

# 3

## The Current International Tax Regime

This chapter describes and evaluates the current regime for taxing the profit of companies in an international setting. The question immediately arises whether we can speak of a single ‘regime’ given the clear differences in the way countries tax companies. There can be considerable differences in detail even when countries tax companies in a similar way. But, taking a step back, it can be seen that countries’ existing rules for taxing companies in an international setting do follow a common broad framework which we set out in very general terms here.

As we noted in Chapter 1, this book as a whole is concerned with the general question of taxing the profit earned by a business—whatever the legal form of that business. However, it is the taxation of the profit of companies, and in particular multinational companies, that has dominated the tax policy debate. In describing the current international tax system, this chapter will therefore focus on the taxation of company profit, and in particular corporation taxes.

Section 1 introduces the current international tax regime. It explains its basis in domestic law and international treaties and sets out three of its distinguishing features: the distinctions between residence and source, between active and passive income, and its basis of separate accounting. Section 2 briefly outlines how companies are taxed within the regime. At the time of writing the existing regime is undergoing a sustained period of review and reform. So far this has resulted primarily in the introduction of a number of new rules and a tightening of existing rules to address base erosion and profit shifting under the OECD/G20 BEPS (Base Erosion and Profit Shifting) project, but these have not changed the underlying framework of the regime. These changes are described in Section 3. Section 4 evaluates the regime as it currently stands against the five criteria set out in Chapter 2.

Section 5 briefly considers further reform proposals that are currently being considered and how they would affect the performance of the resulting regime against these five criteria. These reform proposals, if agreed and implemented, could be more significant than those resulting from the BEPS project, in that they could include elements that depart from the fundamentals of the existing regime. However, these elements would be relatively minor and would be bolted on top of the existing regime, which would still remain in place. Section 6 concludes.

## 1. An introduction to the current regime

### 1.1 Sources

#### 1.1.1 Domestic law and international treaties

The international tax regime is not a neat or perfectly coherent body of law designed following clear first principles; it could hardly be so given its sources and the manner in which it developed. It is the product of a multitude of national laws, international treaties, and soft law.<sup>1</sup>

From a legal perspective, the starting point is that under public international law each country is entitled to tax persons—natural or legal—or taxable events with which it has a sufficient ‘nexus.’<sup>2</sup> Countries generally tax companies either on the basis of their ‘residence’ (i.e. country A can tax profit earned by companies resident in country A for tax purposes—whether the profit arises in country A or elsewhere) or on the basis of the ‘source’ of their profit (i.e. country A can tax profit arising in country A—whether earned by companies resident in country A or elsewhere). The notions of ‘residence’ and ‘source’ are far from straightforward, as we set out below. In the context of cross-border activity, two or more countries might have a sufficient nexus and thus the right to tax. Each country can unilaterally decide whether and how to exercise this right. Unless further action is taken, the uncoordinated nature of individual countries’ domestic tax systems might result in the same profit being taxed by more than one country. For example, a company resident in country A earning profit in country B could be taxed by A on the basis of its residence and by B on the basis of the source of its profit.

Traditionally, concern over this type of double taxation has been at the heart of policies shaping the international tax regime. This double taxation is addressed in two ways. First, countries address it, at least to some extent, through unilateral measures in their domestic laws. In our example, A, the residence country, might allow a deduction, or grant a credit, for the tax paid in B, or it might choose not to tax the income at all (e.g. France does not tax foreign corporate income under a strictly territorial approach). Depending on the nature of the income, B, the source country, might impose a low tax on the income paid to the foreign company or even exempt it altogether (e.g. Germany does not tax outflowing interest). Second, two countries can also address double taxation through coordination with one another, primarily through a bilateral double tax convention (DTC). DTCs allocate taxing rights over certain types of income between two countries; that is, the contracting countries agree on which of the two is to waive its right to tax particular

<sup>1</sup> Soft law includes, in particular, guidance to the interpretation of treaties like the Commentaries to the OECD Model Tax Convention or the OECD Transfer Pricing Guidelines. For a closer analysis of soft law in the area of international taxation, see Vega (2012).

<sup>2</sup> For a recent account see Gadzo (2018).

types of income or to exercise this right in a limited fashion. There are also some limited examples of multilateral treaties—the most significant recent addition is a major multilateral instrument which has arisen from the OECD/G20 BEPS project, which facilitates the amendment of existing bilateral treaties between pairs of countries.<sup>3</sup>

It is worth re-emphasizing that—within the limits imposed by public international law,<sup>4</sup> international treaties such as the European Treaties,<sup>5</sup> and World Trade Organization (WTO) agreements like the GATT and the GATS<sup>6</sup>—in a cross-border situation countries are free to choose what to tax and how to tax it. They are also free to choose whether and how to provide relief from double taxation; they are under no obligation to address the potential for double taxation either unilaterally or bilaterally. Each country may make these decisions on the basis of its own particular set of interests and concerns. But difficult trade-offs arise: for example, the benefit of raising revenue by taxing the corporate income of foreign companies on a source basis has to be set against the impact such a tax would have on the country's competitive position for attracting capital, real economic activity, and mobile tax bases.

As the international tax regime is made up of individual countries' domestic laws and an extensive network of DTCs, it is not surprising that it can be rather incoherent. However, when viewed as a whole, common concepts, principles, and practices, and indeed a common underlying framework, do emerge. This is partly due to the fact that countries deal with some issues on a unilateral basis in a broadly similar manner. But it is also because the majority of DTCs closely follow a small number of model treaties, which themselves are relatively similar to one another.

Countries have addressed the double taxation of cross-border activity through DTCs since the end of the nineteenth century. There are now over 3,000 DTCs and their primary, though not sole, function is to allocate taxing rights between the two contracting countries, in order to remove or reduce double taxation. DTCs are not meant to create new charges to tax. And because DTCs merely allocate a right to tax between two contracting countries, each country retains a choice as to whether or not to exercise, through domestic law, a taxing right allocated to it under a treaty. Many countries choose not to levy taxes on some forms of income even though they are entitled to do so under a particular DTC.

Most DTCs follow the OECD Model Treaty ('OECD Model').<sup>7</sup> This was first produced in 1963 and was revised most recently in 2017. However its genesis can

<sup>3</sup> OECD (2017c).

<sup>4</sup> See Gadzo (2018).

<sup>5</sup> See Section 1.1.2.

<sup>6</sup> This concerns both prohibitions on tax provisions discriminating against foreign goods and foreign service providers and tax provisions conveying export subsidies. For an overview see Schön (2004).

<sup>7</sup> OECD (2019e). The OECD Model is accompanied by a detailed Commentary which assists in its interpretation and is frequently cited by courts. This influential Commentary, like the OECD Model

be traced back to the work of the League of Nations in the 1920s. The main features of this original model can still be found in the current version. The US produces a Model Treaty that is similar to the OECD Model but departs from it in some respects.<sup>8</sup> A third Model Treaty was produced by the United Nations in 1980—and most recently revised in 2017—that is intended for adoption between developed and developing countries.<sup>9</sup> Again, this treaty bears considerable similarity to the OECD Model, but contains some important differences. In particular, as we describe below in more detail, it favours a greater retention of ‘source country’ taxing rights, which, it is thought, is of specific importance to developing countries. For example, unlike the OECD Model, the UN Model allows source countries to tax outbound royalty payments. In this book we focus primarily on the OECD Model as it is the most influential of the three.

### 1.1.2 The impact of EU law

European Union (EU) law has had a considerable impact on the domestic international tax law of its Member States. This impact comes from two sources. First, Member States’ international tax law must comply with EU legislation in the field of direct taxation. For example, the Interest and Royalties Directive<sup>10</sup> forbids Member States from introducing withholding taxes on cross-border payments of interest and royalties between associated companies within the EU (subject to a 25% minimum shareholding requirement). The Parent/Subsidiary Directive,<sup>11</sup> amongst other things, abolished withholding taxes on payments of dividends between associated companies within the EU (subject to a 10% minimum shareholding requirement). As the adoption of such measures requires unanimity amongst Member States—which has proved difficult to achieve—only four directives had been passed by the early 2000s and they were limited in scope. However, the political and public forces that propelled the BEPS project forward also injected fresh impetus into the EU direct tax legislative machinery. As a result, part of the BEPS Action Plan was implemented in the EU through the 2016 Anti-Tax Avoidance Directive.<sup>12</sup> It remains

itself, is produced by the Committee on Fiscal Affairs, a body composed of senior government officials from each OECD member state. The OECD has been accused of undertaking substantive changes through changes in the Commentary rather than the OECD Model itself. The OECD also produces Transfer Pricing Guidelines, which are equally influential.

<sup>8</sup> United States Department of the Treasury (2016). For example, unlike the OECD Model, the US Model does not permit the exemption method of relief.

<sup>9</sup> United Nations (2017).

