International Taxation and Developing Countries

Peter Mullins

Abstract

International tax issues are a concern for both developed and developing countries, with evidence of aggressive tax planning by multinational enterprises (MNEs). MNEs are able to exploit weaknesses in the design of the international tax framework to reduce their tax liabilities. The international tax system has been further complicated by the expansion of the digital economy. Concerns about the international tax system have led to major international tax initiatives, most notably the G20-OECD BEPS project, as well as to proposals for more radical reform of the international tax framework. The dilemma for developing countries is how to respond to these international tax challenges, including the range of international tax initiatives. Developing countries want MNE investment and the benefits they bring, while deriving tax revenues from MNE activities to meet their fiscal needs, including financing the Sustainable Development Goals. Many of the international tax reform initiatives are designed by, and for, developed economies, and so may be too complex and/or not practical in a developing country. This paper considers the problems with the international tax framework for developing countries, and reviews international tax initiatives and alternative taxing mechanisms. The paper then provides guidance on strategies that developing countries can adopt to address international tax challenges, particularly in four priority areas: developing simple and comprehensive international tax rules in domestic laws (including transfer pricing rules); limiting interest deductions; ensuring adequate withholding taxes; and being cautious of new double tax treaties.

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Foreword

This paper on international taxation and developing countries, prepared by Peter Mullins, is part of the Center for Global Development's project on domestic resource mobilization in low-income countries in sub-Saharan Africa. As a region, sub-Saharan Africa has been collecting more taxes domestically in the past two decades, with the average tax-to-GDP ratio in the region rising by around 2 percentage points of GDP since 2000. This is comparable to the progress made by Asia during this period. That said, there are 15 sub-Saharan African countries where the tax-to-GDP ratio is below 15 percent, the level of tax capacity considered essential for the state to become viable and to ensure sustainable growth. These countries (which include many fragile states) pose a particular challenge for policymakers.

Revenues from corporate income taxes in sub-Saharan Africa have remained resilient at 3 percent of GDP, about one-fifth of the average tax take. If these revenues were to fade away and not grow with expanding national output because of erosion of the tax base and profit shifting by multinational companies (MNEs) as well as tax competition, countries in the region would have difficulty in meeting their social and infrastructure needs. This is more so because their options for raising additional domestic resources are limited.

Both developed and developing countries are challenged by aggressive tax planning by MNEs, but low-income countries are particularly vulnerable because of their weak administrative capacity to administer international tax rules and audit and monitor MNE's activities. Taxation of the growing digital economy is posing another challenge for all countries.

The purpose of Peter Mullins' paper is to identify practical actions that sub-Saharan countries could consider in the short to medium term to deal with problems stemming from the current international tax framework. Peter lists four priority areas: developing simple and comprehensive international tax rules in domestic laws; limiting interest deductions; ensuring adequate withholding taxes; and avoiding new double tax treaties. These recommendations are different from those arising from the G20-OECD Base Erosion and Profit Shifting project under its Inclusive Framework.

It is my hope that this paper will stimulate debate among policymakers in sub-Saharan Africa and help them improve their tax design.

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1. Introduction

International tax issues are a growing concern to both developed and developing countries. Many of these concerns arise from evidence of aggressive tax planning by multinational enterprises (MNEs). These tax planning opportunities often result from weaknesses in the design of the international tax framework, as well as from MNEs taking advantage of deliberate policy choices by some countries to obtain competitive advantages. The digitalization of economic activity has further complicated the international tax system.

These concerns with the international tax system have led to major international tax reform initiatives, as well as to proposals for more radical reform of the international tax framework. The most notable initiative for change is the G20-OECD project on base erosion and profit shifting ("BEPS project"), which began in 2013 and has led to a number of further multinational initiatives. The pressure for change has also led some countries to take unilateral initiative to address international tax issues, including introducing diverted profits taxes[1] and country-specific digital services taxes. A range of other alternative taxing mechanisms has also been proposed, some of which require major reform of the international tax framework (these are discussed in section 3 of this paper). Developments in these reform initiatives and proposals often move rapidly.

The dilemma for developing countries is how to respond to these international tax challenges, including the range of international tax initiatives. Developing countries usually welcome MNE investments and the benefits they can bring. However, developing countries are also aware of the need to derive, and protect, tax revenues from MNE activities. These taxes can be important for mobilizing revenues domestically to support a country's fiscal needs, including financing the Sustainable Development Goals.

Many of the international tax initiatives are designed by, and for, developed economies, and so may be too complex and/or not practical in a developing country. It can be especially difficult for developing countries to adopt some of these initiatives given the often-weak tax administrations in those countries. Some of the solutions proposed by developed countries also favor taxing MNEs in the country where the MNE is a resident (usually a developed country), rather than the country where the income is derived (often a developing country). The authorities in developing countries are aware that they need to do something to respond to international tax challenges, but at the same time, they may be reluctant to participate in the various initiatives, either because of the complexity of the proposals and practical difficulties in implementing them, or simply because of lack of capacity.

[1] A diverted profits tax imposes additional tax where there is a diversion of profits through offshore low-tax countries, despite the economic substance of the profit-making activities being in the home country (see further discussion in section 3).

This paper reviews international tax initiatives and alternative taxing mechanisms and provides guidance on strategies for developing countries to address international tax issues. While much of the focus is on corporate income tax, some of the international tax issues faced by developing countries, such as digitalization, may require solutions that involve other taxes, such as the VAT and withholding taxes. The paper is organized as follows: the next section considers the international tax framework and its challenges; section 3 discusses international tax initiatives to address these challenges; section 4 covers the response of developing countries to the challenges and initiatives; section 5 identifies the international tax issues of greatest concern for developing countries and outlines priority international tax reforms for those countries; and section 6 concludes with possible strategies for developing countries.

2. International Tax Framework and Challenges

International Tax Framework

The international tax framework involves the interaction of domestic tax laws and tax treaty obligations; its main concern is the allocation of taxing rights between countries—that is, which country or countries tax a particular item of income. MNEs can use tax planning devices to exploit the tax framework, including the allocation of taxing rights, so as to avoid or minimize tax. Hence, the international tax framework also includes governments' efforts to limit those tax planning devices.

It is usually accepted that the country in which profits are derived (source country) has the first taxing right on that income. However, the source country may forgo that tax for its own policy purposes (e.g., to attract foreign investment) or under a double tax treaty. Identifying the source country, which is essential for applying the current international tax rules, is becoming increasingly problematic, especially with the rise of the digital economy.

The country where the taxpayer resides (residence country*)* may also tax income earned in a foreign country *(*foreign source income), with a choice between two systems: worldwide taxation and territorial taxation. Under worldwide (or residence) taxation, foreign source income earned abroad is taxed in the taxpayer's country of residence. It is usual for a tax credit (i.e., a foreign tax credit) to be given for income taxes paid in the source country. Countries with a worldwide tax system for corporate taxpayers include Brazil, China, India, Ireland, Kenya, Korea, Mexico, Nigeria, and South Africa. Most developing countries apply a worldwide tax system, although there are some exceptions.[2] Under territorial taxation (or an exemption system), foreign source income is exempt from tax in the taxpayer's country of residence and, therefore, is taxed only in the source country. Countries with a territorial tax system include Australia, Canada, Germany, Hong Kong SAR, Malaysia, Thailand, United Kingdom and, since 2017, the United States.

