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Redesigning the international tax system: an update

Legal flash

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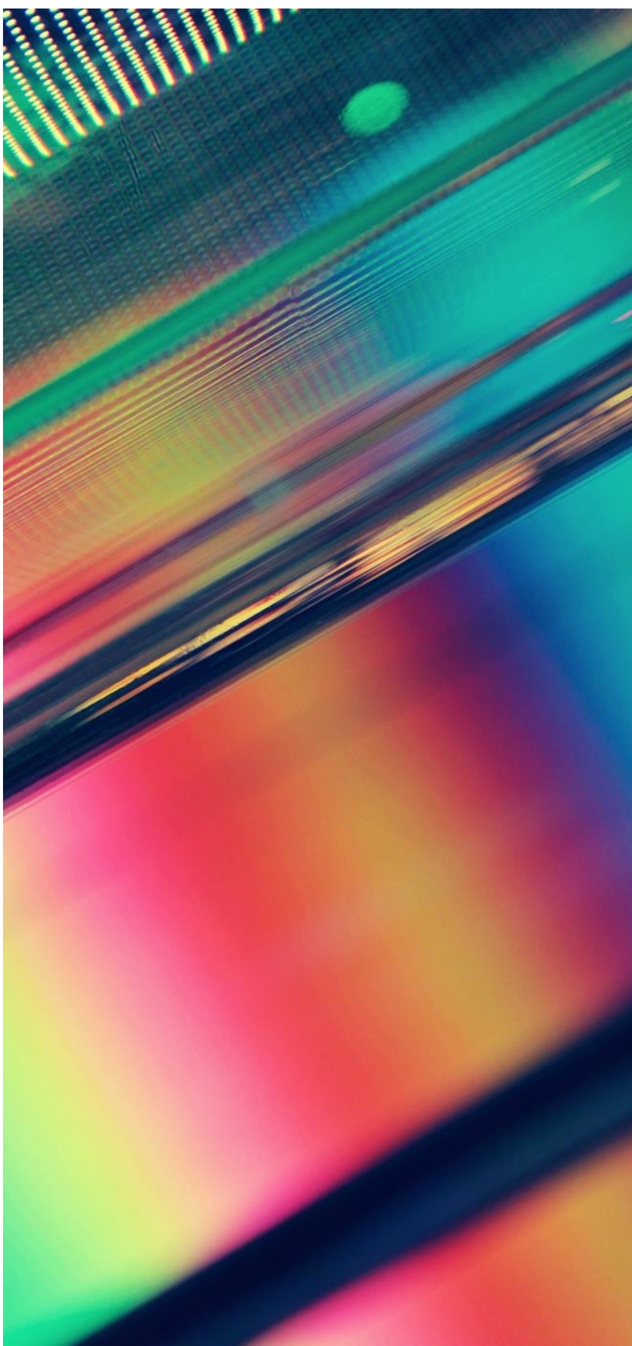

Globalization and digitalization have fundamentally changed the ways in which cross-border business is conducted and undermined the efficacy of international tax rules which were designed nearly a century ago. There are however some signs – not least the recently announced G7 deal – that the world is moving towards a new consensus for the taxation of cross-border business. Here we review the various developments that have taken place in response to these challenges, including the recently announced G7 deal, and look at what might come next.

Over the last decade, and particularly since the original OECD BEPS Action Plan published in 2013, countries have been working to design a tax system that is better able to recognise and adapt to the realities of conducting business in the twenty-first century. Amendments have been implemented at multiple levels and designed to tackle different objectives. At the domestic level, a number of measures have been introduced that seek to

strengthen domestic tax bases and taxing rights, such as the UK's Diverted Profit Tax, and the Base Erosion and Anti-abuse Tax ("BEAT") under the Trump Administration's Tax Cuts and Jobs Act. There have been collective efforts to target anti-avoidance, such as the EU's Anti Tax-Avoidance Directives ("ATAD1 and ATAD2" respectively, together "ATAD"), as well as measures to directly target the value created by digital services, such as the proliferation of digital services taxes ("DSTs") and the prospect of further EU action aimed at fairer taxation of the digital economy.