<sup>10</sup> Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

<sup>11</sup> Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

<sup>12</sup> Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, as amended by Council Directive 2017/952 of 29 May 2017.

to be seen how far this impetus will carry the EU Commission's legislative designs in this area in the future.

The second source are the fundamental freedoms of the Internal Market as fleshed out by the jurisprudence of the Court of Justice of the European Union (CJEU), which, to date, has been of greater consequence to the domestic tax systems of Member States.<sup>13</sup> In a series of cases starting in the mid-1980s the CJEU found important features of domestic international tax regimes to be incompatible with the fundamental freedoms that underpin the EU Internal Market, and thus had to be dismantled. Three strands of this jurisprudence deserve to be mentioned here. In a famous line of judgments which impacts the topic of this book, the CJEU forced Member States to adapt their tax systems in order to achieve neutral treatment of cross-border dividend payments.<sup>14</sup> Another set of judgments constrained the options for Member States to apply special anti-avoidance rules to controlled foreign companies.<sup>15</sup> Last, but not least, a number of cases dealt with issues of special rules on cross-border intra-group transactions under the heading of 'thin capitalization'<sup>16</sup> or the 'arm's length standard'.<sup>17</sup> This case law has created an important constraint on EU Member States' freedom in designing their domestic international tax regime although the Court seems to be currently less inclined to interfere with national tax sovereignty.<sup>18</sup>

## 1.2 Three central features

Despite the multiplicity of sources—domestic legislation and treaties—and the diversity of rules, it is possible to discern a basic framework underlying the existing regime. This framework has a number of features which combine to produce its particular character. We here focus on three central features: (i) the residence/source dichotomy; (ii) the distinction between different kinds of income; and (iii) the treatment of affiliates within a group of companies as separate entities.

<sup>13</sup> For a critical assessment of the jurisprudence of the Court in the area of non-discrimination, see Schön (2015).

<sup>14</sup> For a critical assessment of this jurisprudence see Graetz and Warren (2007).

<sup>15</sup> Case C-196/04, *Cadbury Schweppes*, judgment of 12 September 2006; Case C-201/05, *Test Claimants in the CFC and Dividend Group Litigation*, judgment of 23 April 2008; Case C-135/17, *X GmbH*, judgment of 26 February 2019.

<sup>16</sup> Case C-324/00, *Lankhorst-Hohorst*, judgment of 12 December 2002; Case C-524/04, *Test Claimants in the Thin Cap Group Litigation*, judgment of 13 March 2007; Case C-105/07, *Lammers & Van Cleeff*, judgment of 17 January 2008.

<sup>17</sup> Case C-311/08, *Société de Gestion Industrielle (SGI)*, judgment of 21 January 2010; Case C-282/12, *Itelcar*, judgment of 3 October 2013; Case C-382/16, *Hornbach Baumarkt*, judgment of 31 May 2018.

<sup>18</sup> For further discussion, see Schön (2015).

### 1.2.1 Residence and source

In Chapter 2 we set out four possible locations where multinational companies might in principle be taxed: the location of its shareholders, parent companies, affiliates, or customers. International corporation tax regimes adopt one or more locations, and this choice strongly influences the performance of a regime under our evaluative criteria. Under the existing regime, multinational companies are taxed primarily in the third location, but also in the second: namely, that of their affiliates and parent company respectively. This is achieved through the concepts of residence and source, which are thus central to the regime.

Under the existing regime, companies may be taxed on the basis of their ‘residence’ or the ‘source’ of their income. The international dimension of countries’ current corporate tax systems addresses whether and how to tax the foreign source income of domestic resident companies, and the domestic income of foreign resident companies. Companies can be—and at times are—taxed multiple times on the same income. But domestic legislation and DTCs tend to result in tax being levied—or at least, primarily levied—in either the country of source or residence.

Despite their central importance to the international tax system, the terms ‘residence’ and ‘source’ are used in different ways in tax debates and literature. This is discussed further in Box 3.1.

#### **Box 3.1 The different meanings of ‘residence’ and ‘source’—and introducing ‘origin’ and ‘destination’**

The terms ‘residence’ and ‘source’ can cause considerable confusion in public, academic, and tax policy debates, because they can be used with different meanings.

From a legal perspective, a country taxes on a residence basis when it taxes companies that are resident in that country for tax purposes on income arising in that or in another country. A country taxes on a source basis when it taxes companies that are not resident in that country for tax purposes on income deemed to arise in that country.

A subsidiary has a legal identity that is separate and distinct from that of its parent; and its residence is equally distinct from that of its parent. Suppose that company P, resident in country A, has a wholly-owned subsidiary, S, resident in country B. From a legal perspective, country B may then tax income accruing to S on a residence basis since S is resident in B, whether that income arises in B or elsewhere.

From a legal perspective, source taxation would arise when company P operates directly in country B rather than through a subsidiary. For example, if P operates in B through a branch, B can tax the income generated by the branch (and this income could in principle be identical to the income that would have been generated if the entity in B had been a subsidiary). But in this case, this

would be regarded as source taxation, since B would be taxing the income of P, a non-resident company, as the branch is not a separate legal entity. As discussed below, countries tend to tax non-resident companies on a source basis when the companies' activities in their territory meets a certain threshold, for example, the Permanent Establishment (PE) threshold. A branch meets the PE threshold.

Source country taxation would also arise, from a legal perspective, when subsidiary S pays a dividend to the parent P (or, more broadly makes specific payments, including interest or a royalty payments, to a non-resident) and country B levies a withholding tax on the payment. Since the recipient of the payment is not resident in country B, but the source of the payment is deemed to be B, then from a legal perspective this too is regarded as a form of source country taxation.

Economists and policy makers tend to take a broader perspective. Whatever the legal form of the affiliate in B, the *ultimate* beneficiary of the income generated is the parent company, P, resident in A.<sup>19</sup> Economists therefore tend to regard residence taxation of the underlying income as meaning that it is taxed by A. Any tax levied by B on income arising in B would then be a form of source country taxation, even if the income is earned by a subsidiary resident in B.

Note that part of the distinction here is the use of the term 'income'. In the economists' sense, income arising in S is part of the accrued income of P, irrespective of whether S actually makes a dividend payment to P. So any taxes levied outside the country of legal residence of the parent company (i.e. A) would then be considered as source country taxes, and it would not matter whether a payment was made by S, the entity in B.

For consistency, in this book we have tried to use the terms 'residence' and 'source' according to their legal meaning. Where we have not done so, we have made this clear.

We also make use of two different terms, taken from the academic literature on VAT: 'origin' and 'destination'. We use the term 'origin' to refer broadly to the location in which economic activity resulting in the production of the good or service takes place.<sup>20</sup> We use the term 'destination' to refer broadly to the location where a sale takes place. For example, suppose that the entity in country B—whether a subsidiary or a branch—undertakes some activity and exports the resulting good or service to another country, C.<sup>21</sup> Then we call B the 'origin' country and C the 'destination' country.

<sup>19</sup> Strictly, we should view the ultimate beneficiaries as the shareholders of P, who may be resident anywhere. However, thinking of residence in this sense is not common usage.

<sup>20</sup> For a thorough account of the 'origin' concept in the concept of tax treaties, see Kemmerer (2001).

<sup>21</sup> This is intended to be quite general. For example, suppose a lawyer in B provides advice by phone to a client in C; then B is the origin country and C is the destination country. However, even this distinction may not be clear-cut—for example, if the lawyer flies to C to provide the advice face-to-face, before returning home to B. Such distinctions may become important in designing taxes on a destination basis, as we discuss further in Chapters 6 and 7.

Note that a country can be simultaneously both an origin and a destination country. If the entity in B opens a shop in C selling goods to customers there, C would be an origin country due to the location of the shop, and a destination country due to the location of the customers. Under the existing system, taxing rights are not allocated to destination customers. In other words, the sale of a good or service in a country does not—in and of itself—lead to the allocation of taxing rights to that country. Such countries are only allocated taxing rights under the existing system if they also happen to be origin countries, as in this example.

### 1.2.2 Categories of income

A second feature of the framework is that the tax treatment afforded to a particular item of income often depends on its type.<sup>22</sup>

As a first step, it is helpful to distinguish between ‘active’ and ‘passive’ income (sometimes referred to as ‘business’ and ‘investment’ income). Passive income is defined by the OECD as ‘[i]ncome in respect of which, broadly speaking, the recipient does not participate in the business activity giving rise to the income, e.g. dividends, interest, rental income, royalties, etc.’<sup>23</sup> Active income, on the other hand, entails participation by the recipient in the business activity giving rise to it.<sup>24</sup> Whether a country is entitled to tax the domestic income of a foreign company or the foreign income of a domestic resident company under a DTC, and whether it does so under its domestic law, typically depends on whether the income falls in one category or the other. Each type of income can be—and generally is—subject to further distinctions. For example, the distinction between the returns to debt (interest) and equity (dividends) is also very important and has far reaching consequences for the international tax regime.

