INTERNATIONAL TAXATION

BASE EROSION & PROFIT SHIFTING (BEPS)

BEPS INTRODUCTION

DEFINITION

- **Base erosion and profit shifting (BEPS)** refers to tax avoidance strategies that **exploit gaps and mismatches** in tax rules to **artificially shift profits** to low or no-tax locations.
- With increasing mobility of capital and assets such as intellectual property, and new business models in the 21st century, BEPS has become a serious problem.
- Tax avoidance strategies include; exploitation of bilateral agreements, Hybrid mismatches, tax havens & special tax regimes

BEPS INTRODUCTION-Cont'd

- Although these strategies are generally not illegal, they have in recent times generated a lot of attention due to;
- Governments losing corporate tax revenue
- Other stakeholders such as NGO's, media, politicians questioning whether Multinational enterprises (MNEs) are paying their fair amount of tax
- Multinational enterprises (MNEs) are being accused of dodging taxes worldwide.
- Tax systems have not kept up with changing business environment. E.g the digital economy

BEPS INTRODUCTION-Cont'd

- Domestic rules for international taxation and internationally agreed standards still grounded in an economic environment characterised by a lower degree of economic integration across borders, rather than today's environment of global taxpayers.
- It has been recognised that the interaction of domestic tax systems can lead to overlaps in the exercise of taxing rights that can result in double taxation.
- Domestic and international rules to address double taxation aim at addressing these overlaps so as to minimize trade distortions and impediments to sustainable economic growth

BEPS INTRODUCTION-Cont'd

- The interaction of domestic tax systems however, can also lead to gaps that provide opportunities to eliminate or significantly reduce taxation on income in a manner that is inconsistent with the policy objectives of such domestic tax rules and international standards.
- Multinationals exploit differences in domestic tax rules and international standards that provide opportunities to eliminate or reduce taxation.
- However, business leaders argue they have a duty to shareholders to legally reduce taxes
- Deem governments are irresponsible for having incoherent tax policies, complain about double taxation

BEPS INTRODUCTION-Cont'd

- Issue reached a political level- on the agenda of several OECD and non-OECD countries. The G20 leaders meeting in Mexico on 18-19 June 2012 explicitly referred to "the need to prevent base erosion and profit shifting" in their final Declaration.
- This message was reiterated at the G20 finance ministers meeting of 5-6 November 2012.
- calls for co-ordinated action to strengthen international tax standards and urging their counterparts to back efforts by the OECD to identify possible gaps in tax laws.
- Gave rise to the OECD BEPS project and the resulting 15 Action plans.

Importance of corporate taxes in Africa

- Corporate taxes account for approx 25% of total revenue in developing countries.
- Ability to raise revenue from individuals and consumption is limited- large informal sector.
- Their development depends on these taxes- foreign aid has significantly reduced over time.

Thus it is important to preserve the tax base

(**Read the United Nations Economic Commission for Africa report on Illicit Financial Flows**)

BEPS IN AFRICA

- Lack of relevant international tax laws in place, or clear understanding of how these laws work
- Poor treaty network and lack of negotiation skills
- Limited tax administrative capacity esp. in international taxation

BEPS CONCERNS

- **Challenges of the digital economy**: taxation of ecommerce
- **Excessive deductible payments** such as interest and other financial payments or other deductible payments such as management fees and royalties
- **Use of hybrid mismatch arrangements-** arrangements intended to secure tax advantages within multinational groups resulting from differences in the tax treatment of the same entity/instrument between different jurisdictions. leads to double **non** taxation

❖connected with equity.

❖*Dual residence*

BEPS CONCERNS

- **A hybrid entity** is an entity that is treated as a taxable person in one country but as "transparent" in another country i.e. in the other country the profits or losses of the entity are taxed
- A hybrid instruments- These are financial instruments that present features typically connected with debt but also features typically connected with equity.

BEPS CONCERNS

- Possibility **of creating affiliated non-resident taxpayers and artificially routing income of a resident enterprise** through the non-resident affiliate or controlled foreign corporations eg in low tax countries such as Mauritius where highly secretive jurisdictions don't share information.

BEPS CONCERNS

- **Seeking of treaty benefits in inappropriate circumstances** by locating transactions in countries with favorable tax regime.
- Artificially **shifting intangibles** or risk to low tax jurisdictions.
- **Transfer pricing-** manipulation of prices of goods to reallocate profits to preferred jurisdiction.

