreign company rules (CFC) - The problem with the focus on control

CFC rules have been around since the 1960s and have been adopted, in one form or another, by many countries.[31] Put very simply, CFC rules are designed to deter MNEs from accumulating profits in low-tax jurisdictions, particularly in the form of passive income. To do this they target the profits of foreign subsidiaries of parent companies that are subject to low rates of taxation, have not been paid up as taxable dividends to the parent and, generally, arise from passive investment, rather than substantive economic activity, such as manufacturing. However, like the rules for transfer pricing, CFC regimes have not necessarily kept pace with the way modern MNEs operate. The BEPS project recognized the case for having CFC rules, as a defense against profit shifting that complements transfer pricing:

> *Transfer pricing rules, which generally rely on a facts and circumstances analysis and focus on payments between related parties, do not remove the need for CFC rules. CFC rules are generally more mechanical and more targeted than transfer pricing rules, and many CFC rules automatically attribute certain categories of income that is more likely to be geographically mobile and therefore easy to shift into a low-tax foreign jurisdiction, regardless of whether the income was earned from a related party.*[32]

Action 3 of the BEPS project makes recommendations that are designed to help countries that decide to implement CFC rules to ensure that they are effective in preventing the diversion of profits to lowly taxed foreign subsidiaries. The final report approaches this task by identifying the essential building blocks of an effective regime, the first of which is the definition of a CFC. As the name suggests, the concept of control is central to the CFC regime: it targets subsidiaries and other entities that are under the effective control of a parent entity that is a resident of the jurisdiction implementing the rules. The focus on control can be problematic, especially when viewed from the perspective of a developing country.

It has been argued that the enactment of CFC regimes in developed economies would have a beneficial impact on tax planning that affects developing economies.[33] Simply put, if profits diverted from a developing country into a haven are caught by a CFC rule that applies to the parent, there is less incentive to strip the base of the developing country. The tax savings in the developing country will be offset, or even exceeded by the CFC charge on the parent. In reality, this is not likely to be the case for a number of reasons. Firstly, only some developed countries have CFC rules and several important jurisdictions do not have them and have no intention of introducing them -Action 3 makes recommendations but is not one of the four minimum standards that members of the Inclusive Framework are committed to.[34] Secondly, the CFC regimes in some countries are limited in scope and only target profits diverted from the parent jurisdiction, or are compromised in some way.[35] The EU did mandate the adoption of CFC rules in its 2016 Anti-Tax Avoidance Directive but the primary concern is the diversion of

[31] Thirty of the countries that participated in the BEPS project operate CFC rules. The United States was the first country to adopt CFC rules. See also: Lehuede (2003) and Parada (2012).

[32] OECD (2015 b), p. 14.

[33] See for example, Platform for Collaboration on Tax (2015), which recognized "For worldwide countries, CFC rules in principle provide some protection against tax avoidance through deferral", p. 13.

[34] For more information about the BEPS Inclusive Framework, see: http://www.oecd.org/tax/beps/beps-about.htm.

[35] For a discussion of the United States system as it stood prior to the reforms passed by Congress in 2017, see the American Bar Association report on international tax reform: http://www.americanbar.org/content/dam/aba/migrated/tax/pubs/taskforceintltaxreform.authcheckdam.pdf.

profits from member states.[36] Thirdly, in the past, US and UK MNEs have used inversions (inserting a new top-co to be the ultimate parent of the group) to move to jurisdictions that do not have CFC rules at all, or have less rigorous regimes.[37]

When we consider what developing economies can do themselves, adopting CFC rules domestically will be of limited benefit given that they are mainly recipients of inward investment by MNEs with foreign parents.[38]

In a developing economy context, it may be more sensible to shift the focus of rules designed to complement transfer pricing from the concept of control to the essential mischief, which is profit diversion. However, doing so raises some fundamental questions about the design of an anti-diversion rule. CFC regimes were initially developed at a time when it was more usual to assert worldwide taxing rights over the income of corporate citizens and anything that attempted to avoid this was a legitimate target of the CFC regime. The CFC rules introduced in the UK in the 1980s illustrate this quite well. They included various defenses against a CFC charge, such as an exemption for CFCs carrying on certain types of activity and a motive test. But the motive test was characterized by critics as including a default assumption that if activities are diverted into a low tax jurisdiction, they could have been moved to the UK and the profits arising should be taxed accordingly.[39] More recently developed countries have tended to adopt a more territorial approach to the scope of their CIT systems and the UK is an example of that.[40]

It makes even less sense for an anti-diversion rule that is designed with capital importing countries in mind to be designed to tax all profits diverted to a low tax jurisdiction by an MNE; that would constitute a significant overreach. So, an anti-diversion rule needs to define what constitutes diversion anew and provide a mechanism for calculating the amount of profit that has been diverted from the country itself and how it should be taxed. Australia and the UK have done just that and introduced a Diverted Profits Tax.[41] Unsurprisingly the two regimes

[36] "In particular, in order to ensure that CFC rules are a proportionate response to BEPS concerns, it is critical that Member States that limit their CFC rules to income which has been artificially diverted to the subsidiary precisely target situations where most of the decision-making functions which generated diverted income at the level of the controlled subsidiary are carried out in the Member State of the taxpayer." https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016L1164&from=EN.

[37] Even without tax driven inversions, market forces will tend to encourage the ownership of MNEs in jurisdictions without effective CFC regimes. The lower effective tax rate on foreign profits was cited as one of the reasons Kraft was able to take over Cadburys, for example.

[38] As noted by UNCTAD (2015), a CFC regime "may only be relevant for developing countries that have sufficient outward investments to warrant introducing and administering such legislation". Just 8 of the top 100 global MNEs were domiciled in developing economies in 2017 (UNCTAD 2018).

[39] This was achieved by asking if, had the CFC and any related entities not existed, it was reasonable to suppose the profits would have accrued to a UK taxable person (Paragraph 19(1), Schedule 25, Income and Corporation Taxes Act 1988).

[40] This was an explicit policy goal of the UK's recent changes to its CFC regime and the de facto result of the "check-the-box" system and associated rule changes in the USA (see the consultation document issued by the UK Government in 2011, explaining the direction of its CFC reforms: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81286/corporate_tax_reform_part2a_cfc_reform.pdf).

[41] France also included a Diverted Profits Tax in its 2017 Finance Bill but the Constitutional Council ruled that it was unconstitutional. The tax would only have been applied during an audit. The Council ruled that the law was not specific enough about how the tax would be calculated and the link to an audit meant that the tax would only be applied at the discretion of the tax administration. See: Décision n° 2016-744 DC du 29 décembre 2016, available online: http://www.conseil-constitutionnel.fr/conseil-constitutionnel/francais/les-decisions/acces-par-date/decisions-depuis-1959/2016/2016-744-dc/decision-n-2016-744-dc-du-29-decembre-2016.148423.html. The diverted profit tax was also discussed in New Zealand, see: http://taxpolicy.ird.govt.nz/publications/2017-dd-

have several features in common and illustrate some of the main design questions that the framers of an anti-diversion rule need to address. Both have two legs: a rule targeted at schemes designed to avoid the creation of a taxable permanent establishment (PE) and a charge on profits diverted by means of arrangements, or entities, lacking economic substance. The first issue was the subject of BEPS Action 7,[42] so it is the second element that potentially breaks new ground. What follows is a high-level description of this aspect of the two Diverted Profits Taxes and a discussion of how the concept might be adapted to meet the needs of developing economies.