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[2] For example, some former French colonies in Africa, such as Chad, Gabon, and Mauritania, have a territorial tax system.

In recent years there has been a shift towards adopting territorial taxation, although in practice, no country has a pure worldwide system or a pure territorial system. Countries with a worldwide tax system often have elements of a territorial system, such as deferral of tax on foreign source income until it is repatriated to the residence country. Countries with a territorial system often impose limitations on access to the exemption (e.g., level of ownership or tax rate in the source country) so that foreign source income falling outside those limitations is taxed in the country of residence. Also, countries do not necessarily apply the same system to all taxpayers and forms of income—for example, many countries apply different systems to individual taxpayers and corporate taxpayers.

The concept of permanent establishment is also important to the operation of the international tax framework. A "permanent establishment" arises when a business that is not legally resident has an enduring presence in the source country, so that the source country has the taxing rights on the profits of that business. Therefore, having a comprehensive permanent establishment definition is important in ensuring that the source country can tax foreign MNEs operating in that country. The definition of permanent establishment is included in both domestic law and tax treaties. It is important to note that just because sales are made in the source country, this is not, of itself, sufficient to result in a liability for income taxation in the country.

Double tax treaties play an important role in the international tax framework. A double tax treaty is an agreement between two (or more) countries for the avoidance of double (or no) taxation. They are intended to facilitate trade and investment between countries. Double tax treaties can determine whether the income is taxed in the source country, including defining a permanent establishment, and the rate of withholding tax on that income. Withholding tax is usually applied to payments of interest, dividends, and royalties, and may also apply to fees for technical services (which includes fees of a managerial, technical, or consultancy nature). Double tax treaties can also provide for exchange of information between countries.[3] While the number of double tax treaties is around 3,000, developing countries usually have a much smaller double tax treaty network than developed countries (for example a sample of 20 low-income countries shows that the average number of double tax treaties per country is 11, whereas OECD countries have double tax treaties with an average of 76 countries). However, if a double tax treaty does not exist between two countries, MNEs can often plan so that income flows are routed through countries where a tax treaty exists, and, in many cases, take advantage of the most favorable tax treaty.

Anti-avoidance rules are a key element in the international tax architecture, as governments respond to MNE tax planning. The most prominent rules relate to transfer pricing, thin capitalization (interest deduction), and controlled foreign corporations (CFC).[4] Transfer pricing rules seek to limit mispriced transactions between related parties (see discussion in Box 1 below). Thin capitalization rules limit deductions for interest expenses, especially if

[3] The OECD has also developed Tax Information Exchange Agreements (TIEAs) that allow non-OECD countries with offshore financial centers to commit to eliminating harmful tax practices.

[4] Other anti-avoidance rules include general anti-avoidance rules and rules limiting treaty abuse.

paid to related parties. CFC rules address concerns with MNEs establishing subsidiaries or branches in low tax countries to shelter profits from tax in the residence country of the parent.[5] The CFC rules essentially attribute certain income of the subsidiary to the parent as though the foreign income was earned directly by the parent, thereby preventing the tax sheltering of profits. The profits which are subject to CFC rules are usually income derived from passive investments ("passive income"), such as dividends, interest, and royalties derived by the subsidiary. Income from an active business in the foreign location is not usually taxed under the CFC rules on the basis that the subsidiary is not being used to shelter foreign source income. While many developing countries have transfer pricing rules and some kind of rule limiting interest deductions, CFC rules are not prevalent, mainly because they are designed for capital exporting countries.

What Are the Problems with the International Tax Framework?

The main concern with the current international tax framework is that MNEs can use tax planning strategies to exploit weaknesses in the framework to reduce their tax liabilities. These strategies usually aim to shift income to low tax jurisdictions (or into more lightly taxed forms) and away from higher tax jurisdictions (or out of more highly taxed forms), and/or to shift tax deductions so they can be claimed in higher taxed jurisdictions rather than in low tax jurisdictions. These weaknesses arise because of different tax outcomes in the source and residence country. These outcomes may be due to specific, but different, policy choices of the source and residence country, or because of unintended differences, with unforeseen consequences, in tax treatment between the two countries. Box 1 sets out some of the common tax planning devices.

Box 1. International Tax Planning Devices[6,7,8]

The tax planning devices set out below may be used by themselves or in combination.

Abusive transfer pricing: MNEs can misprice transactions between related parties to shift the supposed source of profits to the taxpayer or jurisdiction that provides the most advantageous tax outcome—that is, to minimize income and maximize deductions in high-tax jurisdictions and vice versa in low tax jurisdictions. While the usual concern is cross-border transactions, transfer pricing can also arise domestically between companies that face different tax rates (e.g., due to an income tax exemption). The opportunities for mispricing often arise due to difficulties in determining arm's

[5] These rules are known as Subpart F rules in the United States.

[6] Some of the more common tax planning techniques are described in more detail in OECD (2013).

[7] The devices listed are common to most countries. There are other devices that are mainly present in specific countries. For example, two devices that were common in the United States are deferral—where companies delay tax under a worldwide tax system by deferring repatriation to the parent company; and inversion—where companies avoid repatriation or CFC rules by changing the place of residence.

[8] See IMF (2014) for a detailed summary of research on the use of these tax planning devices and their potential revenue impact.

length prices, such as for intellectual property rights, creating opportunities to transfer such rights to low tax jurisdictions.

Exploiting related company financial transactions: MNEs often locate financing subsidiaries in low tax countries. These companies can then loan to, or transact with, affiliates in high tax countries in order to maximize tax deductions for costs, such as interest, leases, and insurance, in the high tax countries, while income is derived in the low tax country. These subsidiaries can be further exploited by passing funds through conduit companies (i.e., intermediaries within a company group), potentially allowing MNEs to take interest deductions more than once (i.e., double dipping). A consequence of these transactions can be thin capitalization of companies (i.e., a high ratio of debt to equity).

Locating intangibles in low tax jurisdictions: It is common for MNEs to locate their intangibles (e.g., licenses, trademarks, brands, goodwill, patents) in low tax jurisdictions and then require affiliates in high-tax jurisdictions to pay for the use of those intangibles, so that tax deductions arise in the high tax country and income in the low tax country. It is also often difficult to determine arm's length prices for these intangibles, as there may be no comparable prices, which gives MNEs flexibility in pricing and makes it difficult for governments to argue against that pricing.

Taking advantage of mismatches: Tax planning opportunities are available if different countries treat the same entity, transaction, or financial instrument differently for tax purposes. For example, a hybrid financial instrument may be designed to have characteristics of both debt and equity, so that it is treated as debt in one country and equity in another country, with different tax consequences—that is, the payment on the instrument may be tax deductible interest to the payer, but a tax exempt dividend to the recipient. Another example is the US "check the box" rules[9] where a payment made by a foreign subsidiary of a US company may be tax deductible in the foreign country but the payment would be disregarded to the US company if a check the box election was filed.