As explained below, very broadly, under the existing regime active income tends to be primarily taxed in the country of ‘source’ and passive income tends to be taxed primarily in the country of ‘residence’.<sup>25</sup>

### 1.2.3 Separate accounting

A third key feature of the framework is that subsidiaries within a multinational group are treated as if they were independent entities. This has profound

<sup>22</sup> It should be noted that the OECD Model Treaty is entitled the ‘Model Tax Convention on Income and on Capital’—rather than on ‘profit’. To follow the OECD convention this chapter therefore frequently refers to ‘income’, rather than ‘profit’. We use these terms interchangeably.

<sup>23</sup> OECD Glossary of Tax Terms.

<sup>24</sup> For an active business which earns revenue and pays a royalty, a licence fee, interest, or some other payment, then the notion of ‘active income’ is income net of these payments, which can be regarded as costs of the active business. Active income should be considered to be gross of dividend payments, however.

<sup>25</sup> See, for example, Avi-Yonah (1996) and Graetz (2001).



consequences. It means that even though multinationals operate as a single economic entity, when one part of a multinational transacts with another in a different jurisdiction, then for tax purposes they are treated as different entities. The contractual arrangements between them are recognized, subject to anti-avoidance legislation described below. As a result, the source/residence distinction and related rules are applied to them as if they were independent entities—again, subject to some modification. This is important: the contractual allocation of asset ownership, financial funds, and business risk to specific entities within a group therefore has major consequences for the allocation of taxing rights.

To see some of the consequences of this approach, suppose a parent company (P), resident in country A, pays interest to a wholly-owned subsidiary (S), resident in country B. From B's perspective a resident company (S) has received passive foreign source income which it is likely to tax under its domestic law. From A's perspective a resident company (P) has made a payment of interest; it is likely to allow P to deduct the interest from its taxable profits (although this could be limited under anti-avoidance rules). Furthermore, from A's perspective, domestic source income (the interest) is paid to a foreign company (S), which it might tax by means of a withholding tax. A DTC between A and B may limit or eliminate the withholding tax imposed by A.

For present purposes, the main point of this example is that transactions among subsidiaries have real tax consequences. One can easily see the profit shifting opportunities this presents. If A is a high tax country and B a low tax country, P can set up S in B for planning purposes. It can finance S through the purchase of new equity (which has no tax consequences), which then returns the same funds to P as a loan, thus completing a circular flow of funds. Careful tax planning can ensure that the interest is deductible from P's tax base and that A applies no withholding taxes on the interest payment. If this were successful, the multinational would have shifted profits from a high to a low tax country through relatively uncomplicated tax planning.<sup>26</sup>

As we shall see below, much effort has been expended in recent years in closing, or at least narrowing, such planning opportunities, but fundamentally the problem arises because of this third feature of the regime. The ability of multinationals to set up affiliates all over the world and to create any number of cross-border within-group transactions among them—possibly with little or no economic consequence from the multinational's perspective, but with a real and significant tax consequences—is at the heart of many of the problems faced by the existing regime.

<sup>26</sup> Since S is a subsidiary of P, it may pay the interest that it receives from P back to P as a dividend. This may in principle be subject to a withholding tax in B, and a tax on the receipt in A.

## 2. General trends in the current regime

Having set out some of the key features of the current regime, we can now describe it more directly. This is not intended to be a detailed description—if it were, it would take up many books rather than just a section of a chapter. Rather, it is intended to outline the main elements of the existing regime in enough detail to identify and understand its key problems. We begin with the basics of source-based taxation and residence-based taxation. We then describe some important elements of the regime that arise in response to two fundamental—and to some extent—conflicting policy goals. On the one hand, policy makers need to use a set of complex anti-avoidance rules to prevent profit being shifted to low tax countries. We describe some of the most important anti-avoidance rules: transfer pricing rules, interest deduction limitations, and controlled foreign company rules. On the other hand, policy makers concerned with real economic activity taking place in their country may also compete with other countries for inward investment. They may do so in various ways, as explained below, including reducing corporate tax rates and weakening anti-avoidance rules. Countries have to carefully negotiate the balance between these competing objectives.

### 2.1 Source-based taxation

Income deemed to arise in a country and accruing to a non-resident, may be taxed by that country on a source basis. In considering source-based taxation, we need to distinguish between the treatment of active and passive income. Active income is generally taxed in these circumstances only if the level of domestic activity producing it meets a specified threshold. For example, a company resident in country A is generally not directly taxed in country B on its active income arising in country B unless it has more than a minimal amount of activity there. The level of activity required and the nature of the test setting out the threshold varies from country to country under domestic law. Examples include carrying on a business activity in a country and having a ‘permanent establishment’ (PE) there.

The OECD Model uses the PE concept as a threshold—meaning that active income is allocated to the source country only if a non-resident company operates there through a PE. Following the OECD Model’s traditional definition, this PE threshold is based on the degree of physical presence. This is typically met in countries where the taxpayer has a production unit (e.g. a manufacturing or research and development facility) or a distribution unit (e.g. a sales office). But simply selling goods or services in country B does not—following the OECD Model—in and of itself create a PE in country B and, therefore, it does not give rise to corporate taxation in country B. Whether the threshold is met or not determines in

which country (and therefore at which tax rate) income is taxed. As a result, much tax planning has traditionally taken place around the threshold.

This threshold test has been criticized for being inadequate for many years, in particular by developing countries claiming taxing rights on income from inbound sales and services. Academics have long noted a slow but constant ‘erosion’ of the PE concept.<sup>27</sup> This tendency has been reinforced in the context of an increasingly digitalized economy. A company located in country A can now sell significant quantities of goods and services—digital as well as physical—to consumers in country B without having any physical presence in the latter. The lack of physical presence—and hence a PE—in country B prevents B from taxing the foreign company on a source basis. This has led to calls for a revision of the PE threshold. Some have called for a ‘digital’ PE;<sup>28</sup> others for change that would grant taxing rights to market countries in a more general fashion—even in the absence of a physical presence there.<sup>29</sup>

Under both domestic law and the OECD Model, once the necessary threshold is met, for example by a non-resident company establishing a branch in a particular country, complex rules are then necessary to determine how much income is attributable to the branch. Source taxation of income arising in a PE is restricted to taxing the share of the overall profit that can be attributed to the specific function (e.g. manufacturing or distribution) performed by the PE. For example, the opening of a sales office in a market country does not lead to the allocation of the overall business profit arising from these sales to that country. Rather, the principle is that the market country is entitled to tax the profit that can be attributed to the functions performed by the sales office.

The relevant rules for attributing profit to a PE under the OECD Model extend the third feature of separate accounting identified above.<sup>30</sup> For profit attribution purposes, PEs are treated as if they were separate entities, even if—from a legal perspective—they are not. Take the example of P, resident in country A, which opens a shop (and, therefore, has a PE) in country B. Country B can tax P—a foreign company—on the profit earned in country B on a source basis. Income is attributed to the PE in B by broad analogy with the income which an independent enterprise engaged in the same or similar activities under the same or similar conditions, would have earned taking into account the functions performed, assets used, and risks assumed by the enterprise through the PE. The UN Model Treaty, which attempts to serve the interest of developing countries, diverges from the OECD’s approach to profit attribution.

<sup>27</sup> See Skaar (1991).

<sup>28</sup> Hongler and Pistone (2015).

<sup>29</sup> Devereux and Vella (2014).

<sup>30</sup> For a critique of these rules see Collier and Vella (2019).

A different approach typically applies to ‘passive’ income. Passive income earned by foreign companies may be taxed by source countries through withholding taxes. That is, dividends, interest, or royalties paid by a company resident in country A to a resident in country B may be taxed by A through such taxes. The extent and detail of withholding tax regimes for passive income vary considerably from country to country, and different types of passive income may be treated differently. There is also a need to determine what the source of the income is, and source rules—which determine when such income is deemed to ‘arise’ in that particular country—also differ amongst countries. For example, some countries might deem royalties to arise where intellectual property (IP) is held, and others where the IP is used.

The OECD Model restricts source countries’ taxing rights over passive income. It allows source countries to impose withholding taxes on gross dividends and interest paid to non-residents but only subject to limits. Contracting countries may, and in practice often do, agree to lower withholding taxes below the limit permitted by the OECD Model or waive their right to impose withholding taxes on such items of passive income altogether. The OECD Model does not permit source-based taxation of royalty payments—but the UN Model does, with the aim of shifting taxing rights to developing countries which benefit from technology transfer from industrialized countries.

## 2.2 Residence-based taxation

### 2.2.1 Corporate residence

A country may also tax companies’ income on the basis of their residence. Much can thus turn on the tests for determining corporate residence. These tests fall into two broad categories. The first rely on formal legal criteria, such as the country of a company’s incorporation. The second rely on substantive criteria, such as the place of ‘management and control’ or the place of the ‘primary business location’. For example, the US relies exclusively on a place of incorporation test, but many countries, including the UK and Germany, now use both types of tests. To apply DTCs one must first establish in which country the relevant companies are resident; under the OECD Model this is done by reference to the domestic law of each contracting country.