Notwithstanding the myriad developments above, many countries believe that the above measures have not done enough to counter the original problem of how to tax businesses operating internationally in the twenty-first century, and that further change remains necessary. Negotiations on the taxation of multinational enterprises (MNEs) to ensure they pay more corporate tax continue at a sustained pace in the countries where they are established (headquarter jurisdictions) and in the countries where they operate (market jurisdictions), including the recent G7 meeting discussed further below.

The OECD's work on the Pillar One and Pillar Two proposals is seen as the most feasible solution to the problem. However, some commentators have argued that insufficient time has elapsed following the introduction of the initial BEPS measures; as with any fundamental change, it will take a number of years to determine the impact. Nonetheless, it appears the political reality is that further action needs to be taken sooner rather than later.

This political reality was underscored by the consensus reached by the finance ministers of the G7 over the first weekend in June 2021, which commentators have described as a "seismic" development. Whether or not this fanfare is justified by the substance of the agreement is open to question, but it is undoubtedly a clear signal of commitment to making real progress on the OECD project.

These central tenets of the G7's statement correlate – as discussed below- to the two "Pillars" under which the OECD has undertaken its work in this area to date.

Pillar One was specifically designed to address the challenges arising from digitalisation (primarily, the way in which tech companies harness value in jurisdictions without physical presence), although its scope has expanded over time to include consumer-facing businesses. It is interesting that the relevant text of the G7 communique (relating to the equitable allocation of taxing rights for the "largest multinational enterprises") moves away from this sectoral focus, and towards an approach based primarily on size. This represents a significant departure from the original intention to design a set of rules that would specifically target giant tech companies.

Pillar Two focusses on MNEs that design their international group structures to achieve reductions in their overall tax rate. It is the mechanisms of Pillar Two that are intended to ensure the application of the global minimum tax rate of "at least 15%" as agreed by the G7.

In light of the scale of these developments, it is worth considering their impact on cross-border and domestic situations – in particular, the potential effects of these OECD proposals (either in their current form or as they may be amended) not only on the mechanics of taxing MNEs, but on the configuration of tax systems across the world.

This document summarises the key recent changes associated with Pillar One and Pillar Two, including the anticipated effect of the recent G7 developments, before providing an overview of the implications in the jurisdictions of its contributing editors.

Key ongoing developments – the OECD Pillars, the US perspective, and the "historic" G7 deal

Work and negotiations at the OECD level

While the final content of Pillars One and Two has not been agreed yet, in October 2020 the OECD/G20 Inclusive Framework published blueprints summarising the content of each Pillar as it stood. Their core components are:

- Pillar One addresses the fact that businesses can operate in market jurisdictions without physical presence, and introduces new nexus rules that grant a right to tax these businesses. In the form set out in the OECD Blueprint, it looks beyond the digital world of tech giants to consumer-facing businesses and introduces three mechanisms to achieve this:
    - a new set of nexus rules for two types of business models: Automated Digital Services (ADS) and Consumer-Facing Businesses (CFBs) (Amount A);
    - a fixed return for certain baseline marketing and distribution activities taking place physically in a market jurisdiction (Amount B); and
    - processes to improve tax certainty through effective dispute prevention and resolution mechanisms.

- Pillar Two sets a minimum effective tax rate (ETR) for internationally operating businesses within its scope. The ETR would (i) identify "low tax jurisdictions" (i.e. where a MNE's jurisdictional ETR is below the agreed minimum rate) and (ii) determine how much income must be brought back into the tax net to raise the aggregate tax on income in that jurisdiction to the ETR. The G7 communique is the most significant movement towards agreeing a number for the ETR to date.

  The proposed mechanisms to achieve the global ETR are:

  - the "GloBE rules," which comprise the "Income Inclusion Rule" (IIC) and the "Under-Taxed Payments Rule" (UTPR) and aim to ensure parent companies pay tax on subsidiaries' undertaxed income at the designated globally agreed rate;
  - the "Switch-over Rule" (SOR), which seeks to ensure that tax treaty exemption obligations for income from PEs are not an obstacle to achieving the ETR; and
  - the "Subject-To-Tax Rule" (STTR), which ensures minimum withholding rates on payments to group companies where the recipient is not subject to tax at a sufficient rate. It runs in tandem with the GloBE rules (although is expected to operate in priority).