Manipulating tax treaty rules: Tax treaties can be exploited so that income flows can be diverted to countries with the best tax treaty outcome, even if the source country does not have a treaty with the MNE country of residence. MNEs can undertake treaty shopping to obtain the most beneficial treaty benefits and thus reduce taxes.

Disposing of assets indirectly to avoid capital gains tax: Rather than selling assets directly, an MNE may dispose of the underlying ownership of the assets by selling its interest in an offshore subsidiary holding those assets, so as to avoid tax in the source country. The offshore subsidiary may also be in a low tax country. Such disposals are of particular concern in the extractive industries in low-income countries, where significant interests in petroleum or mining rights can be sold with little tax. Examples of significant indirect sales include in Ghana in 2011, where 18.9 percent equity in two mining companies was sold for $661 million, and Mozambique in 2013, where 28.5 percent of a foreign mining company holding 70 percent of a mining right was sold for $4.2 billion.[10]

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[9] The "check the box" rules allow US businesses to elect for themselves and for each of their foreign and domestic subsidiaries, subject to certain conditions, whether to be taxed as a corporation or treated as transparent for tax purposes (a "disregarded entity").

[10] For a detailed discussion of indirect transfers of interest in the extractives sector, see Burns, Le Leuch and Sunley (2016).

The expansion of the digital economy is also placing pressure on the international tax framework. The OECD has observed three characteristics of digital business models: (1) significant economic activities within a country, and/or stages of production across multiple countries, but with little significant physical presence (referred to as "scale without mass"); (2) reliance on intangible assets, including intellectual property; and (3) the role of data and user participation, including network effects, to generate value (e.g., a social media site may use data on users to sell targeted advertisements).[11] These characteristics enable MNEs to utilize the tax planning devices mentioned above, and also to exploit uncertainties within the existing international framework, such as the need for a physical presence, which is usually required for permanent establishment rules but not necessarily for digital activities. In responding to digitalization, there is debate about the extent of changes necessary to address the issue of digitalization—some argue for fundamental reform, while others argue that the existing rules are broadly sufficient—although there is a general consensus that the digital economy should not be isolated from other activities and granted special treatment, given the rapid change and the wide coverage of these technologies.

Another challenge is that governments can take advantage of both the limitations of the international tax framework and MNEs' desire for lower taxes by offering low tax regimes—that is, tax competition. Lower taxes may be provided through lower corporate income tax (CIT) rates or through tax incentive regimes, such as tax holidays or reduced tax rates for certain taxpayers or sectors. This tax competition not only affects the flow of foreign investment but can also impact another country's tax revenue, as taxable profits may be diverted to the country with the lower tax regime. A 2015 report prepared by the IMF, OECD, and World Bank for the G20 Development Working Group found that many low-income countries provide tax incentives, but these incentives are often ineffective and inefficient.[12] They have a high fiscal cost, but are often redundant (in that the investment would have been made without the incentive) and rank low in investment climate surveys (other factors, such as rule of law, good infrastructure, and macroeconomic stability, may be more important). They are particularly ineffective if targeted at the domestic market or extractive industries; they are more effective if focused on export-oriented sectors and mobile capital.

How Large Is the Problem?

The magnitude of the revenue loss from tax avoidance is difficult to determine but is estimated to be significant. The OECD's BEPS Action 11 (see below) specifically focuses on measuring and monitoring the economic and fiscal effects of tax avoidance. In 2015, the OECD estimated that the annual cost of MNE tax avoidance ranged from US$100 to $240 billion, or around 4 to 10 percent of CIT revenues in 2013 (see OECD (2015)). The IMF, using different methodologies, has estimated that the (unweighted) average revenue loss across all countries in its sample was 5 percent of current CIT revenue, with a much larger

[11] See OECD (2018).

[12] See IMF (2015).

impact for non-OECD countries (IMF (2014)). Crivelli, De Mooij and Keen (2016) estimate the revenue loss for developing countries from base erosion and profit shifting as being at least US$200 billion.

The adverse effects of MNE tax avoidance are not limited to revenue loss but extend also to other economic impacts. Most significant is the distortion in the location of foreign direct investment, with evidence that tax impacts both the flow and stock of foreign direct investment (FDI).[13] MNE tax avoidance can also distort the location of mobile intangible assets, such as patents, trademarks, and copyrights. MNEs may also structure their financing in a country to reduce their tax liabilities, usually with a bias towards debt. The ability of MNEs to exploit these tax avoidance techniques may also give MNEs an unfair competitive advantage compared to local enterprises that do not have the same access to the cross-border tax avoidance devices.

How Are Developing Countries Impacted by International Tax Problems?

Developing countries are also impacted by MNE tax avoidance and are more exposed to profit shifting than developed countries. The tax planning devices outlined in Box 1 and the issues with digitalization and tax competition are also issues for developing countries. However, the evidence suggests that developing countries are much more exposed to profit shifting than developed countries. For example, Crivelli, De Mooij and Keen (2016) concluded that tax base spillovers (i.e., changes to the tax base due to real activities or profit shifting) as a result of changes in another country's tax rate are stronger for non-OECD countries than OECD countries. They also tentatively estimate that the long-run revenue loss due to tax avoidance is higher for non-OECD countries, at around 1.3 percent of GDP, compared to OECD countries, at around 0.9 percent of GDP. This is even more significant given that developing countries' total taxes as a share of GDP are usually much lower than OECD countries—that is, the revenue loss from tax avoidance is likely to be a much greater portion of total revenues. This highlights the importance for developing countries of addressing MNE tax avoidance, given that such countries cannot afford to forego CIT revenues.

3. Initiatives to Address International Tax Challenges

A number of initiatives have been implemented or proposed to address international tax challenges. Some of the most significant initiatives have been multilateral, usually at the initiative of the OECD or EU, while some countries have acted unilaterally in addressing the challenges. There have also been proposals for alternative taxing mechanisms to deal with international tax avoidance, some of which would result in a radical change in the

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[13] De Mooij and Ederveen (2008), reviewing economic literature on investment effects, suggest that a 10 percentage-point reduction in a country's effective average tax rate increases its stock of FDI, on average and in the long run, by over 30 percent. However, Klemm and Van Parys (2012) find that lower CIT rates and longer tax holidays are effective in attracting FDI in Latin America and the Caribbean, but not in Africa.

international tax framework. These initiatives and alternative taxing mechanisms are discussed below.

Multilateral Initiatives

The most significant multilateral initiative is the G20-OECD Base Erosion and Profit Shifting (BEPS) project. The project commenced in 2013, leading to the finalization of plans for 15 BEPS Actions in 2015. Box 2 briefly summarizes the 15 Actions. The project has now moved to the implementation stage, although some issues, such as addressing the digital economy, are still to be resolved. Some countries, mainly OECD members, have already started making changes to their domestic laws and tax treaties to implement BEPS-related changes. There are minimum standards for four of the Actions, with the expectation being that domestic law and treaties will be amended to adopt the standards. The other Actions involve amendments to the guidance in core OECD documents or simply agreement on a common approach. The minimum standards relate to (1) treaty shopping (Action 6), by including in treaties a limitation of benefit or more general principle purpose test provisions to restrict access to benefits; (2) transfer pricing documentation and country-by-country reporting (Action 13); (3) harmful tax practices (Action 5), including the peer review of tax rulings and preferential tax regimes; and (4) tax treaty dispute resolution measures (Action 14).