Both types of test have clear limitations.<sup>31</sup> Formal tests can be easily avoided or even satisfied by ‘false claimants’, thus requiring further legislation to address both concerns. Substantive tests ought to be harder to avoid. However, they often boil down to a number of subtests or factors that can also be met at a manageable cost. The place of ‘management and control’ often ultimately translates into the place where the board of directors meets, meaning that this test can be satisfied by the mere expedient of jetting directors to the country of choice a number of times a

<sup>31</sup> See, for example, Shaviro (2011b) and Schön (2009).

year, ensuring that decisions are ‘taken’ at these meetings, and keeping a careful set of board minutes.

As a result of disparate domestic legal tests, companies might find themselves resident in more than one country, or none. A company incorporated in country A but having its central management and control in country B might be resident in the former under the domestic law of A, and resident in the latter under the domestic law of B. The opposite problem has also arisen where a company was deemed not to be tax resident in either country.<sup>32</sup> Some countries address the problem of dual residence through their domestic law. This may also be addressed through DTCs—previous versions of the OECD Model provided a tie-breaker: if a company was resident in both contracting countries according to their domestic laws, the company would be deemed to be resident in the country in which the company’s ‘place of effective management’ was situated. Some existing treaties employ different tie-breakers, and others do not provide one at all. In the latter case, there is often another clause in the treaty that sets out that the two countries must or shall endeavour to reach an agreement using the ‘mutual agreement procedure’ (MAP). This approach has been adopted in the 2017 version of the OECD Model.<sup>33</sup>

### 2.2.2 Residence tax on foreign source income

Under the existing regime, countries may either tax or exempt resident companies’ foreign source income. In the former case, the country may provide relief for the tax paid in the source country by allowing it to be credited against the tax due in the country of residence.<sup>34</sup> In practice, many countries adopt a mixed approach: taxing but allowing a credit for some forms of foreign income (mostly passive income) and exempting others (mostly business income, dividends from foreign direct investment, employment income, and income from immovable assets).

Depending on the tax rates in the two countries, a credit can wipe out the tax to be paid in the residence country altogether, meaning that the residence country will not actually collect any tax on certain items of foreign source income. The credit is typically not allowed to exceed the underlying tax due in the country of residence. Systems for providing credit can be extremely complex. Detailed rules are generally in place, for example, limiting the credit, setting out which foreign

<sup>32</sup> This was the case for an important subsidiary of Apple, see Ting (2014).

<sup>33</sup> The OECD Model provides the MAP as a mechanism for resolving differences or difficulties regarding the interpretation or application of the Convention on a mutually agreed basis. See OECD (2015d).

<sup>34</sup> Less commonly the tax paid in the source country can be deducted from the tax base in the residence country. Relief through deduction is less generous than through credit. Consider the following example. Company P, resident in country A, earns 1,000 of income in country B. The tax rates in A and B are 30% and 20% respectively. P pays 200 in tax to B. Under a credit system, P pays an additional 100 in tax to A (300 [1000 @30%] less a credit of 200); under a deduction system P pays an additional 240 in tax to A (1,000 less a deduction of 200 taxed at 30%).

taxes may be credited, whether credits may be pooled off-shore or on-shore, and whether they can be carried back or forward and used within a group.

In principle, exemption systems ought to be simpler—creating lower compliance costs for companies and administrative costs for revenue authorities—than a credit system. However, complexity is usually introduced in exemption systems because built-in protections are necessary to address concerns about profit shifting. ‘Subject-to-tax’ provisions and ‘switch-over’ clauses in treaties and domestic legislation make exemptions increasingly dependent on the tax treatment of commercial income derived from PEs, and other categories of income in the source country.

The widespread exemption of dividends from cross-border direct investment can also be exploited. For example, parent company P resident in country A could take advantage of an exemption system in A by setting up and financing through new equity a subsidiary S in low tax country B. S uses these funds to acquire IP and enters into licensing agreements with P for use of the IP. Royalty payments from P to S would normally lead to a deduction in A and a low tax payment in B. The income earned in this way can be returned to P through dividends that A will not tax under its exemption system. As noted above, a similar strategy may seek to strip income out of A through interest payments made to subsidiaries in B. Exemption systems often seek to guard against profit shifting opportunities of this kind through exceptions—such as limiting the application of the exemption to active foreign income—which invariably add complexity to the regime. They can also address such concerns through anti-profit shifting legislation, such as controlled foreign company rules, which are discussed below.

Countries are frequently said to operate either a *worldwide* or a *territorial* system of taxation. Of the thirty-four OECD countries, seven are said to operate a worldwide system, and twenty-seven a territorial system.<sup>35</sup> Countries could be understood to have worldwide systems if they tax resident companies on their domestic and foreign income, and countries could be understood to have territorial systems if they tax resident companies only on their domestic income. However, these terms can be very misleading, because categorization as one or the other often depends on whether a country taxes resident companies on their foreign source dividends.<sup>36</sup> To be more specific, this refers to a large extent to the issue of whether dividends from foreign subsidiaries are fully exempt or only convey an ‘indirect tax credit’ with regard to the underlying corporate tax paid in the subsidiary’s country

<sup>35</sup> Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Estonia, Finland, France, Germany, Hungary, Iceland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the UK, and the US operate a territorial system. Chile, Greece, Ireland, Israel, Korea, Mexico, and Poland operate a worldwide system; see Business Roundtable (2011)—as amended following the 2017 reform of the US corporate tax system.

<sup>36</sup> Although the term ‘worldwide’ is frequently used to mean that dividends received from foreign subsidiaries are taxed on receipt by the parent, it could also have a broader meaning that foreign income is taxed as it accrues, whether or not the income is repatriated to the parent.

of residence. The UK, for example, is usually said to operate a territorial system. It exempts (most) foreign source dividends and profits of foreign branches; however, it taxes other foreign source income, including interest and royalties (providing a credit for foreign tax paid). Categorizing the UK system as territorial is thus somewhat of a misnomer.

This is not to say that the treatment of foreign source dividends is not important—it clearly is. But note also that in practice exemption and credit systems can produce tax results that are substantially similar. Under exemption systems, if a company sets up a subsidiary in a foreign country, income earned by the subsidiary will not be taxed by the parent's country of residence, either when it is earned by the subsidiary or when it is paid up as a dividend. Under credit systems, such dividends will be taxed by the parent's country of residence only when they are distributed to the parent—and then a credit will generally be given for taxes paid in the subsidiary's country of residence. This may—depending on the expectations of tax rates in both countries—create an incentive for the foreign subsidiaries to delay paying dividends back to the parent.<sup>37</sup> Prior to its 2017 tax reforms, the US employed a 'worldwide' system with deferral. Under this system, profits paid by foreign subsidiaries to their US parents as dividends were subject to US tax. As a result, US multinationals delayed dividend payments and instead held trillions of dollars in foreign subsidiaries. In terms of US tax revenue, this approach therefore produced substantially similar tax results to an exemption system.

Both credit and exemption systems give multinationals incentives to hold passive income-generating assets, such as IP, in low tax countries. Under exemption systems, subsidiaries can simply pay the income earned by such foreign subsidiaries to the parent as exempt dividends. Under credit systems multinationals may keep the income generated by such assets in the offshore subsidiaries, although they might be able to make use of it creatively. For example, the parent may be able to borrow domestically against the retained earnings held by foreign subsidiaries, although many countries have sought to address this issue, with varying degrees of success, through anti-avoidance rules. Some supporters of worldwide systems argue that deferral should be eliminated, and parent companies should tax the income of foreign subsidiaries on an accrual basis. This would constitute a significant change from the broad parameters of the existing system, although a form of taxation of accrual has now been implemented in the US with its GILTI provision, and the OECD/G20 Global Anti-Base Erosion (GloBE) proposal would also introduce taxation on accrual. We consider this reform option in Chapter 4.

<sup>37</sup> Strictly, if the company believes that tax rates will not change, and that profit can only be paid to the parent through a taxed dividend, then there is no incentive to delay dividend payments, since the value of the dividend paid will always be reduced by tax at the same rate. If, however, the company believes that the tax rate may fall, then there is an incentive to delay. See Hartman (1985).

## 2.3 Broad patterns

A broad pattern emerges when taking a step back and viewing individual countries' domestic international corporate tax rules as a whole. Active income tends to be (primarily) taxed in the source country once a threshold of activity is met. There is less clarity on the taxation of passive income. Some countries impose withholding taxes on passive income paid to non-resident companies; however, others do not tax certain forms of passive income or tax it at a low rate. As noted above, for example, EU directives eliminate this type of taxation amongst associated companies of EU Member States under certain conditions. Countries tend to tax foreign-source interest and royalties received by resident companies—and give a credit for taxes paid in the source country—but an increasing number of countries exempt (at least some) foreign source dividends and active income generated by overseas PEs.