The UK's Diverted Profits Tax

The United Kingdom's Diverted Profits Tax (DPT) took effect on 1 April 2015. It is primarily designed to act as a deterrent:

> *"The requirement to pay the tax "up front" provides a strong incentive for groups to provide timely information about high-risk transactions and how they fit into the groups global operations. It reduces the information bias inherent in complex cases and promotes full disclosure and constructive early engagement with HMRC."*[43]

This deterrent purpose has affected the design of the tax in a number of ways. It is deliberately designed to be penal in its effect. It is a separate tax from mainstream corporation tax, is charged at a higher rate and in HMRC's view does not fall within the scope of the UK's double taxation agreements. The tax must be paid immediately on the basis of an initial "best of judgement" assessment by HMRC.

HMRC's guidance on the operation of the DPT runs to over 100 pages, but the basic workings of the tax can be described more shortly. It applies to UK resident companies and foreign companies with a UK PE or an avoided PE[44] that are using contrived arrangements with connected persons to reduce UK tax. It targets "material provisions" imposed or agreed between the UK company/PE and the connected person. The term is defined broadly to include any arrangements, understandings or practices affected by means of a transaction or series of transactions. As HMRC's guidance makes clear, the tax is targeted at "arrangements involving entities or transactions lacking economic substance".[45] Deciding whether an arrangement is

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transfer-pricing-pe/chapter-2. But it was not implemented. According to a Cabinet Paper released by Inland Revenue "Introducing a DPT would mean that there would be a new type of tax, separate to income tax, to deal with a minority of aggressive multinationals. It could impact on foreign investor's perceptions of the predictability and fairness of New Zealand's tax system for foreign investment. As a separate tax from our general income tax it may produce unintended adverse consequences for taxpayers – especially with regard to normal grouping of tax attributes (for example income tax losses would not be able to be set off against diverted profits). A DPT may also have an unintentional negative impact on compliant taxpayers. The more we get into imposing arbitrary taxes the greater the risk of other countries doing the same to our exporters. Overall a DPT chips away at the consistency, neutrality and relative simplicity of our tax system from a global perspective." See more: http://taxpolicy.ird.govt.nz/sites/default/files/2016-other-cabinet-paper-transfer-pricing.pdf.

[42] See: OECD (2015c).

[43] See : https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/480318/Diverted_Profits_Tax.pdf, p. 4.

[44] According to HMRC's DPT guidance an avoided PE arises where a person carries on activity in the UK in connection with the supply of goods, services or other property by a foreign company and that activity is designed to ensure that the foreign company does not create a PE in the UK, and either the main purpose or one of the main purposes of the arrangements put in place is to avoid UK tax, or there are arrangements designed to secure a tax mismatch, such that the total tax derived from UK activities is significantly reduced.

[45] Ibid, p. 9.

caught and, if it is, how much tax is due is potentially a complex task. This is another incentive for taxpayers seeking certainty to make an early disclosure of arrangements they think might be subject to the tax.

To trigger the tax, the material provision must result in “an effective tax mismatch outcome”. This is defined as a reduction in the UK taxpayer’s liability by an amount that exceeds the consequent increase in the connected party’s tax liability, although in practice this is not as straightforward as it sounds. There are some exemptions, for charities for example. There is also a let out if the increase in the connected party’s liability is 80% or more of the value of the reduction in the UK liability.

In addition to generating an effective tax mismatch outcome, to be caught, the material provision must lack sufficient economic substance and be designed to reduce tax. The starting point for applying the insufficient economic substance test is “whether it is reasonable to assume that the transaction(s) or the involvement of a person in the transaction(s) was or were designed to secure the tax reduction (as defined through the effective tax mismatch outcome rule)”.[46] However, provisions will not be caught if the expected non-tax financial benefit was greater than the financial benefit of the tax reduction.

If all the conditions for applying the DPT are met, the tax is calculated in one of two ways. If the transactions would have taken place but are not correctly priced, the tax is calculated by reference to the correct transfer price. The taxpayer has the option to correct the transfer pricing in their corporate tax return within a fixed period, and so avoid the imposition of the DPT. However, if the transactions would not have taken place, or would not have been executed in the way that they were, had tax not been a consideration, the tax may be calculated by reference to a re-characterized transaction(s) termed as the ‘relevant alternative provision’ in the guidance: “the alternative provision that it is just and reasonable to assume would have been made or imposed (…) had tax on income not been a relevant consideration for any person at any time”.[47] Finally, DPT does not apply to small and medium enterprises.[48]

Australia’s Diverted Profits Tax

Australia’s provision that resembles the first leg of the UK’s DPT, which is targeted at arrangements to avoid the creation of a taxable PE, took effect on 1 January 2016. The basic design of the second leg was the subject of consultation in 2016[49] and enacted in April 2017.

The design is based on the UK model and has a similar rationale (encouraging greater openness and addressing information asymmetries),[50] but there are differences in the version that has been legislated: it includes finance transactions, which are excluded from the UK DPT, and the economic substance test is based on a functional analysis. The tax applies from 1 July 2017

[46] Ibid, p. 30.
[47] Ibid, page 13.
[48] The legislation relies on the definition of small and medium enterprises provided in the Annex to Commission Recommendation 2003/361/EC of 6 May 2003 (concerning the definition of micro, small and medium-sized businesses).
[49]See: Howe and Khomenko (2017) and the Australian Treasury: http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2016/Implementing-a-diverted-profits-tax.
[50]See: https://www.ato.gov.au/General/New-legislation/In-detail/Direct-taxes/Income-tax-for-businesses/Diverted-profits-tax/?page=1#Legislation_and_supporting_material.

and is focused on significant global entities (defined as having global income of more than A$1 billion).

The principal feature of the Australian DPT is that it applies where it is reasonable to conclude that a principal purpose of the arrangement is to secure a tax benefit. In addition, it needs to be reasonable to conclude that the scheme at stake does not pass the sufficient foreign tax test and does not pass the sufficient economic substance test. So, as in the UK, the Australian DPT applies if the transaction in question gives rise to an effective tax mismatch and has insufficient economic substance. The sufficient foreign tax test is a let out for cases where the increase in the connected party's liability is 80% or more of the value of the reduction in Australian tax payable. The economic substance of entities involved in the arrangement is to be assessed by reference to the functions they undertake, transfer pricing principles and "any other relevant matters". Finally, there is a de-minimis rule, so that the tax does not apply if the aggregate income of the taxpayer in Australia, including any DPT tax benefit, is A$25 million, or less.