It should be noted that the communique resulting from the meeting of G7 finance ministers sits along the same lines as the OECD has divided the project's content. Following a commitment by the member countries to support the work of the OECD Inclusive Framework, the communique commits the G7 to the following objectives which broadly map onto the Pillar One and Pillar Two objectives:

- reaching an equitable solution on the allocation of taxing rights for the largest and most profitable multinational enterprises (on at least 20% of profit exceeding a 10% margin); and
- introducing a global minimum tax of "at least 15%" (which seems to have been the principal headline generator),

A discussion about the tax rate also requires a discussion about the tax base. The proposed GloBE rules are unlikely to be fully compatible with national sovereignty over tax bases, which are at the very heart of a country's tax system and its ability to develop its own tax policy responses to its specific economic needs. If a common tax base is agreed on, countries are likely to lose an element of this economic flexibility. The G7 communique did not provide clarification on what a common tax base may look like.

The OECD has published an economic impact assessment of the revenue that may be collected under the two Pillar approach, although arguably such projections may not be fully reliable. For example, as the projections were prepared without reference to the Covid pandemic, the profitability (and therefore the corporation tax take) of digital services companies under Pillar One may have been understated. Similarly, the first BEPS project and other existing measures may have increased (and continue to increase) global corporation tax revenue, and it is not clear that this trajectory of increased revenue has been taken into account.

The OECD is expected to update and review its work shortly (in mid-2021), and this further work will be informed in part by the agreement on both the minimum tax rate and parameters determining which companies will be subject to the new nexus rules (and to what extent) reached by the G7. The content of the G7 communique marks something of a departure from aspects of the OECD proposals as originally envisaged, and it will be interesting to see whether these departures survive ongoing negotiations (first by the G20, and then by the Inclusive Framework). For example, the focus of the G7's "Pillar One" solution is no longer set out in terms of automated digital services or consumer-facing businesses – rather, its scope is determined solely by size and profit margins. This reflects the desired direction of travel by the US (as discussed below), and its acceptance by six other prominent advanced economies at this stage is likely to increase its chances of becoming permanently embedded in the final Pillar One mechanics.

The Biden administration's proposal

A number of documents circulated in April 2021 set out the US's tax ambitions to reform its domestic tax system, and related to that the interaction with the wider international tax system. This was an important development reasserting the US's role in the OECD tax plans for MNEs and shedding light on where the negotiations might be heading. It also signals a shift in US tax policy: while the Trump administration had openly opposed the Pillar One proposal, the current US Secretary of Treasury Janet Yellen has stated that the US is committed to the multilateral discussions on both Pillars within the OECD/G20 Inclusive Framework.

Despite the US's broad support for the project, its proposals could substantially change the scope of the OECD Pillars.

1. Pillar One would no longer target tech and consumer businesses. Instead, the US proposes a more comprehensive scope based on revenue and profit margin regardless of sector or business model. Only the largest 100 businesses would be in the spotlight for Pillar One market-jurisdiction tax whereas by contrast, the OECD proposals targeted 2,300 businesses. The proposed quantitative screening criteria would be based on revenue, with a secondary profit margin test to capture the businesses that are most profitable, and likely to be intangibly driven and have the most potential for profit shifting. The G7 agreement is silent on how many businesses will be in scope of this measure.
2. Given the US's non-sector focus, it is unclear whether the Pillar One sector exclusions would apply. This is particularly relevant as some of the largest global businesses by revenue and margin tend to be financial services and to a lesser degree oil and gas – two areas that were previously excluded. If any sector-based carve-outs remain these would need to be adopted against a backdrop of stringent principles.
3. The US is also calling for the roll-back of existing DSTs as a condition of accepting the new Pillar One rules. The G7 agreement also commits to coordinating the removal of all DSTs and "other relevant similar measures".
4. The Pillar Two global minimum tax was never constrained by the sector focus of Pillar One in its original form. So it would be unaffected by Pillar One's changing scope and would continue to apply to a wide-range of MNEs (subject to certain thresholds and exclusions).
5. In its initial proposals, the US signalled a global minimum tax rate of 21%. However, its agreement to the G7's rate of 15% indicates that it has been willing to move on this. That said, the wording of the communique is clear that the agreement is to "at least" this number, so it is possible the rate may still rise. In any event, despite its role in the G7 deal there remains an open question as to whether the US will be able to adopt the OECD's proposals domestically as it would also have to be approved by Congress.