Box 2. G20-OECD BEPS Project Actions

Action 1: Address the tax challenges of the digital economy.
Action 2: Neutralize hybrid mismatches.
Action 3: Strengthen CFC rules.
Action 4: Limit deductions for interest and other financial payments.
Action 5: Counter harmful tax practices.
Action 6: Prevent tax treaty abuse.
Action 7: Prevent avoidance of permanent establishment rules.
Action 8: Transfer pricing rules for intangibles.
Action 9: Transfer pricing rules for allocation of contractual risk.
Action 10: Transfer pricing rules for high- risk areas, such as management fees and head office expenses.
Action 11: BEPS data analysis.
Action 12: Mandatory disclosure of aggressive tax planning arrangements.
Action 13: Country-by-country reporting.
Action 14: Treaty dispute resolution mechanisms.
Action 15: Multilateral instrument for treaty modification.

A key outcome of the BEPS project was the formation of an Inclusive Framework (IF) in 2016 to implement the BEPS Actions. The IF was established as a forum so that all countries, especially developing countries, could participate on an equal footing in the development of standards on BEPS related issues, including digitalization. Countries are required to commit to the comprehensive BEPS package and its implementation, in particular the four BEPS minimum standards, but it is recognized the timing for developing countries may differ from other countries. The IF currently has 129 country members (many of them developing countries) and 14 observers. The IF covers the four minimum standards relating to BEPS Actions (as mentioned above); best practices in relation to the other BEPS Actions; and a peer review of the country's legal and tax framework.

Another key instrument arising from the BEPS project is the Multilateral Instrument for amending double tax treaties. The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, known as the Multilateral Instrument (MLI), is a multilateral treaty that allows countries to modify their bilateral treaties without the need to reopen, and renegotiate, each separate treaty. It was introduced to allow for the efficient amendment of treaties to implement BEPS measures to combat tax avoidance. The MLI can cover OECD and non-OECD countries. The MLI convention currently covers 88 jurisdictions, with 25 signatories (all developed countries) having ratified the MLI, modifying around 60 double tax treaties.[14]

Taxation of the digital economy has been a difficult challenge for the BEPS project. There is much debate about the extent of changes necessary to address the issue of digitalization. The OECD is seeking to apply the principle of taxing where value is created. The OECD and IF are considering various proposals (referred to as Pillar 1) to reform the profit allocation and nexus rules, including broadening the definition of "permanent establishment." A discussion draft was released in February 2019[15] with a final report expected in 2020. The OECD, in November 2019, also released a public consultation document on a Global Anti-Base Erosion proposal[16] (referred to as GloBE or Pillar 2), which is a more radical alternative to address the digitalization issue, but can be applied more broadly to all cross-border transactions. The GloBE proposal seeks to apply a global minimum rate of tax where the effective tax rate on foreign source income is below a certain level.[17] This proposal has implications for developing countries as it could limit the effect of tax incentives provided by such countries to foreign investors.

The BEPS project complements earlier OECD initiatives, including the Automatic Exchange of Information and the Multilateral Convention on Mutual Administrative Assistance in Tax Matters. The Global Forum on Transparency and Exchange of Information for Tax Purposes was formed to implement global standards on transparency and exchange of information for tax purposes. The two standards are on exchange of information on request (EOIR) and automatic exchange of financial account information (AEOI). The Global Forum has 157 members, including from developing countries. The Multilateral Convention on Mutual Administrative Assistance in Tax Matters is a multilateral instrument that facilitates administrative cooperation between countries in the assessment

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[14] For more information on progress of the MLI see OECD (2019a).
[15] See OECD (2019b).
[16] See OECD (2019c).
[17] There are four parts to the GloBE proposal: (1) income inclusion rule—a country can tax foreign income if it was taxed at an effective tax rate lower than a minimum rate; (2) under-taxed payments rule—a country can deny a tax deduction or impose withholding tax if a payment to a related party was taxed below a minimum rate; (3) switch-over rule—can change the tax treaty implications for profits taxed below a minimum rate; and (4) subject-to-tax rule—can change the treaty benefits for certain income if the payments are taxed below a minimum rate.

and collection of taxes. There are currently 130 signatories to the convention, including developing countries. These OECD initiatives are important in addressing corruption, money laundering and illicit flows, which are of significant concern for developing countries, especially in sub-Saharan Africa.

The EU has also sought to address tax avoidance through its anti-tax avoidance directive (ATAD). The ATAD, which was adopted in 2016, seeks to address tax avoidance practices that directly affect the functioning of the EU internal market. From 1 January 2019, EU member countries have applied the following five legally binding anti-avoidance measures: (1) CFC rules; (2) switchover rule (ensures taxation of dividends from low tax countries where the income has not been adequately taxed); (3) exit taxation (to prevent companies from avoiding tax when relocating assets); (4) interest deduction limitations; and (5) general anti-avoidance rules.

Digitalization is also a concern to the EU, so it has proposed a digital services tax. The European Commission (EC) proposed a long-term solution to taxing the digital economy that would allow EU members to tax profits generated in the country without the need for the business to have a physical presence. However, that proposal needs to be further developed, so in the short term the EC proposed a digital services tax of 3 percent on gross revenue from digital services. At this stage there has not been agreement amongst the EU member countries on the proposed tax.

The main international organizations involved in tax have also developed a joint Platform for Collaboration on Tax (PCT) to support governments in addressing tax challenges. The PCT is a joint initiative, launched in 2016, between the IMF, the OECD, the UN, and the World Bank Group. The cooperation includes jointly developed guides,[18] capacity building and technical assistance, and sharing of information and knowledge. The PCT is especially focused on supporting developing countries in all aspects of raising revenues from domestic sources.

Unilateral Initiatives

One unilateral initiative to address tax avoidance is the diverted profits tax. This tax was introduced in the United Kingdom in 2015 and in Australia in 2017. The diverted profits tax is essentially a protective measure to deter tax avoidance, and is not expected to directly raise significant revenue. In Australia, the tax applies where there is a diversion of profits through offshore low-tax countries, where the economic substance of the profit-making activities is in Australia. The rate of tax is 40 percent (compared to the standard CIT rate of 30 percent) and is limited to larger MNEs (global income of A$1 billion). The UK tax applies a rate of 25 percent (compared to the standard rate of 19 percent) to arrangements

[18] The PCT has developed toolkits on tax incentives and external support for building tax capacity in developing countries. There are also draft toolkits on offshore indirect transfers and transfer pricing documentation. The toolkits can be found online at https://www.worldbank.org/en/programs/platform-for-tax-collaboration.

that divert profits to a low tax country (i.e., a country where the tax rate is less than 80 percent of the UK rate).