A clearer overall pattern emerges, both in terms of consistency and universality, once DTCs are overlaid onto domestic tax regimes, particularly as they uniformly tend to limit the scope of source-based taxation of passive income. Broadly and generally, treaties tend to allocate active income to the source country and passive income (primarily) to the residence country. However, this is not to say that there are no differences between treaties; treaties do depart from the OECD Model. Furthermore, there are many pairs of countries that are not covered by a bilateral treaty.

## 2.4 Anti-avoidance rules

The fundamental structure of the existing system makes it susceptible to avoidance. A system employing the separate entity approach, where the tax paid by a multinational group on its global profit depends on the terms of the transactions between different entities within the same group, clearly requires significant policing to limit manipulation. Over the years, countries have adopted reams of anti-avoidance legislation, often of mind-boggling complexity.

By way of example, this section describes three prominent anti-avoidance rules: rules regulating transfer pricing, controlled foreign company (CFC) rules, and rules limiting the deductibility of interest payments. Many countries have operated such measures—domestically and through treaties—for a number of years. The OECD/G20 BEPS project—discussed further below—sought to bolster existing measures and to increase the number of countries operating them.

### 2.4.1 Transfer pricing rules

As seen above, a separate accounting approach is used for international tax purposes meaning that tax rules are applied separately to each company within a



multinational group, even when these companies are transacting with one another. If, for example, a company (P) in country A pays a royalty to a wholly-owned subsidiary (S) in country B, A is designated as the source country and B as the residence country and the latter is broadly allocated the right to tax the royalty income. This system is manifestly susceptible to manipulation because these companies are under common control. Profits can be shifted from one country to the other by creating and mispricing within-group transactions. In our example, inflating the royalty payment reduces taxable income in country A and increases it in country B, which benefits the multinational if the tax rate in the former is higher than in the latter.

This opens the door to extensive problems, which the OECD Model seeks to address through the arm's length principle (ALP). The basic premise of the ALP, which is also adopted by many countries in their domestic legislation, is that within-group prices should be aligned with the prices that would have been charged between independent parties. The underlying rationale is that the prices charged by independent parties are determined by market forces and thus untainted by manipulation. This simple principle may seem both justified and straightforward to operate. In fact it is neither.

The approach is not necessarily persuasive at a conceptual level, largely because companies within a group differ from independent parties in a number of respects.<sup>38</sup> For example, a multinational group can choose whether to produce an intermediate good used in production through a wholly-owned subsidiary or a joint venture, or to buy it from an independent party. In principle, the multinational would choose the most profitable approach. As long as the overall profit earned differed amongst the three approaches, the 'true' price of the intermediate good is likely also to be different. Another, well-understood, example is that synergies arise from running a business through an integrated multinational group.<sup>39</sup> That is, in some cases the multinational can make higher profit because it is multinational. Transactions between subsidiaries are not necessarily the same as transactions between unrelated parties.<sup>40</sup>

But even if the ALP is thought to be a reasonable approximation, it can be difficult to apply in practice. The OECD thus produces guidelines (Transfer Pricing Guidelines) that are extremely—and increasingly—complex to expound its operation. At their core are five recommended methods for reaching an arm's length price: the comparable uncontrolled price (CUP), resale price minus, cost plus, profit split, and transactional net margin method. The CUP approach employs the price charged on comparable transactions between independent parties and thus reaches what can be easily understood as an arm's length price. The other

<sup>38</sup> See Vann (2010) and Schön (2012a).

<sup>39</sup> This point is elaborated in Kane (2014).

<sup>40</sup> For a fuller discussion see, for example, Keuschnigg and Devereux (2013).

methods are deemed to be reasonable alternatives when a CUP cannot be found since certain types of transaction or classes of assets, intangibles being a notable example, are simply hard to value. But these methods clearly move away from the principle of an ‘arm’s length’ price. For example, the profit split approach<sup>41</sup> is based on estimating a reasonable level of profit in each of the transacting parties; in practice, this comes much closer to allocation by formula rather than by an arm’s length price.<sup>42</sup>

In practice, the ALP approach can justify wildly varying prices, thus creating uncertainty and undermining its legitimacy. Overall, it is fair to say that the ALP does not provide a satisfactory answer to the transfer pricing problem.<sup>43</sup>

The treatment of risk under the ALP provides an instructive example of its inherent conceptual difficulties and limitations.<sup>44</sup> Risk is an important factor in determining the expected return required by independent parties when contracting. If a party assumes a high risk, she generally requires a higher expected return as compensation for the greater risk borne. In a contract between separate parties, the party taking on more risk would generally therefore require a higher rate of return to compensate for the higher risk. However, this reasoning does not carry over to the context of contracts between entities in the same group. It is simply not economically meaningful to speak about risk being allocated to one or the other wholly-owned affiliate in such a case (certainly as long as third parties, such as creditors or insurers are not involved). Ultimately risk is borne by the shareholders of the multinational, and this does not change by locating risk in one subsidiary over another.

Unsurprisingly, multinationals have used this feature of the regime for tax planning purposes. Profits of successful businesses could relatively easily be located in low tax countries by contractually allocating risk to affiliates in these countries. Indeed, in the years preceding BEPS risk allocations were ‘at the heart of much tax avoidance planning’.<sup>45</sup> The BEPS Action Plan attempted to address this issue by allocating profit, at least in part, to the location of the people within the multinational group ‘controlling’ risk, rather than the location of the contractual risk.<sup>46</sup> We discuss the issues this approach raises below.

#### 2.4.2 Interest deduction limitation rules

Within-group debt provides another significant tax planning channel. As seen in the examples given above, profit can be shifted from a high to a low tax

<sup>41</sup> OECD (2018d).

<sup>42</sup> Formulary apportionment is described and evaluated in some detail in Chapter 4..

<sup>43</sup> See, for example, Avi-Yonah (1995); Avi-Yonah and Benshalom (2011); and Collier and Andrus (2017). For empirical evidence see, for example, Lohse and Riedel (2013).

<sup>44</sup> For a more detailed discussion, see Devereux and Vella (2014); and Schön (2014).

<sup>45</sup> Durst (2012), page 285.

<sup>46</sup> OECD (2015c).

country through an interest payment from an entity in the former—for which it receives a deduction—to an entity in the latter—where it is taxed. Limitations on interest deductibility are found in many countries to address this profit shifting channel. Under these rules, interest deductions can be limited by reference to a variety of tests, for example, ranging from the ALP to fixed ratios such as equity to debt, interest to assets, or interest to EBITDA<sup>47</sup> ratios. These limitations are commonly known as ‘interest barriers’ or ‘thin capitalization’ rules.<sup>48</sup>

### 2.4.3 Controlled foreign company rules

CFC rules were first introduced by the US (known as ‘Sub-Part F’) in the 1960s and have since been adopted by many other countries. Under these rules the (generally passive) income of subsidiaries located in low tax countries can be taxed in the hands of domestic parents, even if such profits have not been distributed to the parents in the form of dividends or realized in the form of capital gains. CFC rules could address, for example, a strategy based on locating IP in low tax countries. If parent company P, resident in high tax country A, transfers its IP to subsidiary company S, resident in low tax country B, robust CFC rules could allow A to tax the income from royalties received by S in B on accrual, thus defeating this profit-shifting strategy. CFC rules vary in their breadth, partly to reflect the international tax policy of the country in question.<sup>49</sup> Action 3 of the OECD/G20 BEPS Action Plan urged countries to introduce CFC legislation, and the EU’s Anti-Tax Avoidance Directive has turned this recommendation into an enforceable mandate in Member States. Yet CFC legislation has its own constraints, even in the EU: according to a consistent jurisprudence of the CJEU, CFC legislation has to focus on clearly abusive structures, so-called ‘artificial arrangements’, which does not include shifting real investment abroad.<sup>50</sup>

## 2.5 Competitive features of a corporate tax regime

Countries balance conflicting goals when setting their domestic international tax policies. On the one hand, they seek to raise revenue from taxing cross-border income and to clamp down on perceived avoidance activity. On the other hand, they seek to attract real economic activity—and mobile profit—by competing along

<sup>47</sup> Earnings before interest, taxation, depreciation, and amortization.

<sup>48</sup> As we discuss below, there is empirical evidence that thin capitalization rules affect choices about internal and external debt. See, for example, Büttner et al (2012) and Blouin et al (2014).

<sup>49</sup> Evidence on the impact of CFC rules is provided by Büttner and Wamser (2013); Egger and Wamser (2015); and Clifford (2019).