The role of the EU: taxation of the digital economy

The EU seems keen on ensuring that the original aims of the OECD proposals (in particular, Pillar One) in terms of taxing international tech businesses are achieved, whether or not this is through the mechanism of the OECD

project or through an EU initiative. This is now especially pertinent given the move away from the focus on tech companies signalled by the G7 communique. Therefore, it has proposed several directives targeted at the problems arising from taxing the digital economy, which it intends to implement if it loses confidence (and patience) that an agreement will be reached through the OECD/G20 Inclusive Framework.

In 2018, the EU Commission proposed two alternative directives, one on a "significant digital presence" (COM(2018) 147 final) and one on a EU DST (COM(2018) 148 final). Neither was introduced, but a number of EU Member States used the DST proposal as a benchmark to introduce DSTs at domestic level.

In general terms, domestic DSTs apply to gross revenues from certain itemized digital services earned by large businesses. In 2020, the DSTs were challenged in the EU on the grounds that they were either directly or indirectly discriminatory based on the location of the companies' registered office–therefore, incompatible with the freedom of establishment–in the cases of C-75/18, Vodafone Hungary and C-323/18, Tesco-Global. However, in both cases the CJEU upheld Hungary's turnover tax on telecommunications business and retail trade, which has been interpreted as broad confirmation of the legitimacy of DSTs in the EU.

In early 2021, the EU Commission started working on a new proposal for an EU-wide digital levy that may be brought in from 2023 to address similar issues of fair taxation of the digital economy. The proposal is expected to be disclosed in the second quarter of 2021. If international agreement is reached the legacy of DSTs should be short-lived. In the meantime, the US has initiated a number of investigations and issued notice of suspended tariffs in a number of jurisdictions including the UK, France, Spain and Italy. The Commission's Communication "Business Taxation for the 21st Century", dated May 18, 2021 also takes aim at digital companies and reasserts that the EU digital levy can co-exist with the OECD's Pillar One proposal. Discussions also continue as to whether the EU will allow the possibility of national vetoes against these measures, or whether it will require only a majority vote under article 116 of the Treaty on the Functioning of the European Union.

Assessment: How may this affect you?

From a market jurisdiction standpoint

How are taxing rights currently allocated to market jurisdictions?

- The established position is that countries can tax non-resident companies when they have a permanent establishment (PE) in that country. This is the current mechanism through which taxing rights are given to market jurisdictions of businesses operating internationally, including those providing automated digital services and consumer-facing businesses. However, as these businesses can lack either a fixed place of business or an agent with authority to enter into contracts on behalf of the company required for a PE to exist, market jurisdictions are often in reality denied any mechanism to tax such businesses, even where they have a substantial market presence.

- Business structures relying on these rules to limit their source taxation have been affected by recent international developments.
    - One example are commissionaire structures, which were addressed in the MLI through updating the PE concept such that commissionaire structures are more susceptible to being classified as PEs and subject to taxation at source. As a result, these structures can now potentially create a taxable PE in a number of jurisdictions, including Spain and France.

- Based on these changes, some groups have already restructured to have a taxable physical presence in the market jurisdiction as local limited risk distributors.

How might this change in the future?

- The international approach to source taxation may change under the various EU, OECD and US proposals as follows:
    - Withholding tax on payments for digital services: several proposals to enable broader powers to withhold tax at source such as the STR included in Pillar Two and more specific amendments to the United Nations' model tax convention mean they may become a more prevalent source of revenue;
    - Unilateral DSTs: some jurisdictions – such as the UK, Italy, Spain and France- have implemented DSTs that will be abolished in case of international agreement. By contrast, Ireland and Germany do not have a DST, and Ireland favours tackling this issue at the OECD level rather than unilaterally or at EU level. A proposal for a new EU levy is under consideration (although it currently lacks unanimity).
    - The concept of economic or digital presence: the basis of OECD's Pillar One seeks to tax the residual profit where there is "active and sustained participation of a business in the economy of that jurisdiction through activities in, or remotely directed at, that jurisdiction". The characterization of this activity and the new nexus is different for ADSs and CFBs. For ADSs market revenue would be an indicator of "active and sustained" participation in a jurisdiction, however for CFBs there is discussion around plus factors where the physical presence falls short of a PE but there are key personnel in a market jurisdiction and advertising and promotion activity that supports sales in that jurisdiction.
    - Dispute resolution process: these proposals involve a significant number of new principles, taxes, international interactions and international allocations. Pillar One specifically involves the redistribution of certain taxing rights between jurisdictions, which means some countries will lose out and the dispute resolution process is likely to take on greater importance. In recognition of this, the OECD proposes a new binding dispute prevention process with a panel as existing bilateral dispute resolution mechanisms would be impractical given the number of jurisdictions that might be under dispute. The risk is, without an effective mechanism, it becomes more likely that businesses will suffer double taxation.