The United States recently introduced three international tax measures in the US Tax Cuts and Jobs Act. The first measure is Global Low Tax Intangibles Income (GLTII), which is a new form of foreign income for US tax purposes. This measure is aimed at reducing the incentive for US companies to shift profits offshore by moving intangible assets (e.g., patents, trademarks, and copyrights) to a low tax country, while also attempting to retain their competitiveness. GLTII is earnings in excess of a 10 percent deemed return on foreign intangible assets. A minimum tax is imposed on that excess, which can range between 10.5 percent and 13.25 percent, depending on the tax paid in the foreign country. The second measure is Foreign Derived Intangible Income (FDII), which provides an incentive for US companies to keep their intangibles in the US, and then export the goods and services arising from those intangibles. FDII is foreign income in excess of a 10 percent deemed return on the US-based intangible assets, taxed at a concessional tax rate of 13.25 percent. The third measure is the Base Erosion and Anti-Abuse Tax (BEAT). The BEAT targets large US MNEs that make tax deductible payments to foreign related companies, such as for interest, royalties, and certain service payments (only applies to MNEs with gross receipts of US$500 million and if more than 3 percent of total deductible payments are made to foreign affiliates). The BEAT is calculated by first applying the usual CIT at the standard rate of 21 percent, and then adding back the relevant deductible payments and applying the BEAT rate of 10 percent. The MNE's tax liability is the higher of the two calculations.

Some countries have also attempted to address the digitalization issue with specific taxes on digital services. France has recently introduced a digital services tax while it awaits action by the EU. A tax of 3 percent is imposed on digital services revenue of large MNEs operating in France (the MNE must have global taxable digital services in excess of €750 million and taxable digital services in France greater than €25 million). The tax applies to two types of services: (1) online intermediary services, which are digital services that allow users to find and interact with others, and to facilitate supplies of goods and services between users (but not banking and financial services); and (2) online advertising services based on user data. Another example is India's equalization levy, introduced in 2016, which imposes a 6 percent tax on business-to-business payments to a nonresident service provider that provides online advertising or any digital advertising space or facilities for the purpose of online advertising. The tax is withheld at the time of payment by the recipient, but only applies to annual payments exceeding Rs 1 million.

The VAT is also being used to address some of the digital economy issues by ensuring VAT is imposed on imported goods and services acquired online. Many countries are concerned that goods and services are being acquired online and imported into the country without VAT being payable. This is because the vendor is not a taxpayer in the country where the goods and services are consumed, and the receiving country usually has an exemption from import VAT for goods and services below a certain minimum amount (usually to avoid the administrative burden of collecting tax on small items at the border). Some countries have addressed this issue by requiring large online suppliers to register for VAT in the country where the goods and services are sent, if sales into the country are above a certain threshold. Once registered, the retailers are required to impose VAT on the sales and remit the VAT to the country where the goods and services are sent. Some countries also require that the nonresident supplier appoint a local tax agent or representative to facilitate the collection of the tax. This approach has been adopted by developed countries, such as Australia, New Zealand, and Norway, and by developing countries, such as Angola, Belarus, and Bangladesh.[19]

Alternative Taxing Mechanisms

There are two broad alternative taxing mechanisms: minimum corporate taxes and mechanisms that seek to better allocate profits between jurisdictions. As previously mentioned, some of these measures would result in a radical overhaul of the international tax framework. The alternative mechanisms are discussed below.

Minimum corporate tax schemes

Minimum corporate taxes have been used for a long time, and can be a simple, but crude, tax collection mechanism. Many developing countries have adopted simple minimum corporate taxes, usually as a safety mechanism to ensure businesses pay some income tax.[20] The tax is usually calculated by applying a low tax rate to turnover or the value of assets. For example, minimum corporate taxes are imposed in African countries such as Algeria, Côte d'Ivoire, Equatorial Guinea, Gabon, Madagascar, Nigeria, and Tanzania. Most of these taxes are based on turnover with rates ranging from 0.1 to 3 percent, although in some cases there is also a fixed minimum amount of tax. These minimum taxes are generally simple to administer and can also reduce the revenue impact of tax preferences. However, they are crude in that they do not usually account for the profitability of a business. These minimum taxes are often targeted at improving tax collections from domestic businesses, although they can also apply to MNEs.

Other mechanisms, such as limiting deductions or certain anti-avoidance rules, can have a similar impact as a minimum tax. For example, imposing limits on the amount of carry forward losses that can be offset against future income, or capping deductions on expenses such as interest or management fees. CFC rules can also act as a minimum tax by imposing additional residence country tax if insufficient tax has been paid in the source country. The recently introduced GLTII and BEAT in the US are effectively minimum taxes on outbound and inbound investments, respectively. The OECD's GloBE proposal is also a minimum tax.

Withholding taxes on payments to foreign investors can also be a source of minimum taxes. For example, withholding taxes can apply to interest, dividends, rent, royalties, and

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[19] This approach is also endorsed by the OECD—see OECD (2017).

[20] Minimum corporate income taxes have also been used in developed countries. For example, up until 2018 the US had a corporate alternative minimum tax, which was a recalculation of the CIT after reducing certain tax incentives and deductions.

possibly technical services. This ensures at least some tax is collected from MNE activities in the country. However, the rate of tax may be significantly reduced under double tax treaties.

Profit allocation mechanisms

There have also been proposals for more fundamental reforms of the international tax framework, focusing on new methods to allocate profits between jurisdictions. These mechanisms seek to overcome many of the current problems with the international tax framework by overhauling the basis for allocating profits between jurisdictions. The mechanisms are as follows:[21]

- *Formula apportionment:* This approach allocates the global profits of MNEs across countries in which an MNE conducts business by a formula that approximates the activities in each location. The allocation could be based on sales, payroll, or assets, or some combination of these factors. The advantage of this approach is that it ignores the prices charged between related entities. The challenge is in determining an appropriate formula, given that the three factors may not be accurate indicators of the level of business conducted in a country, and the factors can also be manipulated. The US states and Canadian provinces use a form of formula apportionment to determine state and provincial corporate taxes.

- *Destination-based cash-flow tax (DBCFT):* A DBCFT, as the name suggests, is a cash-flow tax—that is, immediate expensing of investment and no deduction for interest—but with border adjustments.[22] As it is a destination-based tax, the border adjustments exclude receipts from exports and deductions for imports. The DBCFT is similar to a VAT, where imports are taxed and exports are zero-rated, but it also includes a deduction for labor costs, which is not the case with the VAT. A key advantage of the DBCFT is that taxing on the basis of place of destination of income negates tax avoidance through inter-company transactions, and reduces the incentive for tax competition. There are also economic efficiency advantages as the DBCFT should not distort the scale or the location of business investment, and it also removes the tax bias towards debt finance. However, if it is not adopted consistently across all countries, it could cause greater profit shifting from non-adopters, due to a mismatch in tax treatment (i.e., the income from exports in a country applying the DBCFT will not be taxed, yet the company acquiring the exported products will obtain a tax deduction if it is located in a country using the standard CIT).[23]

- *Destination-based allowance for corporate equity (DBACE):* The DBACE is similar to the DBCFT, with border adjustments, but it would allow depreciation rather than immediate expensing of investments; it also allows a deduction for interest together with a deduction for a notional return on equity. It would retain some of the advantages

[21] For a more detailed discussion and analysis of these reforms see IMF (2019).
[22] See Auerbach, Devereux, Keen and Vella (2017) for a more detailed explanation of the tax.
[23] Hebous, Klemm and Stausholm (2019) find that on a global average, DBCFT revenues under unchanged tax rates would remain similar to the existing CIT revenue, but with sizable redistribution of revenue across countries. Developing countries are some of the countries that are more likely to gain revenue from a DBCFT.

of the DBCFT but also some incentives for profit shifting and tax competition, depending on the rate for the notional return to equity.