If the Australian DPT applies, the Australian Tax Office (ATO) issues an assessment (the tax does not operate on a self-assessment basis). The ATO may impose a penal tax rate of 40 percent on profits transferred offshore through related party transactions with insufficient economic substance. The Australian DPT also provides the ATO with more options to reconstruct the alternative arrangement on which to assess the diverted profits where a related party transaction is assessed to be artificial or contrived. It requires upfront payment of any DPT liability, which can only be adjusted following a successful appeal against the assessment, which cannot be lodged until 12 months after the assessment. It puts the onus on taxpayers to provide relevant and timely information on offshore related party transactions to the ATO to prove why the DPT should not apply.

Table 1. Main features of the two DPTs

Feature	**UK**	**Australia**
Rate (higher than CIT)	25%	40%
Tax payable up front	√	√
Threshold/de minimis	SMEs out and 80% rule for tax mismatch	Targets MNEs with income >A$1bn and let out if Aus income <A$25m plus 80% rule for tax mismatch
Onus on TP to declare potential liability	Yes	No
Creditable?	No	No

A Diverted Profits Tax for Developing Economies?

The UK and Australian DPTs have similar features and have been developed in a similar context. Both countries have a developed transfer pricing capacity and a sophisticated suite of anti-avoidance measures, including GAARs and CFC rules. The DPTs have been designed to incentivize greater compliance with the mainstream CIT regime and more openness about controversial transactions or arrangements. The aim is not to raise large sums from the DPT itself but to change the dynamics around avoidance of existing taxes.[51]

The context for developing countries is rather different. In many cases capacity to address transfer pricing risks is limited and existing anti-avoidance legislation may not be effective, or comprehensive (Cooper and others, 2016). In this context, there may be a greater need to supplement transfer pricing defenses with a more mechanical and targeted rule that is integrated into the corporate tax system. That suggests that, rather than adopting an entirely new tax targeted at diverted profits, policy makers may prefer to address profit diversion by way of an additional anti-avoidance rule that is incorporated into their corporate income tax system. An anti-diversion rule can be designed to help tackle tax avoidance directly, rather than as an indirect deterrence measure. An additional advantage is that, as most CIT regimes operate on the basis of self-assessment, the onus will be on the taxpayer to compute the amount of any adjustment to profits required by the rule. Obviously, if the taxpayer fails to make an adjustment, the legislation will need to give the tax administration the authority to impose one.

There are other reasons for adopting this approach. Incorporating an anti-diversion rule into the CIT system ensures that the tax is creditable and subject to existing Double Taxation Agreements (DTA). As further discussed below, it can be argued that the computation of the amount of diverted profits should rely on methods that are not necessarily consistent with international norms as reflected in DTAs. If the rule is part of the CIT, however, DTAs will generally override the domestic rule and the effects of its application will be limited to amounts that can be shown to be consistent with the DTA. The rule would therefore be primarily targeted at territories that are outside a country's DTA network. In practice, many developing countries have limited treaty networks. This reduces the likelihood that the rule will be overridden by treaties but also makes it even more important that the measure is carefully targeted at profits subject to very low rates of taxation.[52]. For countries that are net importers of capital, adopting an approach that is within the corporate tax regime and so subject to treaty override is less likely to concern foreign direct investors. By contrast, an additional, non-creditable tax, levied at penal rates is likely to unnerve investors.[53]

The benefits of a diverted profits tax to any country will depend on its specific circumstances. For example, how extensive is the treaty network and does it include the countries that are the main sources of inward direct investment? How well do existing or alternative measures function as defenses against profit shifting? Countries with very limited capacity in their tax administration may be better advised to ensure that they have a good system of withholding taxes that are relatively simple to operate. That said, complexity cannot be avoided altogether. For example, withholding tax from royalty payments is likely to encourage MNEs to include the cost of any intellectual property in the overall price charged for the intra-group supply of goods and services. Even if the withholding tax regime is capable of being applied to these "embedded" royalties, quantifying the amounts will still be a technically demanding task.

[51] The Australian Government has estimated that DPT will raise A$100m a year: http://kmo.ministers.treasury.gov.au/media-release/024-2017/. HMRC raised £219 million from DPT charges in 2017-18, which compares with £1,682 million yield from transfer pricing in the same period: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/729876/Transfer_Pricing_and_Diverted_Profits_Tax_statistics.pdf.

[52] There are good reasons for developing economies not to enter into overly generous treaties with low tax jurisdictions in any case (Beer and Loeprick 2018).

[53] The decision not to introduce a DPT in New Zealand reflected this concern.

An Anti-Diversion rule for Developing Economies?

Drawing on the UK and Australian examples, what might a diverted profits rule (DPR) for developing countries look like?

Defining the target

The first step would be to define the taxpayers and arrangements that will be subject to the anti-diversion rule. Here the approach taken by the UK and Australia seems like a sensible model for countries to follow. So, a generic version of the rule would apply to taxpayers with related parties and arrangements directly or indirectly governing commercial and financial transactions between the parties (something similar to the material provision concept in the UK DPT). Some form of *de-minimis* rule would also be sensible, to exclude SMEs and focus on MNEs. The precise parameters would depend on the nature of the economy of the country.

The second step would be to determine whether or not there has been, or there is a risk of, tax driven diversion of profits. The DPT does this by using the idea of a tax mismatch, where the tax reduction achieved by the taxpayer is greater than the corresponding increase in the liability of the related party. It may be simpler to apply the DPR whenever the corresponding income is subject to a lower rate of taxation than it would have been if taxable in the hands of the taxpayer. It would be important to frame this so it could catch transactions where the profit passes through one or more entities before arriving at its final destination (using the concept of a series of transactions).

In the context of the relationship between a sophisticated tax administration and MNEs, addressing these two steps in the way Australia and the UK have chosen is sensible. Application of their DPT rules will take place within the overall framework of that relationship, in which the application of complex law to complex commercial arrangements is relatively commonplace.[54] The analysis of economic substance involved is a common undertaking for these tax administrations. For many developing economy administrations, it is, however, more likely to represent an additional layer of complexity. In these situations, a more mechanical back-up to transfer pricing rules could help administrations secure their tax base and would be more commensurate with available administrative resources and capacity.[55] Often, what is needed is a simpler approach that does not entail any effort to "trace" income or profits and does not involve the exercise of discretion and professional judgement.

A simplified version of the DPR would not attempt to identify the entities, and so the arrangements, that may have given rise to profit diversion. All related parties would potentially fall within the scope of the DPR, subject, as before, to a *de minimis* rule.[56] Similarly, the simplified DPR would not attempt to precisely determine the amount of any actual tax mismatch. It would simply ask if the related parties' income, or a specified part of its income (to address jurisdictions that exempt from taxation mobile income such as royalties) is subject to a lower rate of taxation. The rate of taxation should be the effective rate applying in the

[54] It is interesting to note that the DPT in France was clearly seen as operating in the context of a broader examination of the affairs of large businesses, because it was only triggered if there was an audit. This was one of the reasons it was ruled unconstitutional, as the incidence of the tax was entirely governed by the discretionary decisions of the tax administration.