- One of the aims of Pillar Two is to reduce tax competition between jurisdictions and reverse the "race to the bottom" in corporate tax rates. As above, the floor for the minimum effective rate proposed by the G7 is 15%, although there remains room for this to increase. For context, the current rates in the contributors' jurisdictions are as follows:
    - In Spain, the current nominal corporate tax rate is 25% and the effective tax rate has usually been around 15% to 20% for the last decade. Based on this, Spanish blending would be above minimum ETR, if examples of Pillar Two blueprint are taken into account however, the US position may change this, if a minimum ETR of 21% or 15% is required. In any case, an increase of the nominal tax rate could be implemented, given the top-up effect for the foreign parent company.
    - France has started a progressive decrease of its corporate tax rate, from 33.3% in 2018 to 25%. As from 2022 the current nominal corporate tax rate will be 25,83% (including a social contribution of 3.3%) thus above the 15% minimum provided however that the effective tax rate is generally lower in practice since France applies a strict territorial approach to determine corporate tax basis and generally exempt dividend received from foreign subsidiaries. It is however expected that the ETR will be generally above the applicable minimum rate save in some circumstances if the R&D tax credit is treated as reducing ETR.
    - In Italy, nominal corporate tax rate is 24%, but a regional income tax also applies at a nominal 3.9%, which qualifies as a covered tax under the GloBE proposal; in relation to these taxes, limitations on deduction may significantly raise the effective tax rates compared to nominal ones. On the other hand, payments made to low-taxed entities may trigger WHT issues under the STTR: this appears to be a point of attention in light of the aggressive approach of the tax authorities on WHT duties.
    - The 12.5% rate of corporation tax in Ireland may fall below the minimum ETR, so these proposals will certainly have an adverse effect on Ireland, which is home to the EMEA headquarters of numerous MNEs. A top-up will likely be required from the foreign parent company, although the effective rate may be higher when interest limitation is taken into account. It is estimated that these proposals will cost Ireland approximately 20% of its corporate tax revenues. It is also feared that an increase in corporation tax costs could dampen economic growth and investment in Ireland.
    - The UK recently announced that it will raise its corporation tax rate from 19% to 25% with effect from April 2023. The reason for this is revenue raising in the aftermath of high pandemic expenditure and little appetite to increase the taxation on individuals. The prospect of a global minimum tax rate provides some cover that the UK has reduced its international competitiveness however this will depend on the level that the rate is introduced. At 15% it is unlikely that UK companies would be caught. The UK's Patent Box (that offers a rate of 10% for certain profits) would have diminishing appeal for international groups investing in the UK, but may still benefit those below the agreed thresholds or wholly domestic groups.
    - The German corporate tax rate is 15.825%. An additional trade tax is levied, ranging from 7% to 17% depending on the municipality where the corporation is situated. Both the corporate tax and the trade tax fall within the definition of a covered tax under GloBE. Therefore, it seems unlikely that the ETR for German companies will be below the applicable minimum rate.

- In Luxembourg, whether the Luxembourg entities of a group will actually be treated as having an ETR below the minimum ETR will depend, as in other territories, on the final agreed minimum rate (the current income tax rate in Luxembourg is approximately 25%), the tax base under consideration, the possibility to use pre-regime losses and the extent of the carve-out. The application of a patent box regime may prove problematic in this respect.
- Depending on the canton of residence, the effective corporate income tax rate in Switzerland currently is between 11.85% and 21%. It is estimated that roughly 250 Swiss MNEs and several hundred Swiss companies of foreign MNEs would be affected by a global minimum ETR of 15%. For over a year now, in discussions with the cantons, academia and the business community, the Federal Department of Finance has been examining the possible transposition of an international standard into Swiss law, as well as internationally accepted measures that will safeguard Switzerland's appeal as a business location. The Federal Council informed on June 11, 2021 that it is set to decide on a coordinated reform plan in the first quarter of 2022.