- *Schemes for sharing residual profit:* This approach proposes distinguishing between "routine profit" (i.e., a normal rate of return) and "residual profit" (i.e., profit in excess of routine profit—essentially economic rent). Routine profits are taxed in the country where associated costs are incurred, while residual profits are then allocated to jurisdictions on a formula basis. Various bases for allocation have been proposed, including destination-based sales, location of intangibles, or active users for digitalized businesses.[24] An advantage of this approach is that it would secure the taxation of routine profits to a country, but there are challenges in determining how to share the residual profit.

4. Response of Developing Countries to International Tax Issues and Initiatives

There are a number of obstacles that developing countries face in effectively responding to international tax issues and the potential initiatives to address those issues. It is important to consider these obstacles before designing a response to international tax issues. Developed countries do not usually face these obstacles.

The law in many developing countries often lacks adequate international tax provisions and/or a clear understanding of how those provisions work. For example, a country's law should have, as a minimum, arm's length rules to ensure arm's length prices are charged between related parties, and adequate permanent establishment rules to capture businesses with an enduring presence in the country. Even if countries have these rules, they also need to be able to understand how they operate so that they can ensure that taxpayers are complying with them. Unfortunately, in many developing countries there is a lack of understanding of these rules (e.g., transfer pricing rules), and, therefore, reluctance to apply them.

Developing countries also often have low capacity to administer international tax rules and audit and monitor MNE's activities. Tax authorities in developing countries often find it difficult to build and maintain capacity across all taxes (e.g., audit and law interpretation skills), let alone have the capacity necessary to understand and implement international tax rules, which are often complex. This lack of capacity makes it difficult to monitor and challenge MNEs tax practices. Sound processes for gathering and analyzing information (from both domestic and overseas sources), which is essential for monitoring MNE activities, are also often lacking.

Developing countries that have transfer pricing rules may find it difficult to apply the rules in practice. Over recent years, many developing countries have introduced transfer pricing

[24] For an example of the sharing of residual profits see Devereux, Aeurbach, Oosterhuis, Schon, and Vella (2019).

rules, often based on the OECD Guidelines,[25] that should allow them to address some abusive transfer pricing, at least the most obvious. However, in many developing countries the rules are rarely, if ever applied, and often only in very simple cases. There may be various reasons for this: a lack of understanding of how to apply the rules; difficulty in finding, or knowing how to determine, comparable arm's length prices; and uncertainty or reluctance in dealing with MNEs, who are often supported by very skilled representatives with significant experience in dealing with transfer pricing issues.

Developing countries often have few double tax treaties and those that are in place may be entered into for political purposes and do not favor developing countries. As mentioned previously, developing countries usually have a much smaller double tax treaty network compared to developed countries. Those treaties are usually entered into to attract inward foreign direct investment, which it is hoped will provide significant benefits to the country. However, these treaties often include reduced withholding tax rates, which cost revenue and tend to favor developed countries. This is because MNEs from developed countries are more likely to benefit from reduced withholding tax rates given that their investments will be significantly larger, and hence give rise to more cross-border income, than the foreign outbound investments of MNEs from developing countries. In any case, the empirical evidence on the investment effects of treaties is mixed.[26]

Developing Countries' Responses to International Tax Initiatives

One of the main concerns of developing countries with the BEPS process is that those countries believe they were not adequately consulted, at least in the initial development stages. As mentioned previously, the BEPS project was an initiative of the G20 and OECD countries. It was not until later in the process—after the problems were identified and the Actions determined—that developing countries were included. Therefore, developing countries had no initial decision-making role, and are concerned that the issues identified and solutions proposed may be more relevant to developed than developing countries.

Subsequent attempts to engage developing countries, including participation in the IF, are positive, but these countries are uncertain of the cost and benefits of participation. The IF has benefits for developing countries, such as access to capacity building, in particular on transfer pricing. However, there is uncertainty in developing countries as to whether they should adopt the reforms recommended by the BEPS Actions and the timing of such reforms. They are often uncertain of the costs of introducing the reforms (such as obligations, participation requirements, administrative capacity requirements, and changes to the law) and whether the benefits justify the costs of participation.

Developing countries may also find it difficult to effectively meet the BEPS minimum standards. As mentioned previously, under the IF, countries are expected to meet four minimum standards relating to treaty shopping; transfer pricing documentation and country-

[25] See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*.
[26] For a discussion of the impacts see Appendix V of IMF (2014).

by-country reporting; harmful tax practices; and tax treaty dispute resolution measures. Some of these requirements may be too strict for these countries or too difficult to implement effectively.

The difficulties developing countries face are evident in their participation in the AEOI process. The legal and process preconditions of participation in the AEOI have been challenging for developing countries (e.g., inserting the requirements of AEOI into domestic law; providing adequate administrative and information technology infrastructure; and ensuring safeguards to protect the information). While developing countries have participated in AEOI, the information provided by those countries is often inaccurate due to inadequate information gathering systems. Developing countries also receive information as a result of the AEOI, but any benefits of receiving that information are often lost as the developing countries are unable to use or process the information due to a lack of analytical capacity. The information may also not be received in a timely manner. The problems with developing countries participation in the AEOI could also be repeated with country-by-country reporting under BEPS Action 13.

Another dilemma for developing countries is tax competition and whether to continue to provide generous tax incentives to MNEs, as many developing countries do. The BEPS Actions do not directly address international tax competition, although Action 5 on harmful tax practices indirectly targets tax competition by seeking to prevent preferential regimes that provide benefits to geographically mobile business income (such as intellectual property regimes), and, therefore, are a risk for tax avoidance activity. As mentioned previously, the OECD's GloBE proposal may also have implications for international tax competition, as it seeks to impose a global minimum tax. Providing tax incentives to MNEs, especially tax holidays, can defeat the purpose of limiting tax planning opportunities, as the government is giving up the potential revenue in any case. In fact, it may lead to the country becoming a location to shift profits to lower the MNE's tax liability. Other problems with tax incentives are well known and include perceived unfairness by taxpayers who cannot benefit from the incentive, leading to noncompliance or "exemption creep" (i.e., an exemption for one sector or taxpayer creates pressure for exemption from similar "worthy" taxpayers); redundant incentives (i.e., the investment would have been made irrespective of the incentive); and opportunities for abuse, including domestic transfer pricing between exempt and taxable related companies.

5. Priority International Tax Reforms for Developing Countries

Which International Tax Issues Should Developing Countries Be Most Concerned About?

Addressing all the international tax issues faced by developing countries may not be possible, at least in the short term; it is necessary, then, to identify which issues should be given priority. Even developed countries are struggling to address all the international tax issues of concern. This is due to the challenges and complexities in addressing the issues, and the uncertainty of the implications of some of the response measures. It is also often difficult to obtain agreement amongst countries on a common response to an issue. For example, the EU is taking some time to come to an agreed response to the digitalization issue.