[55] See also: The Platform for Collaboration on Tax (2017).

[56] The de minimis rule could exclude all SMEs and additionally related entities that have profits below a certain threshold, subject to an anti-fragmentation provision to prevent MNEs from splitting profits up among multiple entities that then fall below the de minimis threshold.

corresponding taxable period, rather than the statutory rate. This would ensure that the rule provides protection in cases where diverted profits can be covered by losses brought forward. However, it may be argued that this goes too far if the losses are the results of genuine commercial operations. This is an aspect of the rule that would benefit from further analysis. If the effective rate in the other country is lower than the domestic rate by sufficient margin, then the entity is potentially subject to the DPR charge (bearing in mind that this will be embedded in the overall liability to CIT of the resident entity and/or PE).

Defining the "lower rate" of taxation will give a country one way of adjusting the scope of the anti-diversion rule. Setting the rate at a low level would focus the rule on no or low tax countries and arrangements that largely extinguish taxable profits. This would also make it easier to present the rule as clearly targeted at low tax jurisdictions, or arrangements that exploit gaps in the tax systems of other countries for the purposes of tax avoidance. The scope of the measure can be further limited by setting the level of profitability that is proposed as a trigger for the rule in the next section high.

Defining diversion

Once the parties and/or transactions to which the rule applies are identified, it would then be necessary to determine if there was tax driven diversion. The DPTs in the UK and Australia do this using the concept of insufficient economic substance, which is in turn linked to the tax driven nature of the transaction, or arrangements. In both the UK and Australia, where it is possible to do so, transfer pricing rules can be used to determine if there has been diversion and the amount involved. Alternatively, the transaction or arrangements can be reconstructed on a just and reasonable basis.

An anti-diversion rule that is incorporated in the CIT will supplement, rather than duplicate the transfer pricing rules that should already be part of the system. The anti-diversion rule should target transactions and arrangements which result in profits that would have been taxable in the country, being taxed elsewhere at an unacceptably low rate. The onus would then normally be on taxpayers to demonstrate that the transaction was not tax motivated, perhaps by showing that the non-tax benefits are greater than the tax saving, following the UK approach.

It may be sufficient to limit the anti-diversion rule to these demonstrably tax motivated transactions and arrangements but, once again, this would involve the exercise of considerable judgement and complex analysis of the facts. How might the rule be simplified to address the needs of developing countries? This could be done by defining the lowly taxed entities that will be subject to the DPR charge more mechanically. Typically, target entities in low tax jurisdictions have unusually high rates of return from relatively low cost and asset bases. This is an inevitable consequence of maximizing the income enjoying low taxation. The DPR could include a rule that entities subject to a low rate of taxation, as defined, and that generate "super-profits", shall be subject to the DPR charge. Given the way the mechanical approach works, the charge would apply to any related entity, regardless of whether it has any direct dealings with taxpayers in the country.

The definitions of super profits could be set in an absolute way (profits are greater than X times operating costs for example) or in a relative way (profits are greater than X times the profit margin of the MNE as a whole). An analysis of reported results of MNEs could be used to determine the definition of what are super profits, possibly differentiating between key economic sectors. The precise ratio chosen is another way in which the impact of the DPR charge can be adjusted by countries. At its heart is a simple proposition – beyond a certain level, profitability is just too good to be true and can only be explicable as the result of profit diversion. That makes the profits a legitimate target for anti-avoidance rules, even ones that are somewhat mechanical and so, to a degree, arbitrary. This approach also lessens the likelihood that the rule will catch genuine profits of activities in other countries that are relatively lightly taxed, for example because there is a patent box regime in the other country.

This approach would identify highly profitable but lowly taxed subsidiaries of an MNE, but it would still leave open the question of how much of the profits of these subsidiaries represents amounts diverted from the country in question. In some cases, this is very difficult to do. Treasury operations are a case in point, because of the fungibility of money.[57] However, in many instances the entities affected will be in low or no tax jurisdictions, so countries may feel less compunction about using simplified approaches to calculate their "share" of the profits. A formulaic approach (say based on the country's share of the MNE's global turnover) might suffice.[58] This is the method proposed in the draft legislation included in Annex 2 to this note, with provision to recalculate the amount of profits to be assessed if there is an audit. For example, if a transfer pricing audit increases the taxable income of a local subsidiary, the amount of diverted profits would also increase. Where the entity is in a normal rate country and there is a DTA, the treaty will override the formulary approach in line with international norms. However, given the twin requirement that there be a low rate of taxation and "super profits", an entity in a normal rate country is only likely to be affected if it benefits from some special tax treatment in that country (such as the exemption of royalty income). The taxpayer could be allowed the option to demonstrate that the lowly taxed entity had no direct or indirect dealings with related parties taxable in the jurisdiction and so displace any addition to profits under the DPR. This option, to allow taxpayers to demonstrate that there has been no actual erosion of the country's tax base, is explored further below. The charge should also exclude profits that are already subject to taxation in the country, for example as a result of other anti-avoidance rules that apply to the taxpayer. So, if profits in a lowly taxed entity have been attributed to a taxable entity in the country under transfer pricing rules, they will not be taxed again under the DPR.

The draft legislation assumes that the DPR will bring additional profits into charge at the standard rate of corporate income tax. However, a jurisdiction could choose to impose a minimum rate of tax instead. This is the approach taken by the United States GILTI regime, which subjects foreign earnings that exceed a 10% return on assets to a minimum tax of 10.5%, rising to 13.125% in 2026. If a jurisdiction was particularly anxious not to deter foreign investment, this would be one way to limit the impact of the measure. A simple example of the legislation that might apply is included as Annex 3.

Scope

In addition to the options already described, a country might choose to further refine the scope of its anti-diversion measure. For example, it might choose to exclude certain types of activity (manufacturing for example) on the basis that transfer pricing should address the profit shifting risks adequately and it reduces the number of entities that the taxpayer and tax administration would need to review. Exempt activity exclusions feature in some CFC regimes but it is

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[57] For example to what extent is a regional treasury function in a low tax territory diverting profits from its parent (because it is holding capital that would otherwise be managed in Head Office) or from operating subsidiaries in the region (because it is holding some of their operating capital)?

[58] The proposal here has some commonality with earlier proposals to introduce residual profit allocation to capture returns to intangibles by allocating normal returns using the arm's length principle and distributing the remainder using a sales based formulaic allocation key (Devereux 2016).

important to focus the let out. If it is too loosely framed, MNEs may choose to mix in income from non-exempt activities, for example by allocating intra-group loans to manufacturing subsidiaries in low tax jurisdictions. If the definition of super profits is set high enough, this type of exclusion is probably not necessary.