<sup>50</sup> Case C-196/04, *Cadbury Schweppes*, judgment of 12 September 2006; Case C-201/05, *Test Claimants in the CFC and Dividend Group Litigation*, judgment of 23 April 2008; Case C-135/17, *X GmbH*, judgment of 26 February 2019.

a number of dimensions with one another, including cutting tax rates, allowing their tax bases to be eroded and facilitating the erosion of other countries' bases. Countries strike this balance in different ways; some countries appear to move aggressively in both directions simultaneously.

The most visible source of international competition is the headline corporate tax rate, which has fallen steadily in many countries over time, as shown in Figure 1.2 in Chapter 1. Countries also compete through tax rates for particular types of income. Patent box regimes, for example, essentially offer reduced tax rates on income generated by IP and were the subject of much attention during the BEPS process. Both the OECD and EU countries agreed on the 'nexus standard' which tries to link the preferential tax treatment of intangible income to 'real' activities in the field of research and development.<sup>51</sup>

However, the terrain over which countries compete also includes substantive rules affecting the tax base such as capital allowances, and, perhaps less obviously, anti-avoidance rules. Strong anti-avoidance rules can weaken a country's competitive position by raising the effective tax burden on activities operating within its jurisdiction. This is particularly true when countries compete for 'headquarters functions', trying to attract the seat of the parent company of a multinational enterprise. As a result, some countries either do not introduce certain common anti-avoidance rules (e.g. CFC rules) or introduce weak versions. This might be to the detriment of other countries too. For example, in 1997 the US introduced 'check-the-box' rules which substantially weakened its Sub-Part F (CFC) rules as applied to certain types of passive income, thus allowing US multinationals to set up structures, such as the notorious Double Irish Dutch Sandwich, to shift profits to favourable jurisdictions. Similarly, the UK Finance Company Partial Exemption regime introduced in 2013 as part of the reform of the UK CFC rules, facilitated the shifting of profits by UK multinationals from high to low tax countries.<sup>52</sup> Whether the BEPS project marks a sea change in countries' willingness to compete along this dimension is discussed further below.

## 2.6 Resulting allocation of taxing rights

This section has described the basic structure of the existing system in relatively simple terms. But the system is not simple, and this description constitutes a mere starting point in understanding its operation. Many of the rules mentioned above are tremendously complicated, and their detail is unknown to all but those who engage with them on a regular basis.

<sup>51</sup> OECD (2015c).

<sup>52</sup> On these rules see Devereux and Vella (2014).

Ultimately, the tax due by a multinational on its profits, and its allocation among different countries, is determined following the combined application of several of the rules described above, and many more. An example makes this point. Suppose a multinational enterprise has its headquarters and parent company in country P; shareholders in country S; a manufacturing subsidiary in country M; owns intangible assets in a subsidiary situated in a low tax jurisdiction L; and sells products to consumers in country C.

Under the existing system, the company may pay tax on its profit in some or all of countries P, M, L, and C—and shareholders may pay additional tax in S—depending on the precise nature of the arrangements and the specific rules (domestic and treaty-based) in force. Different outcomes are possible depending on these two factors.

The subsidiary resident in M would generally pay tax in M on the profits it generates. However, suppose that the manufacturing subsidiary paid a royalty to the subsidiary in L owning the intangible asset—this could be for IP used in production, for example. This would allocate profit from M to L, since the royalty would be deductible in M and taxable in L. On the other hand, transfer pricing rules might restrict the impact of such profit re-allocation. If the IP had been developed in a country other than L—say P—there might also have been tax paid on the transfer to L, and again transfer pricing rules would attempt to police the within-group price charged. If P operated robust CFC rules, the profits arising in the subsidiary resident in L might then be taxed in the hands of the parent in P.

As there is no subsidiary in C, the subsidiary in M sells products directly to consumers in C. The question then becomes whether the subsidiary in M is operating in C through a permanent establishment (PE), which in turn depends broadly on the physical presence of the company's employees in that country. If M's operations in C do constitute a PE, then part of the profit of the manufacturing subsidiary in M would be allocated to C for tax purposes. If not, C does not tax any of the profits arising from the sales.

Finally, if a dividend is paid to the parent company in P, then there may also be a withholding tax levied in M on the dividend from M, as well as a tax on P on the receipt of that dividend, usually after receiving a credit for taxes paid elsewhere.

The allocation of taxing rights thus depends on the specifics of the arrangements and the particular rules governing them. Taking a step back, however, can we provide a high-level picture of how a multinationals' overall profit is divided among countries? As a starting point, and as noted above, we can see that out of the four possible locations for taxing multinationals' profit set out in Chapters 1 and 2—the locations of the ultimate shareholders, parent company, affiliates, and customers—the existing system primarily allocates rights to tax the profit of the multinational to the origin country, where the affiliates are located. The country where the parent company is located also might be allocated taxing rights through the application of CFC rules. Note that while taxing rights might be allocated to the country where

customers happen to be located (the market or destination country) this would only be because an affiliate (PE) is located there. The mere presence of customers does not lead to the allocation of taxing rights to that country.

How then are taxing rights allocated amongst the countries where the parent and the various affiliates are located? One could start by saying that income is allocated among countries where the activity generating the income takes place—either because the multinational operates there through a company or through a PE. But the limits of this descriptive statement are easily shown.<sup>53</sup> As seen above, countries can tax resident companies on their foreign (passive) income even if no real activity takes place in the country of residence. And this simple picture may be further complicated, even undone, through careful planning. A substantial portion of a multinational's profits may be allocated to a low tax jurisdiction even if little real activity takes place there. Anti-avoidance rules had for some time sought to counter this outcome. However, by 2013 they had been deemed to be insufficient, leading to the OECD/G20 BEPS project. That large-scale project did, in fact, narrow some important loopholes in the regime, but did not eliminate the problem. It is to the BEPS project that we now turn.

### 3. The BEPS project

The OECD/G20 BEPS project was heralded in 2015 as the 'first substantial—and overdue—renovation of the international tax standards in almost a century.'<sup>54</sup> However, and despite reference in its early documentation to the importance of re-visiting 'some fundamentals',<sup>55</sup> the project ultimately had the relatively limited goal of addressing the perceived excesses of multinationals' tax planning. It did not aim to alter the existing system's fundamental framework; neither was it 'directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income.'<sup>56</sup>

But its failure to address countries' discontent over the current allocation of taxing rights—which ultimately is the main purpose of the international tax system—was bound to re-open the question of reform. Soon after the conclusion of the BEPS project the OECD noted that 'BEPS measures do not necessarily resolve the question of how rights to tax are shared between jurisdictions, which is part of the long term issue.'<sup>57</sup> Unsurprisingly, further reform proposals were put forward and are currently being considered. These proposals do alter the allocation

<sup>53</sup> See Section 3.2.

<sup>54</sup> OECD (2015e), p. 3.

<sup>55</sup> OECD (2013a), p. 8.

<sup>56</sup> OECD (2013b), p. 11.

<sup>57</sup> OECD (2018a), p.1.

of taxing rights among countries, if only to a limited extent. At the time of writing, it is not clear whether these proposals will be adopted, and if so, what their precise content will be. We discuss this further in Section 5 of this chapter. Here, we look at the BEPS project and the changes it brought.

### 3.1 The road to BEPS

The history of the BEPS project can be traced back to the OECD's report on 'harmful tax competition' published in 1998.<sup>58</sup> In that report, the OECD went beyond its traditional remit of technical work on double taxation and addressed the interaction between tax competition amongst countries and corporate tax planning. The OECD drew a distinction between what it perceived to be two types of tax competition. It argued that 'harmful' tax practices include those that are either operated by 'tax havens' or 'ring-fenced'<sup>59</sup> in favour of foreign investors and which grant preferential treatment to highly mobile tax bases like financial assets and services. On the other hand, a country's strategy to create a generally friendly tax environment that even-handedly benefits foreign and local investors and does not distinguish between different kinds of taxable activity was considered to be acceptable as part of sound tax competition.

This distinction between 'good' competition for substantial activity and 'bad' competition for purely tax driven arrangements was taken up elsewhere, in particular in the tax policy work of the European Union.<sup>60</sup> The EU Member States agreed on the 'Code of Conduct for Business Taxation' in 1998 which introduced both a standstill and a rollback of 'harmful tax measures', where the assessment of whether a measure was harmful depended on (among other things) 'whether advantages are granted without any real economic activity and substantial economic presence within the Member States offering such tax advantages'.<sup>61</sup> Similar references can be found in the jurisprudence of the CJEU on the Member States' right to fight abusive tax planning. And in recent years, the European Commission has extended this mission for 'good tax governance'<sup>62</sup> to non-EU countries.

The idea that tax competition between countries to attract economic activity is in some way 'good' is highly questionable. To the extent that lowering the tax rate in one country reduces economic activity in another, then that creates a negative impact—what economists call a 'negative externality'. This represents a social cost of the policy which is generally not taken into account by the tax-cutting

<sup>58</sup> OECD (1998).