There is general agreement that BEPS Actions 4, 6 ,7, and 10 (interest deductions, treaty abuse, permanent establishment rules, and transfer pricing) are important for developing countries. These priorities have been identified by the IMF (IMF (2014)) and the OECD (OECD (2014)), although the OECD also suggests developing countries focus on Actions 11 and 13—that is, collecting and analyzing data for BEPS, and country-by-country reporting. In 2014, a UN country survey found that developing countries were most concerned about transfer pricing (including excess management fees, intellectual property and royalties, and research and development) and deductions for interest paid to related parties.[27] Other issues that were important but lower priorities were treaty shopping and preferential tax regimes. Clarifying permanent establishment rules and digitalization were considered important but not priorities. [28]

The IMF has also identified additional issues for developing countries that were not specifically addressed in the BEPS project. These include (1) indirect transfer of interests in domestic assets through offshore transactions; (2) lack of transfer pricing data for comparative analysis; (3) wasteful tax incentives; and (4) capacity development.[29]

International Tax Reform Options

The reform options chosen should fully recognize the realities that developing countries face. The options clearly have to allow the country to better address profit shifting, but they also need to take account of the legal obstacles to reform in developing countries and the limited administrative capacity. This indicates that the options chosen should not be too complex. Developing countries should also avoid trying to base their responses on how a residence country may tax the income. It is better to focus on how the developing country wants to tax income sourced in its own country.

In designing a response, it should be noted that there is no universal solution; the appropriate response for a country will depend on that country's individual circumstances. For example, it will depend on the country's level of economic development, political capacity for tax reform, and tax administration capacity. A country's tax history can also be important, as a negative experience with reform in the past can impact the acceptance of future reforms.

There are a number of feasible, and usually simpler, reform options available to developing countries to address international tax issues. A developing country could

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[27] See United Nations (2014).

[28] Oguttu (2017) also identifies these as priority issues for African countries, although he suggests that Action 12 (mandatory disclosure of aggressive tax planning arrangements) is more important than Action 11 (collecting and analyzing data for BEPS).

[29] See IMF (2014).

adopt all, or some combination, of these reforms over the short to medium term. It may not be feasible for a country, such as a fragile state, to implement some of these reforms within that time frame. Therefore, priority reforms include developing simple and comprehensive international tax rules in domestic laws (including transfer pricing rules); limiting interest deductions; ensuring adequate withholding taxes; and avoiding new double tax treaties.

- *Develop simple, clear, and comprehensive international tax rules in domestic laws*. These rules should at least cover the basics, such as a comprehensive definition of permanent establishment (ensuring it covers all onshore and offshore natural resources), an arm's length rule to address related party transactions, and crediting of foreign taxes paid by a resident company.

- *Limit deductions for interest expenses.* Many countries, including in sub-Saharan Africa,[30] have introduced thin capitalization rules, which limit interest deductibility and thus prevent MNEs from stripping out profits through debt shifting. Interest payments between related parties are targeted as they are often one of the simplest methods for shifting profits. The two broad approaches, which can be combined, to limit interest deductions are: (1) to establish a maximum debt-to-equity ratio (e.g., 2 to 1), with interest payable on debt in excess of the specified ratio denied a deduction; and (2) adopt an "earnings stripping" rule that restricts deductions for interest payments exceeding some specified proportion of a company's income (e.g., Germany limits the deduction for net interest expense to 30 percent of earnings before interest, tax, depreciation, and amortization (EBITDA)). The current trend is towards earnings stripping rules, as these are considered simpler to understand and implement, including for developing countries. Earnings stripping rules are recommended as an outcome from the BEPS project (Action 4), with a suggested range of ratios from 10-30 percent of EBITDA.

- *Comprehensive withholding tax on payments to nonresidents.* The domestic tax laws should include withholding taxes on all payments to nonresidents that have the potential to be used to shift profits out of a country. These payments include interest; dividends; rent; royalties; management fees; and technical service fees. The advantages of withholding taxes are that they are usually simple to calculate (as a percentage of the payment) and are payable by a resident payer, making it easier to collect. *For developing countries, a rate of at least 10-15 percent would be reasonable.* Withholding taxes can provide some revenue protection for a developing country, in that it is at least able to collect some tax from MNEs operating in the country. However, care needs to be taken that these withholding taxes are not unduly eroded under double tax treaties.

- *Apply some transfer pricing rules.* As mentioned previously, it is essential that domestic laws include an arm's length rule. This rule should be supported by basic

[30] Sub-Saharan developing countries with thin capitalization rules include Benin, Cameroon, Chad, Congo (Brazzaville), Cote d'Ivoire, Ethiopia, Gabon, Ghana; Kenya, Namibia, and Mozambique.

transfer pricing rules. These rules can be included in domestic laws and regulations, or in guidelines. Guidance in applying transfer pricing rules can be found in OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017 and the UN Practical Manual on Transfer Pricing for Developing Countries (2017). Developing countries may find it useful to introduce some safe harbor or fixed margin rules, which require taxpayers to adopt a specified margin for specified transactions or category of transactions, potentially with the option of a let-out if the taxpayer is able to demonstrate that the fixed margin does not approximate to an arm's length return for its actual transactions. This can improve compliance in low-capacity jurisdictions and allows the tax administration to focus its resources on more complex or aggressive cases. In addition, they can provide certainty to taxpayers, reduce compliance costs, and be easier to administer. While transfer pricing rules usually apply to cross-border related party transactions, they should also apply to domestic related party transactions, especially if there are companies entitled to tax holidays or lower income taxes in a country (e.g., in special economic zones), as abusive transfer pricing can arise with these transactions.

- ***Be cautious in entering into new double tax treaties and consider revisiting existing treaties, while taking time before entering into the MLI.*** It is preferable that developing countries delay entering into new tax treaties until they have developed a clear tax treaty policy, setting out the position they wish to take in tax treaty negotiations, and setting guidelines for choosing tax treaty partners. This policy should ensure that the developing country does not unduly cede its right to source taxation, such as by ensuring reasonable withholding taxes. There are two main model tax treaties that can guide the development of a treaty policy: (1) the United Nations Model Double Tax Convention between Developed Countries and Developing Countries (UN Model), which is generally more favorable to developing countries as it favors source-based taxation over residence-based taxation; and (2) the OECD Model Tax Convention on Income and on Capital (OECD Model). Once its tax treaty policy is established, the country can then decide if existing treaties need to be revisited.[31] The MLI provides an instrument for amending multiple existing treaties at once. However, developing countries may want to delay entering into the MLI until it sees how it is applied by those countries that have ratified the MLI and are amending their treaties.

- ***Consider limiting deductions for other payments between related parties***. This is a revenue protection measure to address concerns with excessive payments to related parties for costs such as royalties and management fees. The deductions are usually capped at a fixed percentage of a base, such as income or deductions (e.g., Ecuador limits tax deductions for royalties, technical services, and consulting fees to related parties to 20 percent of the tax base plus the expenses; Papua New Guinea (PNG) limits deductions for management fees to related parties to 2 percent

[31] For example, Mongolia terminated four double tax treaties, with Kuwait, United Arab Emirates, Netherlands, and Luxemburg, because of concerns that they were being used for treaty shopping and tax planning.

of PNG assessable income or 2 percent of allowable deductions excluding management fees).