A country will also need to decide whether to include financing subsidiaries in the scope of its anti-diversion rule. This may seem an obvious decision, given the money box example quoted at the beginning of this section. However, the fungibility of money referred to earlier makes the tracing of financial returns hard, if not impossible to do. There are also reasons why cash-rich subsidiaries of some MNEs exist that are not related to profit shifting from developing countries. This issue is discussed further below. For these reasons, a country may prefer to tackle its exposure to interest deductions by means of an EBITDA restriction of the kind advocated in the final report on BEPS Action 4 (OECD 2015d). Having done so, it could choose to leave finance outside of the scope of an anti-diversion rule. [59]

Risks to the investment climate: Double taxation

The mechanical version of the DPR charge just described would tax a proportion of the profits of all foreign related entities that are subject to a low rate of tax and that earn "super profits" as defined by the measure. The amount of the charge would be determined by means of a formula. Clearly this process is a long way from current international practice.[60] The need to raise revenue must be weighed against the need to attract foreign direct investment.

Incorporating the charge within the framework of an existing CIT and so making it subject to treaty override places an important limit on the risk that the tax may give rise to double taxation. Consequently, a country contemplating a tax measure along these lines will want to carefully assess the sources of foreign investment in its country and the extent of its treaty network. Moreover, as the measure should target profits that are subject to no, or low rates of taxation, it is unclear whether significant double taxation would arise in the first place. If the primary target is entities in tax havens,[61] double taxation would not seem to be a problem. However, it could arise if the profits were caught by the anti-avoidance rules of a third country (CFC rules or its own DPT). This can happen where two countries seek to exercise taxing rights over the profits attributed to a lowly taxed entity inserted into a value chain that involves those countries for the purposes of tax avoidance. In both cases the remedy would be the treaty between the two normal rate countries.

Many developing economies have relatively small treaty networks. Consequently, the design of a DPR would need to take into account the absence of a treaty between the country and an important source of foreign investment. This can affect how the rule approaches the definition of a low rate of taxation and what level of profitability is used as a trigger. If the profits are caught by the DPR, or another anti-abuse rule of another country, with which there is no treaty, the remedy to potential double taxation just discussed would not be available. In that case, a country might want to contemplate some form of unilateral system for taking account of the tax charged by the third country. This could be done by defining the rate of tax paid on the profits of an entity to include tax payable in any country and not just the country of residence.

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[59] The UK's DPT excludes loan relationships but the UK is adopting an interest restriction based on EBITDA. Financial transactions are within the scope of Australia's DPT.
[60] This was also an argument raised against the Australian DPT. See: Howe and Khomenko (2017).
[61] However, the measure will also bring into charge "super profits" that are not taxed in normal rate countries because there is some form of beneficial regime, or there are past losses available to shelter them.

That is probably necessary in any case to take account of taxes paid by permanent establishments and withholding taxes. However, there may be circumstances in which a country would not want to apply the DPR charge, even if the profits in question are not being taxed elsewhere, or only at a very low rate.

Not my tax base? – DPR as a rebuttable presumption

Some cash-rich and lowly taxed entities exist that have little, or nothing to do with base erosion in developing economies. A highly simplified reading of the current dispute between Apple and the EU can serve to illustrate the point.[62] The EU's complaint is that the Irish Revenue accepted an allocation of taxable profits to the Irish branch of Apple's dual resident Irish-Bermudan subsidiary that was far too low. Not so says Apple. The profits were generated elsewhere but, prior to the 2017 reforms, the US did not tax those profits until they are repatriated. As a result, Apple and several other US MNEs held cash and marketable securities outside the US in lowly taxed entities as a direct consequence of the way the US taxed, or rather did not tax, foreign source profits.[63] A mechanical DPR charge of the kind just described would still catch part of the earnings of these cash-rich entities. That might be regarded as a good thing by some, but it could also act as a deterrent to foreign investors, unwilling to accept a potentially large tax exposure that is unrelated to their activities in the country that imposes the charge. Consequently, a country contemplating a DPR charge might want to provide a let-out. Doing so makes it much easier to defend the otherwise deliberately mechanical approach of the DPR.

The difficulty with a let-out clause is that it reintroduces a degree of discretion and judgement into the operation of the DPR charge, both of which the mechanical approach was designed to avoid. Unfortunately, any tax charge that is sensitive to the specific circumstances of a large business taxpayer will involve some degree of professional judgement. However, the risks involved can be mitigated if the DPR charge is structured on the basis that it is payable unless the taxpayer can successfully demonstrate that the profits earned by the lowly taxed entity are unrelated to any activities undertaken in the country. The fungibility of money makes attribution of profits from financial activity particularly difficult. Therefore, the exclusion of finance would simplify the discussion of whether profits are related to activities undertaken in a country.

Making the DPR charge payable but subject to rebuttal helps address one of the central problems that face tax administrations in developing economies, namely the asymmetry of information; generally, MNEs know much more about the operation of their business than the tax authorities they deal with. Requiring the taxpayer to make a case why the DPR should not apply allows the tax administration to require a much greater degree of transparency about the taxpayer's value chain than would otherwise be the case. It would have the incidental benefit of greatly improving the tax administration's understanding of operations in the industry concerned.

There are further steps that could be taken to improve the rigor and propriety of the process for dealing with claims that lowly taxed profits are unrelated to a country's tax base. As these decisions will involve the largest taxpayers, they should be subject to a discrete governance process involving senior managers in the tax administration. They should not be taken by a single individual acting alone. The tax administration could publish an explanation of how it

[62] See: http://europa.eu/rapid/press-release_IP-17-3702_en.htm.
[63] The American Bar Association report cited in footnote 29 explains why this was the case.

will analyze these claims and what evidence should be supplied. It may be possible to develop a model approach, including a guide to the analysis of international value chains, building on existing guidance (Cooper and others, 2016). The tax administration should commit itself to providing timely and reasoned decisions on any claims. The tax administration could publish details of the claims it has accepted. The factual elements could be greatly simplified, or omitted altogether, to protect any commercially sensitive data provided by the taxpayer. Publishing details of those taxpayers that have applied for and been granted exclusion from the DPR charge would make that process highly transparent. The tax administration's decision should be subject to appeal to the courts.

Alternative mechanical rules

The main target for a DPR charge are instances when MNEs manage to recognize very high levels of profitability in a manner that secures low or no taxation of those profits; that, after all, was one of the key drivers behind the efforts to reform the international tax system. However, ensuring compliance with the proposed DPR would require tax administrations to have information about the global operations of MNEs and how the activities undertaken in their territories fit into the overall supply chains of the business they are taxing. This is also a feature of the revised transfer pricing guidelines and the results of BEPS Action 13 should assist tax administrations in this regard. Nonetheless, obtaining and processing the relevant information remains a challenge for many tax administrators. Some developing economies may prefer to supplement their mainstream CIT rules with alternative measures that are even more mechanical and that can be based on information they know they will have at hand.[64]

Alternative corporate minimum taxes (ACMT) are a simple instrument operated in a number of developing economies. They usually take the form of an alternative measure of tax due based solely on turnover. Durst (2018) identifies 20 countries that have an ACMT based wholly or partly on turnover, making the calculation of the tax very straightforward: if the CIT due under normal rules is less than the amount due under the ACMT, the taxpayer pays the turnover tax. This limits the effectiveness of avoidance measures that erode the tax base by inflating payments to related parties for services, intangibles or debt. It does assume that the level of reported turnover is accurate, but in practice this may consist wholly or partly of related party transactions. There is still scope for the taxpayer to under-report gross income.