➢ *One of the underlying assumptions of the arm's length principle is that the more extensive the functions/assets/risks of one party to the transaction ,the greater its expected remuneration will be and vice versa. This therefore creates an* ***incentive to shift*** *functions/assets/risks to where their returns are taxed more favorably*

HARMFUL EFFECTS OF BEPS

- Loss of tax revenue for governments which means the government may have to spend less.
- Many governments have to cope with **less revenue** and a higher cost to ensure compliance.
- BEPS undermines the **integrity** of the tax system as the public, the media and some taxpayers deem reported low corporate taxes to be unfair.
- Governments may be forced to close the revenue gap by additionally taxing resident companies and individuals which may negatively impact their tax compliance

HARMFUL EFFECTS OF BEPS

- MNEs may face significant **reputational risk** if their effective tax rate is viewed as being too low
- Similarly, corporations that operate only in domestic markets including family owned businesses or new innovative companies, have **difficulty competing** with MNEs that have the ability to shift their profits across borders to avoid or reduce tax
- The **techniques and facilities** devised by the tax avoidance industry, using the **offshore tax haven and secrecy system**, are also used for all kinds of **evasion** ,not only of taxes, including **money-laundering** for crime, corruption and terrorism
- Base erosion and profit-shifting, and generally tax avoidance and evasion, seriously undermine **efforts to tackle poverty and inequality**

POSSIBLE SOLUTIONS

- Governments should ensure that the international rules for the taxation of MNCs are thoroughly **reformed** to make them fit for the 21st century.
- Sign DTAs based on sound business case and negotiate for **limitation of benefits** to prevent treaty abuse.
- **Economic substance** should be the basis for evaluating the level of profit declared in each country.
- Adoption of a more unitary approach to taxation of MNCs
- Introduction of requirement for multinationals to submit to the tax authorities of each country where they do business a Combined Report. This should include, for the current and previous 4 years

➢ worldwide consolidated accounts,

➢ both global data and a country-by-country breakdown of the main measures of the real economic activity in each country (physical assets, employees and sales),and(b)the taxes actually paid.

POSSIBLE SOLUTIONS

- Strengthen the tax and other legal regimes for dealing with the problem.
- Others- co-operation with other governments, reform of tax laws and regulations, building capacity, enforcing the Rules..

OECD BEPS PACKAGE

- The OECD/G20 BEPS package published in **October 2015** contains measures based on the following core principles ;

1. **coherence**

- Domestic tax systems are coherent–tax deductible payments by one person results in income inclusions by the recipient.
- We need international coherence in corporate income taxation to complement the standards that prevent double taxation with a new set of standards designed to avoid

2. **economic substance**

- Current tax rules must be modified to align tax with substance. Existing tax treaty and transfer pricing rules can, in some cases, facilitate the separation of taxable profits from value-creating activities, such as through shell companies that have little or no economic substance.

OECD BEPS PACKAGE

- Domestic and international tax rules should relate to both income and the economic activity that generates it. Flaws in the area of transfer pricing should be fixed within the current system.

3. **Transparency**

- Greater transparency and improved data are needed to evaluate the impact and magnitude of BEPS.
- Further, requiring taxpayers to report their aggressive tax planning arrangements and rules about transfer pricing documentation, breaking down the information on a country-by-country basis, will help governments identify risk areas and focus their audit strategies.
- And making dispute resolution mechanisms more effective will provide businesses with greater certainty and predictability.

OECD BEPS PACKAGE

- These include changes relating to;

➢ bilateral tax treaties - a minimum standard to prevent treaty shopping

➢ revisions to the transfer pricing rules- focus on the substance of the transactions rather than their legal form

➢ an update of the framework for evaluating the potential harmful effects of preferential regimes introduced by governments- focus on patent boxes and tax rulings

➢ model domestic law measures to counter BEPS

BEPS ACTION PLAN

- **Action;**

1. Addressing the tax challenges of the Digital Economy
2. Neutralising the effects of Hybrid Mismatch Arrangements
3. Designing effective Controlled Foreign Company (CFC) Rules
4. Limiting Base Erosion Involving Interest Deductions and other Financial Payments
5. Countering Harmful Tax practices more effectively taking into account Transparency and Substance
6. Preventing the Granting of Treaty Benefits in inappropriate circumstances
7. Preventing the Artificial Avoidance of Permanent Establishment

8-10 Aligning Transfer Pricing Outcomes with Value Creation

BEPS ACTION PLAN

- **Action;**

11. BEPS Data Analysis
12. Disclosure of Aggressive Tax Planning
13. Transfer Pricing Documentation
14. Dispute Resolution
15. Multilateral Instrument

BEPS Action plans with most relevance to developing nations

- Action 4: Limit base erosion via interest deductions and other financial payments;
- Action 6: Prevent treaty abuse;
- Action 7: Prevent the artificial avoidance of PE status;
- Action 10: Assure that transfer pricing outcomes are in line with value creation with respect to other high-risk transactions;
- Action 12: Require taxpayers to disclose their aggressive tax planning arrangements;
- Action 13: Re-examine transfer pricing documentation.

Questions?