<sup>59</sup> OECD (1998), para. 62.

<sup>60</sup> The legal perspective of tax competition in Europe is laid out by Schön (2000).

<sup>61</sup> European Council (1997), para. B.3.

<sup>62</sup> European Commission (2009).

government. The result of such competition is that tax rates on corporate income are lower than governments would otherwise choose. Unless one believes that governments would otherwise systematically choose tax rates on corporate income that are too high, this constraint on government choices is unlikely to be ‘good’ or ‘sound’. It is hard to escape the conclusion that at the time there was simply not enough political will to address this issue, which would have required considerably greater coordination between countries; and so the OECD and EU actions focused on low tax jurisdictions.

However, there is little doubt that what the OECD and the EU regard as ‘harmful’ tax competition is indeed also harmful to other countries. The opportunity to shift profit to a low tax jurisdiction where there is little or no economic activity undermines the tax base in other countries. This is, of course, a direct result of the very structure of the international tax system, where the overall tax paid by a multinational depends on intra-group cross-border transactions. We described this structure in broad outline above. As long as it is possible—for example—to set up affiliates in low tax jurisdictions which license IP, lend, or assume other business risks in relation to other affiliates, then the basic rules will identify profit as arising in such jurisdictions. Given this fundamental approach, it becomes difficult to prevent profit being located in those jurisdictions. Yet this is precisely what the BEPS project aimed to do.

### 3.2 BEPS: target, guiding principle, and actions

The BEPS project was launched in 2013 in response to the public and political clamour over the tax planning activities of multinationals. Unprecedented press coverage of these activities and campaigning struck a chord at this particular point in time; possibly because of broader factors, including perceptions of fairness in a period characterized by the lingering effects of the 2007–08 global financial crisis and increased awareness of rising inequality among income groups.

In its 2013 BEPS Action Plan the OECD reached the conclusion that:

Fundamental changes are needed to effectively prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it... A realignment of taxation and relevant substance is needed to restore the intended effects and benefits of international standards, which may not have kept pace with changing business models and technological developments.<sup>63</sup>

<sup>63</sup> OECD (2013b), p. 13.



The guiding principle adopted by the BEPS project—and which, to some extent, harked back to the OECD's earlier work on harmful tax competition—was that 'profits are taxed where economic activities generating the profits are performed and where value is created.'<sup>64</sup> Guided by this principle, the substantive actions produced by the BEPS project sought to address specific tax planning channels (hybrid mismatch arrangements, debt contracts, patent boxes, treaty abuse, planning around the PE threshold, and transfer pricing) to better align taxing rights and value creation.

In a remarkably short space of time, the principle that taxing rights should be aligned with value creation has become widely accepted as the guiding principle for taxing business profit in an international setting. The OECD, the EU Commission, some Finance Ministries, academics, and even multinational companies regularly repeat the mantra that profits should be taxed where value is created. The principle has popular appeal, perhaps because it appears to follow an intuitive understanding of fairness. In Chapter 2 we set out the difficulties in using fairness as a criterion for designing a system to tax business profits in an international setting. We here set out five additional reasons to question this principle.<sup>65</sup>

First, the existing system does not follow the principle. As we have discussed, under the existing system countries tax foreign profits earned by resident companies, for example, even if value is not created in the country of residence. Perhaps the issue here is that the BEPS guiding principle did not properly track the specific problem BEPS was designed to address: 'no or low taxation . . . when it is associated with practices that *artificially* segregate taxable income from the activities that generate it.'<sup>66</sup> Note that this implies that that taxable income can be segregated from the country where it is generated—for example through the payment of cross-border royalties or interest, as long as it is not done 'artificially'. Of course, this requires a workable distinction between 'real' and 'artificial', which can be difficult, even impossible, especially in the context of within-group finance and other types of business risk allocation. Long-standing allocation rules with regard to 'passive income' do not follow the 'value creation' concept and have never done so.

Second, BEPS did not seek to redesign the existing system following this principle; it simply adopted rules that—in some cases—better aligned the system with the principle. Tax planning has not become impossible or useless, but it has largely become more costly in terms of the 'frictions' confronted by taxpayers.<sup>67</sup> The result has been an even less coherent and principled, and more complex, system.

<sup>64</sup> OECD (2014a), p. 4.

<sup>65</sup> See the discussion in Devereux and Vella (2014, 2018b) and Hey (2018).

<sup>66</sup> OECD (2013b), p. 10 (emphasis added).

<sup>67</sup> The concept of legal 'frictions' which make tax planning more costly, has been developed by Schizer (2001).

Third, the principle focuses exclusively on the supply side; no value is deemed to arise in the market jurisdiction. This reflects the operation of the existing system; it ignores the market and is based, instead, ‘on a determination of how different activities *by the firm* contribute to [the multinational’s] profits.’<sup>68</sup> In Chapter 4 we question the rationale for allocating taxing rights over a multinational company’s profit only to countries where its functions and activities take place. Here we merely note that a notion of ‘value creation’ that ignores the market is not sufficiently comprehensive. The corporate profit being taxed requires a market just as it requires the various parts of a supply chain. The profit is dependent on the price charged at the point where supply and demand meet; it simply would have not arisen in the absence of a market.

Fourth, even when it is possible to identify the countries where activities creating value take place, it is extremely difficult to establish *how much* value is created in each country.<sup>69</sup> But the latter is necessary for setting up and operating a tax system that follows this principle. This is true of companies operating in the traditional economy, but it is even more so in a digitalized economy. As the EU Commission explained: ‘[i]n a digitalised world, it is not always very clear what that value is, how to measure it, or where it is created.’<sup>70</sup> It is therefore not surprising to find strong disagreement among countries, and even businesses, as to whether certain factors generate value, let alone how much. But it does seem surprising that despite this, the EU Commission—and the OECD—persist with this principle to guide the design of a tax system in the age of digitalization.

It might be argued that the principle should be understood as providing a negative prescription: that profit should *not* be taxed where *no* value is created, or no real activities take place. In this case, the point of the principle is to deny that profit is generated in low tax jurisdictions which have little or no real activity. This may be a reasonable point, but it is a different principle. Its proponents frame the value creation principle in positive terms to provide guidance on sharing profit among countries where value is deemed to be created. Proposals by the EU Commission and the UK Treasury for taxing highly digitalized businesses, for example, explicitly sought to allocate taxing rights over these businesses’ profit in proportion to the value created by their users.<sup>71</sup>

Fifth, for the reasons discussed in previous chapters and also further below, a system which taxes profit where value is created—or where economic activities take place—distorts the location of activities; in turn this intensifies competition, is not incentive compatible, and hence is unstable in the long run.

<sup>68</sup> OECD (2019a), p. 12 (emphasis added).

<sup>69</sup> For further discussion see, for example, Devereux and Vella (2017) and Schön (2018).

<sup>70</sup> EU Commission (2017), p. 7.

<sup>71</sup> HM Treasury (2017, 2018) and EU Commission (2018c). See also the Gaspar Committee (2014).

### 3.3 BEPS and the allocation of taxing rights

Despite not being directly aimed at doing so, BEPS changed the allocation of taxing rights among countries *to some extent*. In particular, consistent with its aims, it made it harder for low tax countries to be allocated taxing rights over income in the absence of real activity.

The BEPS Action Plan attempted to water down the relevance of concepts like ‘ownership’, ‘contracts’, ‘funding’, and ‘risk’ for within-group profit allocation.<sup>72</sup> Under pre-BEPS rules, as set out above, profits could be shifted through careful contracting, including locating the ownership of assets and risk in particular affiliates, and within-group funding. BEPS actions sought to alter the system so that taxation more closely follows ‘real activity’ and ‘value creation’ instead, thus reducing the allocation of taxable income to low tax jurisdictions where no, or little, ‘economic substance’ is to be found.<sup>73</sup>

The policy can be seen in play in a number of BEPS Actions. Action 2, for example, addressed hybrid mismatch arrangements (HMA), which were used by companies to exploit arbitrage opportunities arising from differences in countries’ tax rules. HMA generated deductions that could ‘artificially’ shift profits away from the countries where the value creating activities were deemed to take place. Action 4 proposed interest limitation rules, which limit companies’ ability to use ‘excessive’ interest payments to shift profits away from countries where value creating activities were deemed to take place. Action 5 addressed patent box regimes that offered lower tax rates on income generated by patents resulting from research and development (R&D) undertaken in a different country. This proposal sought to align taxing rights over the patent income with the activity (R&D) that created it.