- *Consider a minimum corporate income tax.* Minimum taxes can be a crude way of ensuring some tax is collected from all companies, including MNEs. For developing countries, it is preferable to keep the tax simple, such as applying a low tax rate to turnover or the value of assets. It would only apply if the tax liability under the standard income tax is less than the minimum tax.

- *Tax gains on offshore indirect transfers of interests.* These gains arise where immovable property (such as real estate or petroleum or mining rights) in a country is sold indirectly through the sale of shares in an offshore holding company that beneficially owns the underlying asset. These rules are common in tax treaties and usually allow the country to tax the gain if 50 percent of the value of the shares is directly or indirectly attributable to the immovable property in the country. The laws usually only apply if the seller of the shares is disposing of an interest above a certain ownership threshold, such as 10 percent.

- *Reconsider the role and design of tax incentives to attract foreign direct investment.* Income tax holidays and tax exemptions for MNEs can attract foreign direct investment but, as mentioned previously, they come with a number of disadvantages. These including costing revenue, including valuable revenue from MNEs; creating opportunities for abuse, including transfer pricing; they are often redundant—that is, the investment would have been made without the exemption; are inequitable and inefficient; and complicate tax compliance and administration. Better alternatives are investment tax credits or accelerated depreciation, which are better targeted at the actual investment.[32]

- *Develop international tax policy and administration capacity.* Ultimately developing countries will need to develop international tax capacity within their government agencies. Ideally this would involve establishment of an international tax unit within the ministry of finance to develop international tax policy, including a tax treaty policy. There should also be international tax specialization within the tax administration that is capable of implementing the various international tax laws, including transfer pricing rules, and able to audit MNEs. The tax administration should also develop capabilities to gather and use information from other countries, using AEOI and country-by-country reporting. There is much technical assistance available to assist developing countries in building capacity, including Tax Inspectors Without Borders, a joint initiative of the OECD and the UN Development Programme, and various bilateral technical assistance arrangements.

[32] For a more detailed discussion of the options available to developing countries see IMF (2015).

- ***Participate in the IF, but also consider using regional forums to discuss international tax issues and pursue developing country focused solutions***. Participation in the IF allows developing countries to observe, and, if desired, participate in the implementation of BEPS Actions. This will at least ensure developing countries are kept informed about what is happening with the BEPS Actions. However, participation in the IF does not mean that developing countries should make implementation of the four minimum standards a priority. It would also be beneficial for developing countries to use their existing regional forums (e.g., African Tax Administration Forum, Pacific Island Tax Administrators Association, Centro Interamericano de Administrationes Tributarias) to discuss international tax issues and potential responses that are appropriate for the countries in the region. For example, in regions with smaller countries, it may be possible to have regional transfer pricing audits. The regional forums can also be used to address regional tax competition.

The importance of the above reforms may differ by the type of developing country. For example, addressing indirect transfers of interest is a higher priority for resource-rich countries, where mining and petroleum rights are the types of valuable assets that may be sold through offshore transactions. In the case of small island countries, it is difficult to develop critical mass in the tax administration to address international tax issues, so these countries may have to rely heavily on regional assistance rather than establishing a fully functional international tax unit.

Other reforms not listed above should be viewed as lower priorities, or as longer-term reforms. While the issues they address are important, these reforms are more complex and should be less of a focus for developing countries. They include:

- ***Addressing digitalization.*** At this stage there is still a lot of debate about the appropriate way to tax digital services. Some developing countries, especially in Africa, have introduced taxes that tax access to social media services, although their success is still to be determined (e.g., Benin imposed a low tax on social media use, which led to significant increases in the price of data; after much public pressure, the tax was withdrawn). Also, if one country unilaterally imposes a digital services tax, there is potential for double taxation and likely major compliance cost implications for taxpayers. Due to these uncertainties it is better for developing countries to hold off imposing direct taxes on digital services until a clearer multilateral position is taken. However, developing countries could consider requiring nonresident suppliers of online goods and services to register for VAT and remit VAT for goods and services provided to the country's residents.

- ***CFC rules.*** As mentioned previously, CFC rules address concerns with MNEs establishing subsidiaries or branches in low tax countries to shelter profits from tax in the residence country of the parent. The rules target MNE's outbound investment. Most developing countries are more concerned about inbound investment, with few resident companies having significant outbound investments.

CFC rules can also be complex and difficult to enforce. Therefore, the introduction of CFC rules for developing countries is not a high priority.

- *Implementing remaining BEPS Actions.* Some of the BEPS Actions, such as the hybrid mismatch rules, dispute resolution rules, strengthening CFC rules and some of the more complex transfer pricing rules are of lesser concern to developing countries. These Actions are targeted at more developed tax regimes, and thus are less of a concern to developing countries.

It is too early for developing countries to adopt alternative taxing mechanisms that would result in a fundamental reform of the international tax framework. While these alternative tax mechanisms have appeal, and have much potential for developing countries, there are still practical issues to resolve before they can be introduced, and no country has implemented these reforms.

6. Conclusion

Developing countries need to respond to the international tax challenges, so as to protect, and potentially gain, revenue from MNEs operating in the country. While the challenges are significant, there are feasible steps that developing countries can take to begin to address these challenges.

The reform options for developing countries outlined above provide a possible international tax reform strategy for developing countries. The strategy would include the following:

1. Review domestic laws and amending them, if necessary, to ensure they adequately include:

    - arm's length principle;
    - permanent establishment rules;
    - transfer pricing rules (with presumptive safe harbors);
    - deduction limitations on related party interest, and possibly other related party expenses, such as royalties, management fees and technical service fees; and
    - taxation of gains on offshore indirect transfers of interests (if the country has a capital gains tax regime).

2. Ensure withholding tax is imposed on payments to nonresidents (e.g., dividends, interest, rent, royalties, management fees, and technical service fees).

3. Develop a clear double tax treaty policy, including:

    - being wary of signing any new double tax treaties, and especially avoiding double tax treaties with income tax free countries;
    - ensuring adequate rates of withholding tax are preserved in treaties; and

- following developments in the MLI but considering delaying participation until the consequences for countries that have ratified are understood.

4. Consider introducing a simple minimum income tax on companies.

5. Consider rationalizing tax holidays and income tax exemptions and look at alternative incentives targeted at the actual investment.

6. Develop capacity in tax policy and administration to understand and administer international tax rules, to challenge and deal with MNEs, and to analyze and effectively use information provided from other jurisdictions.

7. Participate in the IF but be wary about making the four minimum standards a priority; consider using regional forums to discuss international tax issues; pursue developing country focused solutions (e.g., regional transfer pricing audits); and discuss tax competition.

To implement such a strategy, developing countries should make use of technical assistance available from international organizations and bilateral donors. The IMF, the World Bank, and the OCED can provide technical assistance on both international tax policy and tax administration. There are many bilateral donors who are also interested in providing technical assistance on international tax issues, given their objective to encourage revenue mobilization. The most suitable technical assistance provider for a country will depend on the nature of the assistance being sought.

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