From a headquarters jurisdiction standpoint

<u>How do jurisdictions currently try to prevent profit shifting to low tax jurisdictions?</u>

- Under current rules, the main approaches include the application of CFC rules together with the US GILTI included in the Trump administration's reform.
    - The application of the ATAD CFC rules since 2019 by headquarter jurisdictions (such as Luxembourg that opted for Option B of the ATAD CFC rules) is expected to have limited effects on multinational groups that already comply with the at-arm's-length principle in their intra-group transactions. The actual impact of the CFC rules rather lies with the necessary compliance costs associated with the reporting of information on all direct and indirect subsidiaries concerned. The new regime is expected to go further than current CFC rules, since the level of substance (otherwise known as genuine economic activity) will not be relevant, unless a substance carve-out is introduced. This would mean that taxation may arise in situations that are actually not targeted by the current CFC rules (as is the case in Luxembourg).
    - Spain has CFC rules similar to ATAD's Option A since 1994, although their application has been limited. However, amendments over the last years, as well as those linked to ATAD's transposition, could strengthen their use.
    - France did not modify its CFC rules following the implementation of ATAD as it considered the existing rules were sufficient; however, the reform could stimulate a simplification and harmonisation of these CFC rules.

  - Italy has had CFC rules in place for many years now, but after ATAD certain aspects have become more complicated. For example, CFC rules are coupled by a full taxation regime (*i.e.*, disapplication of participation exemption regime) of dividends and gains from undertaxed companies, which may create extremely complex issues.
  - Ireland opted for Option B, which affects some, but not all, companies headquartered in the country. This is largely driven by the fact that Ireland is a small country, so it cannot reasonably be expected that all the significant people functions of a large MNE will be located in Ireland.
  - Germany introduced CFC rules back in 1972. In the course of the ATAD process, the German government intends to amend the CFC rules since they are stricter than the previous ones and, in some aspects, even stricter than required by ATAD. According to the latest draft, German CFC rules are applicable if, inter alia, the foreign tax rate (to be determined by applying German tax law provisions) is below 25%.
  - By and large, the UK considered its CFC rules comprehensive in so much as they meet or exceed the requirements set out by ATAD. It is unlikely that the UK CFC rules would be abolished in totality in light of a global minimum tax to ensure it still has the powers to tax CFCs in jurisdictions where Pillar Two is not adopted, or due to particular attributes of the UK CFC it wants to retain, for example the exclusion if local tax paid is 75% of the UK's rate (which may be a higher threshold than the global minimum rate).
  - Since Switzerland is not in the EU, it has not introduced any CFC rules yet. The Federal Council has never planned to do so. It is yet to be seen how this topic will develop in the coming months.

<u>How would the minimum ETR address this problem?</u>

- Pillar Two will principally affect headquarter jurisdictions as it imposes a right to tax income in a low tax jurisdiction at the global effective minimum tax rate , the applicability of which depends in part on whether profits received in a headquarter jurisdiction have been taxed elsewhere:
  - The IIR (and the "switch over rule" for PEs), in coordination with UTPR, would result in a top-up tax to ensure profits were taxed at the ETR. The OECD maintains that it is compatible with CFC rules (that will continue to apply to MNEs below EUR 750 million).
  - From an EU perspective, it is not clear that the application of these new rules (in particular, the IIR and STTR) comply with the EU fundamental freedoms. Various EU cases provide that the fundamental freedoms can only be restricted in limited circumstances, including where there is an overriding general interest, e.g. the prevention of wholly artificial and non-genuine arrangements. This goes to the core of BEPS: is it a mechanism to address aggressive tax planning, or is it a mechanism to achieve global tax harmonisation?
  - In addition, the restriction on the freedom of establishment inherent in any CFC rule is permitted within the EU is currently only justified where that rule contains an exclusion for genuine economic activities. It remains to be seen whether Pillar Two will contravene the EU Treaty and whether a Treaty amendment will be required to implement this proposal.

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