The ACMT has some advantages over the DPR from the point of view of a tax administration with limited capacity. It is wholly mechanical, being a simple percentage of reported turnover. It can be calculated on the basis of information that is readily at hand and that does not require information about entities outside the jurisdiction in question. However, being based on turnover, it takes no account of whether the taxpayer is actually profitable. This means that businesses that are in a loss-making start-up phase, or in highly cyclical businesses, will end up paying taxes when there is no profit being made. This can be addressed by special exemptions, but these complicate the operation of the tax. Taxes on turnover are also arguably better suited to economies that are dominated by fairly routine, low margin activities. Turnover taxes impose a much lower effective tax rate on higher margin activities, such as service provision. As a result, they may be less effective in countering profit shifting in these sectors.

[64] Following Durst (2018).

Another recent example of a mechanical anti-avoidance measure is the Base Erosion and Anti-Avoidance Tax (BEAT) that formed part of the 2017 United States tax reform.[65] This measure is targeted at large taxpayers (defined as having average gross annual receipts of $500 million or more). It is targeted at potentially base eroding payments to foreign related parties. The basic principle of the BEAT is that it compares the mainstream CIT liability with an alternative tax measure, which is the rate of BEAT (currently 10%) applied to the "modified taxable income". The modified taxable income is, simplifying somewhat, the amount reported for CIT purposes plus the amount of any base eroding payments that have been deducted. The idea is that if the base eroding payments to related parties (generally speaking, royalties, interest, rent and high-margin service payments) are a high proportion of the overall deductions, the BEAT will exceed the amount of CIT due and the taxpayer will pay the higher amount. The US BEAT is rather more complicated than this, but this simplified statement of the idea illustrates how it might be relevant to the needs of developing economies. It provides a relatively simple way to cap the value of tax deductions for payments to related parties that are relatively high risk in terms of base erosion. It is also mechanical in the way it operates. However, there are some drawbacks too. If the BEAT is only to apply to certain types of payments, these need to be defined and this may give rise to complexity and/or risk. For example, targeting royalties may simply encourage MNEs to embed the payment for intellectual property in a broader payment for goods or services. It could also be argued that the BEAT is discriminatory as a foreign parented group is inherently more likely to make cross-border payments to related parties, in which case it could violate the principle of non-discrimination embodied in double taxation agreements. This is a contested issue but whatever the merits of the treaty arguments, there could be a negative impact on foreign direct investment.

This brief survey of just two alternative mechanical means of protecting a jurisdiction's tax base is neither exhaustive (there are other measures in use) nor prescriptive. It is intended to underline the need to consider the DPR as one of a set of alternatives that developing economies may wish to consider. Which is best for any particular economy will depend on the structure of its economy, the nature of existing and potential foreign investment, the scope of its tax treaty network and the capabilities of its tax administration.

4. Some Practical Considerations

The focus of this paper has been on exploring policy and legislative options. These options are designed to take account of the capacity challenges facing tax administrations in developing economies. However, as these ideas are developed, it will be important to complement any policy advice with thinking about operational implementation and the fit with wider tax compliance strategy. While under self-assessment the onus will be on taxpayers to comply with the legislation we have proposed, tax administrations still need to be able to detect and deter potential non-compliance. To do that, tax administrations need reliable information.

In the case of offshore structures controlled by wealthy individuals, the growing number of countries that will be adopting the Common Reporting Standard and receiving, as well as transmitting, financial account information will be key to securing better compliance outcomes.[66] Experience shows that the best results are achieved when the tax administration works closely with other law enforcement agencies. Tax crimes are often associated with other

[65] Now incorporated in the US Tax Code § 59A - Tax on base erosion payments of taxpayers with substantial gross receipts.

[66] See footnote 10 above.

criminal activity and corruption.[67] Tax administrations can also benefit from the exchange of information about the types of structures and entities that are being exploited for the purposes of offshore tax evasion. This type of intelligence sharing is something that tax administrations that are members of the OECD's Forum on Tax Administration (FTA) have undertaken and the FTA's current work program includes a project on "Tackling offshore evasion: intelligent use and assurance of CRS data".[68] Regional groupings of tax administrations, such as the African Tax Administration Forum, the Inter-American Center of Tax Administrations and the Intra-European Organisation of Tax Administrations, also help to encourage the sharing of intelligence between their members, which include many developing economies.

In addition to the data that are being exchanged under the Common Reporting Standard, countries are beginning to develop registers of beneficial ownership. The UK government plans to launch a public beneficial ownership register in 2021. EU member states will make public the ownership of legal entities such as companies by January 2020 and other countries around the world have also committed to put in place public registers of ownership.[69] Increased transparency about ownership will clearly help tax administrations across the world to detect and deter offshore tax evasion.

Addressing profit diversion by MNEs is more complex as it requires information about entities and transactions that may not be directly subject to a tax administration's jurisdiction. However, the G20/OECD BEPS project's Action 13 outcomes are improving the data available to tax administrations about the global operations of MNEs with a presence in their jurisdictions. The Master File in standard transfer pricing documentation includes information about the overall structure of the group, including the geographical location of operating entities. It also includes information about the MNE's intangibles and financing. Whenever available, the Country by Country report is likely the best source of information on risks of profit diversion that need closer examination. Currently, the number of MNEs preparing Country by Country reports is limited, partly because preparing these reports represents a significant compliance burden for taxpayers. The current Country by Country reporting standard is subject to review in 2020 and its value to developing economies should be an important element of that review. It is possible that a simpler reporting requirement that focuses more on profits subject to a low rate of taxation could be both less onerous to prepare and more valuable for developing economies.

The review of the Country by Country reporting standard will take place against the backdrop of a trend towards greater transparency of reporting by MNEs. The Extractive Industries Transparency Initiative has developed a standard that requires the disclosure of information about the governance of natural resources. This includes information about the beneficial ownership of entities involved in the extractives sector and comprehensive disclosure of information about taxes paid by companies and government revenues.[70] The European Union has already mandated public country by country reporting by listed and large unlisted companies in the extractive and logging industries. In 2016 the European Commission

[67] Project Wickenby in Australia illustrates what can be achieved by a coordinated cross-agency approach to the problem of offshore tax evasion. For more information visit the ATO website: https://www.ato.gov.au/General/The-fight-against-tax-crime/News-and-results/Project-Wickenby-has-delivered/.

[68] For more information about the FTA and its current projects visit: http://www.oecd.org/tax/forum-on-tax-administration/about/.

[69] For a recent review of registers of beneficial ownership see: https://researchbriefings.parliament.uk/ResearchBriefing/Summary/CBP-8259#fullreport.

[70] https://eiti.org/sites/default/files/documents/the_eiti_standard_2016_-_english.pdf.

proposed that public country by country reporting be extended to include all large MNEs. More recently, the Global Reporting Initiative published a draft of a new reporting standard on "Tax and Payments to Governments".[71]

Another administrative concern regarding the proposed DPR charge is the importance of good governance in its administration. There is a risk that an aggressive tax administration might exploit the charge to demand payment of tax upfront and then fail to deal with any rebuttal of the charge in a timely and fair manner. The risk of abuse may be reduced if the approach becomes part of generally agreed options to change the way in which profits are allocated for tax purposes.

The introduction of a DPR could present a risk of double taxation in countries with limited tax treaty networks and the related risk that the measure may deter inward investment. Again, to the extent that the DPR proposal is consistent and would be broadly applied and accepted as consistent with revised international norms, the risk of double taxation and negative impacts on investment should be greatly reduced.

5. Conclusion

International standards developed in the early part of the last century have failed to keep pace with the way business is conducted in the modern, highly connected, digitized and globalized economy. International tax policy makers have responded to strengthen the tax base of countries. But, important gaps remain. Resource constrained developing economies need to augment their ability to tax individuals and businesses that are significant participants in the local economy but pay little tax. This paper explores options to address two of these gaps and suggests ways in which it is possible to capture individual and corporate income that is diverted to low tax jurisdictions.

Developing economies need an effective charge on the income and gains of wealthy individuals who make use of offshore structures and low tax regimes to minimize their tax liabilities. Existing practices in a number of countries provide a useful template to follow in implementing effective tax provision.

An anti-diversion rule can complement transfer pricing regimes in developing economies. To make such a rule commensurate with limited administrative capacity, it needs to be mechanical and targeted at the main abuse risks. Such an approach may appeal to countries that are less comfortable with anti-avoidance rules that require the exercise of judgement and discretion, whether that is because they are more familiar with rules-based approaches, or because they are concerned that too much discretion increases the risk of favoritism, or corruption. By incorporating the proposed rule in the design of the CIT, countries can ensure it is subject to treaty obligations to avoid double taxation and that the tax is creditable. To address the concerns of foreign direct investors that have lowly taxed entities that are unrelated to activities in developing countries, an anti-diversion rule could be subject to rebuttal.

[71] https://www.globalreporting.org/standards/work-program-and-standards-review/disclosures-on-tax-and-payments-to-government/.

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Annex 1: A Draft Schedule of Taxation of Resident Individuals Who Are Controlling Persons in Relation to Certain Non-Resident Entities

1. A resident natural person who is a Controlling Person in relation to a Relevant Entity shall be taxable in respect of a share of the Chargeable Income of that Relevant Entity calculated in accordance with the provisions of this Schedule.

2. A resident natural person is a Controlling Person in relation to an Entity if at any time during a year of assessment that person is able to exercise control over that Entity, or on whose behalf that Entity conducts a transaction. For this purpose, an Entity means any legal person, or other legal arrangement that has ownership of assets or has a right to receive income. In the case of a trust, Controlling Person means the settlor(s), the trustee(s), the protector(s) (if any), the beneficiary(ies) or class(es) of beneficiaries, and any other natural person(s) able to exercise control over the trust as defined in Paragraph 3, and in the case of a legal arrangement other than a trust, such term means natural persons in equivalent or similar positions.

3. For the purposes of this Schedule, a person is able to exercise control over an Entity if that person alone, or that person and natural persons to whom they are related [insert reference to definition of related persons for tax purposes], directly, or indirectly exercise ultimate effective control over at least 25% of the assets or income of the entity.

4. For the purposes of this Schedule, a Relevant Entity is an Entity as defined in Paragraph 2, that is not resident [here] for tax purposes and is not an Excluded Entity as defined in Paragraph 5.

5. For the purposes of this Schedule, an Excluded Entity means one of the following:

    a. A company or other entity, if the principal class of its shares is regularly traded on one or more recognised stock exchanges [cross refer to domestic definition of recognised stock exchange and principal shares];

    b. An entity that, if it were resident [here] would be exempt from income tax under [cross refer to provisions exempting charitable organisations];

    c. A government of another jurisdiction, or a political subdivision or local authority thereof, or any agency or instrumentality of such jurisdiction, or political subdivision, or local authority;

    d. A retirement fund established to provide retirement, disability, or death benefits, or any combination thereof, to beneficiaries that are current or former employees (or persons designated by such employees) of one or more employers in consideration for services rendered, provided that:

        i. The employee and employer contributions to the fund are limited by reference to earned income and compensation of the employee that has been subject to income tax [here] or would have been if the employee had been resident here at the time the income and compensation arose; and

ii. The fund is subject to regulation and provides information reporting to the tax authorities.

6. For the purposes of this Schedule the Chargeable Income of a Relevant Entity is income arising from passive investment that is not otherwise chargeable to tax [here, including amounts taxed under CFC provisions] that is subject to a Low Rate of Taxation as defined in Paragraph 7. Income from passive investment includes in particular:

   a. dividends, except where the Relevant Entity, or Relevant Entities in relation to which the same resident natural person is a Controlling Person under this Schedule, control 10% or more of the voting power in the paying company, in which case the amount to be treated as Chargeable Income shall be limited to the amount of the dividend that is representative of income that, if it had been received directly by a Relevant Entity, would have been Chargeable Income;

   b. interest, including income equivalent to interest;

   c. substitute dividends and substitute interest;[72]

   d. rents and royalties, other than rents and royalties derived in the active conduct of a trade or business;

   e. annuities;

   f. the excess of gains over losses, including foreign exchange gains and losses, from the sale or exchange of property that gives rise to passive income; and

   g. net income from financial assets including swaps, interest rate swaps, interest rate caps, interest rate floors, currency swaps, basis swaps, commodity swaps, equity swaps, equity index swaps, sale and repurchase agreements, stock loans, forward contracts, future contracts, options and insurance contracts.

7. Income is subject to a Low Rate of Taxation if the total tax paid and not repaid by Relevant Entities in respect of that income is less than x% of the income.

8. The share of Chargeable Income attributed to a Controlling Person under this Schedule shall be calculated by reference to the extent to which that person can exercise control over the Relevant Entity. Where more than one Controlling Person is assessed to tax under this Schedule in respect of a share of the Chargeable Income of the same Relevant Entity, the total income assessed in respect of those Controlling Persons shall not exceed the total Chargeable Income of the Relevant Entity in the year of assessment. Where a Controlling Person is assessed to tax in respect of a share of the Chargeable Income of more than one Relevant Entity, in calculating the share

][72] Substitute dividends and interest, also known as manufactured interest and dividends, are paid when an investor enters into a stock loan, or sale and repurchase agreement (repo) and during the period of the agreement an interest or dividend becomes payable in respect of the security that is the subject of the agreement. The standard forms of these agreements provide for the payment of an amount equivalent to the interest or dividend by the counterparty to the investor. Tax policy is usually to treat the investor as if they had received the actual dividend or interest, although the amounts are usually "other income" for treaty purposes. If existing domestic law does not specify how such payments are treated for tax purposes it may be necessary to clarify that and define the terms.

of Chargeable Income to be assessed, payments from one Relevant Entity to another Relevant Entity shall be left out of account to the extent that they are representative of income that is Chargeable Income in the hands of the Relevant Entity that first received the income.

9. If tax has been paid and not repaid by a Relevant Entity on Chargeable Income that is subject to tax under this Schedule, the amount of that tax may be offset against the tax payable in accordance with [existing provisions for giving relief from double taxation].

Annex 2: A Draft Schedule for The Taxation of Diverted Profits

Clause 1: The purpose of this schedule is to bring into the charge to corporation tax income accruing to the taxpayer, or to parties that are related [as defined elsewhere] to the taxpayer that would otherwise not be subject to taxation [here] and that is not taxed in any other country or is subject to a low rate of taxation, as defined in Clause 4, and is deemed to be diverted from [here] under the provisions of this schedule.[73]

Clause 2: This schedule shall not apply if the taxpayer together with any related parties are in receipt of income subject to corporation tax [here], including any amounts calculated in accordance with the provisions of this schedule, that in aggregate does not exceed $x million.

Clause 3: For the purposes of this Schedule, where more than one related party is subject to corporation tax [here], “taxpayer” shall be the entity that chooses to report the diverted profits on behalf of all the related parties liable to tax [here] and the amount of diverted profits will only be taxable in the hands of this reporting entity. If no entity chooses to report the amount of profits that should be calculated in accordance with this Schedule, the Commissioner may determine which entity is to report the income and impose an additional assessment in that amount, along with interest and a penalty for non-reporting of taxable income [cross refer to the relevant penalty provisions].

Clause 4: For the purposes of this Schedule, income is subject to a low rate of taxation if the total income tax actually paid, and not repaid, in any overseas jurisdiction on that income is less than [x%] of that income.

Clause 5: A taxpayer, or parties related to the taxpayer, that receives income that is not subject to corporation tax [here] and that is subject to a low rate of taxation as defined by Clause 4, shall be deemed to be in receipt of diverted profits if that lowly taxed income, but not including income specified in Clause 7, exceeds [x] times the costs of earning that income and for this purpose those costs shall be only the amounts that are incurred in the jurisdiction in which the income is recognized for tax purposes in respect of employment, overheads and administration that can be demonstrated to genuinely relate to the generation of the lowly taxed income.

Clause 6: If a taxpayer, or a party or parties related to the taxpayer that is subject to corporation tax [here], is deemed to be in receipt of diverted profits in accordance with Clause 5, the taxpayer shall increase the amount of taxable income declared for the relevant accounting period by the following amount:

a) the amount of income received in the accounting period that exceeds [x] times the costs of earning that income determined in accordance with Clause 5 multiplied by the fraction determined in sub-clause b);
b) the fraction to be applied to the amount of income defined by sub-clause a) shall be the gross income of the taxpayer and related entities that are subject to corporation tax [here] divided by the gross income of the taxpayer and all related parties, wherever they may be resident for tax purposes; and

[73] This wording is intended to extend to members of a multinational group that are resident in a tax haven but have a PE in the country. Income subject to a low rate of tax and attributed to the operations of the entity outside the country shall be included in the calculation of diverted profits.

c) for the purposes of sub-clause b) gross income shall mean the amount of gross income recorded in accounts prepared in accordance with international accounting standards, or that would have been recorded had such accounts been prepared; and
d) in any case where the taxable profits of the taxpayer and related entities subject to corporation tax [here] are adjusted as the result of an audit by the tax authority, the amount of any diverted profits shall be recalculated and any additional tax included in the audit settlement, along with any related interest and penalties.

Clause 7: Diverted profits defined by Clause 5 shall not include income from the making of loans, bank deposits and other forms of interest income, nor foreign exchange gains relating to monetary debts and income for the purposes of Clause 5 shall not include dividends received to the extent that they represent distributions of the profits of related parties [as defined elsewhere].[74]

Clause 8 : For the purposes of Clause 5 "income" means the profit recorded in accounts prepared in accordance with international accounting standards, or that would have been recorded had such accounts been prepared, and for the purposes of Clause 7 it means that portion of income as defined for the purposes of Clause 5 as is referable to the activity of the making of loans, bank deposits and other forms of interest income, foreign exchange gains relating to monetary debts and the receipt of dividends that represent distributions of the profits of related parties.

Clause 9: A taxpayer that is required to increase its taxable income in accordance with Clause 6, may make a claim to the Commissioner that the profits deemed to be diverted under the provisions of this Schedule have no connection with any activities undertaken by the taxpayer or any related party in the territory of [country]. Such a claim shall be supported by relevant evidence and the Commissioner may request additional information in support of that claim. Such a claim may be made after the relevant accounting period has closed but before the tax return for the period is submitted. Tax will remain payable on the additional income computed in accordance with this Schedule until the Commissioner has decided that the claim should be accepted, in whole or in part.

Clause 10: The decision of the Commissioner on a claim made under Clause 8 shall be subject to appeal in the normal way.

Clause 11: If a taxpayer believes that profits taxed under the provisions of this Schedule have been subjected to taxation not in accordance with the terms of a double taxation convention that is in force, the taxpayer may make a request that the Competent Authorities of the two countries find a satisfactory solution, in accordance with the terms of the mutual agreement procedure set out in that convention.

[74] This exclusion of finance income is an option for countries that consider that they already have effective measures in place to prevent profit shifting involving finance, for example because they have capped interest deductions in line with the BEPS Action 4 proposal.

Annex 3 An Illustrative Example

Subsidiary X of an MNE is resident for tax purposes in a low tax jurisdiction. It procures raw materials and manufacturing services and then sells finished products to third party customers. X has minimal substance and no direct employees.

In the period with which we are concerned, the accounts for X show:

- Purchases of raw materials to which X has legal title (i.e. contractually purchases them) totaling $50m. These purchases are made from third parties.
- Payments of toll manufacturing fees to a related manufacturer totaling $25m.
- Sales of finished branded products to third parties totaling $150m.
- Payments to third party agents in some countries to sell on its behalf totaling $10m.
- Payments to an independent logistics provider to carry out physical distribution of products totaling $5m.

X has a net profit for the period of $150 – ($50 + $25 + $10 + $5) = $60m.

The MNE has subsidiaries and operation in jurisdiction Y. Jurisdiction Y has introduced the diverted profits rule and specified in Clause 5 that the Schedule shall apply to income in excess of 1.2 times the amounts that are incurred in the jurisdiction in which the income is recognized for tax purposes in respect of employment, overheads and administration that can be demonstrated to genuinely relate to the generation of the lowly taxed income.

Profit totals $60 million. Costs of employment, overheads and administration incurred in the tax haven are nil. The gross revenue of the MNE in jurisdiction Y is 10% of the total gross income of the group. The DPR charge will result in an addition to taxable profits in jurisdiction Y of $6 million.