This policy is most clearly visible in the work on transfer pricing under Actions 8–10 of the BEPS Action Plan. Post-BEPS the real allocation of assets and the actual performance of business functions and the control of risk by real people on the ground has become a key factor for international tax allocation. Consider the case, for example, in which a multinational subsidiary resident in a low tax country assumes risk on a contractual basis, for example by funding R&D activities performed by another group company in a high tax jurisdiction, and where the return earned by the company undertaking the R&D is determined as a simple mark-up on costs. According to the relevant OECD/G20 BEPS report, the resulting income should not be allocated to the low tax subsidiary simply on the basis that this entity funds the activity, owns the relevant assets, and bears the financial risk of failure.<sup>74</sup> Instead, the BEPS project moved towards the allocation of income being based on the active performance of tasks, for example, the presence of people obliged

<sup>72</sup> OECD (2015e) Annex A, p. 15.

<sup>73</sup> Saint-Amans and Robert (2015).

<sup>74</sup> OECD (2015c).

and able to ‘control’ the risk in a meaningful manner.<sup>75</sup> Practically speaking, there has to be a sufficient number of ‘experts’ present in the low tax country to justify the assumption of risk by the local subsidiary.<sup>76</sup> It is very clear that this approach will frequently clash with the within-group allocation of asset ownership and financial risk to separate subsidiaries under property law and contract law. Against this background, current OECD work favours an intensified policy to partially re-characterize or even completely disregard existing contracts and asset allocations between affiliated companies.<sup>77</sup>

This incremental change of paradigm has met with a lot of support among the governments of OECD countries, and has recently been strongly endorsed by the European Commission,<sup>78</sup> but it is itself subject to major criticism.<sup>79</sup>

First, it undermines the fundamental approach of the international tax system based on separate entity. This is clearly based on the notion that a subsidiary of a multinational company should be treated as if it were an independent entity. In this case, factors like ownership, funding, contracts, and risk are important in determining the taxable income of the subsidiary—consistent with defining income in terms of ownership and contracts, and not from ‘activity’. Of course, as already identified, this approach does offer multinationals the opportunity to organize the contractual relationships between their affiliates in such a way as to make profit appear in low tax jurisdictions. It would therefore perhaps be reasonable to acknowledge the problems of the basic system and define a new set of principles; but this is not the approach of the BEPS project. Instead, it sought to layer a new principle, and new rules, on top of existing principles in, what is in effect, a pretence that there had been no change.

Against this background, criticism should not go against the value of concepts like ownership, contracts, funding, and risk for international income taxation in general. It should be accepted that between independent parties these legal relationships are central in determining the allocation of profit. Rather, it makes sense to doubt the value of these concepts for the tax treatment of within-group relationships of multinational enterprises in particular. But this is not the result of the work done on BEPS.

To give a simple example outside the context of multinational enterprises: nobody would seek to tax an agent on income produced by her work on behalf of her principal simply because the agent performs the ‘real activity’ while the principal simply ‘funds’ the activity and ‘owns’ the resulting income.<sup>80</sup> This is because

<sup>75</sup> See Bilaney (2016).

<sup>76</sup> Verlinden et al (2016), p. 111, rightly note that ‘control’ in this sense is regularly scattered among different levels in the hierarchy of the firm.

<sup>77</sup> See Hickman (2016). For a critical view see Schön (2014); Verlinden et al (2016), p. 113; and Wittendorff (2015), p. 461.

<sup>78</sup> European Commission (2015).

<sup>79</sup> IMF (2014), para. 59 fn.79.

<sup>80</sup> See Boidman and Kandev (2015).

the income is in no way related to any ‘activity’ as such and rather relies on the ownership of the underlying capital assets and the receipt of the resulting income. Instead, it is natural to tax the principal on the income that she receives.

To make one last point in this context: business profit may be derived from a combination of capital and labour. The return to labour is generally taxed where labour is performed. It does not follow (as the BEPS Action Plan seems to suggest) that the remuneration for the provision of capital flowing to the capital owner should be taxed in the same place—simply due to the fact that this is where the ‘real activity’ is performed by the labour force. The same can be said for an allocation of the capital income on the basis of where ‘real’ assets are used. Thus, a new standard for profit allocation based on the central notion of ‘economic activity’ is evidently out of sync with long-standing treaty practice and does not provide a solid basis for future international tax reform.

## 4. Evaluating the current regime

In Chapter 2 we set out five criteria to evaluate different systems for the international taxation of corporate income: economic efficiency, fairness, robustness to avoidance, ease of administration, and incentive compatibility. We now turn to an evaluation of the current regime based on these criteria. In subsequent chapters we evaluate a number of reform proposals using the same criteria.

### 4.1 Economic efficiency

In Chapter 2 we set out the main issues regarding the economic welfare costs arising from economic inefficiencies in both the domestic and international taxation of business profit. As we noted there, the existing international corporate tax regime distorts corporate choices in a number of dimensions—and these distortions are likely to create a reduction in economic welfare for global society as a whole. For example, if, for tax reasons, a business is induced to choose a more costly location for its activities, then those higher costs reflect a cost to society; they are likely to be reflected in higher prices for consumers, lower income for employees, or lower post-tax income to the business owners. Similarly, projects that are worth undertaking in the absence of tax may become uneconomic in the presence of tax; the value of those projects would then be lost to society.

#### 4.1.1 Measuring economic inefficiencies

Policy makers may reasonably ask how important economic inefficiencies are—what estimates are there of the size of economic cost (the ‘excess burden’ or ‘deadweight loss’ of the tax) and hence its importance relative to, say, distributional

concerns. There is now a considerable body of economic evidence that the existing tax system affects the choices of business. In general, the more sensitive behavioural choices are to prices and taxes, the higher is likely to be the excess burden.

A starting point for evaluating the excess burden resulting from distortions to different types of business decision is that taxes on profit tend to raise the cost of capital—the required rate of return on investment—and as a consequence they depress the level of investment, and hence, ultimately, the size of the economy. Research on the extent to which taxes depress investment goes back over half a century at least to Hall and Jorgensen (1967). Recent work has tried to distinguish different aspects of the tax regime on investment—for example, contrasting the role of the tax rate and the permitted depreciation rate for tax purposes. This recent literature has tended to find large effects of taxation. For example, estimates of the elasticity of investment with respect to the net of tax cost of an asset (that is, the percentage fall in investment in response to a 1% rise in the net cost of an asset, after taking into account tax allowances) range from around 1.6 to as high as 14.<sup>81</sup> These elasticities are very high, but the implied elasticity of the size of the long-run capital stock with respect to the net cost of investment is lower.<sup>82</sup> These estimates are hard to translate directly into a measure of the excess burden, but they suggest an important role for taxation in determining the size of the business sector, and hence the economy.

A second form of distortion is to the location of investment and economic activity more generally. There is also a large empirical literature investigating how flows of investment between countries, and location decisions by businesses, are affected by differences in taxes between countries. There are numerous complications in estimating the effects of taxation, not least in determining the relevant form of taxation for different elements of investment decisions. However, a recent survey of the literature reports that the median semi-elasticity of flows of foreign direct investment (FDI) with respect to an effective tax rate (that is, the percentage change in FDI in response to a one percentage point change in the effective tax rate) is around 2.5.<sup>83</sup> This is again a large effect, indicating that the location of economic activity is very sensitive to differences in tax between countries.

<sup>81</sup> For recent evidence, see House and Shapiro (2008); Zwick and Mahon (2017); Ohn (2018); and Devereux et al (2019). These estimates are much higher than in an earlier literature summarized by Hassett and Hubbard (2002). Zwick and Mahon (2017) offer three explanations. First, recent studies include more small and medium-sized firms than have been previously available; evidence suggests that these are more responsive to taxes. Second, recent studies have used tax return data, thereby avoiding significant measurement error which arises with accounting data. Third, more recent studies have focused on the impact of depreciation incentives; these might be expected to have a larger impact on investment than other elements of taxation.

<sup>82</sup> That is because ultimately it is the size of the capital stock that should be influenced by taxation. Investment represents additions to that stock. A reduction in tax, for example, may induce a moderately higher capital stock in the long run; but that may require a substantial increase in investment in the short run.

<sup>83</sup> Feld and Heckemeyer (2011). See also De Mooij and Ederveen (2008).

A third form of distortion is between the use of debt and equity finance. The tax advantage to the use of debt may lead business to borrow more, and hence raise the probability of default, although the effects of this may depend also on investor-level taxation. Again, this has been the subject of empirical investigation for decades. A recent survey and meta-analysis of the literature has estimated that, on average, a ten percentage point rise in the tax rate would raise the share of debt in the total funds of a business by 2.7 percentage points.<sup>84</sup> However, this masks a large variation in estimates and there is evidence that this rate of response is rising over time. A more recent study using detailed tax return data found much larger effects, with a ten percentage point rise in the tax rate raising the share of debt in the total funds of between seven and fourteen percentage points.<sup>85</sup> The effects are particularly important in the financial sector. One study finds that eliminating the bias to debt finance would increase banks' use of equity capital in the long run by more than 50%, which would be significant in terms of the fragility of the financial system.<sup>86</sup>

Another decision that may be affected by taxation is the choice of legal form, and in particular whether to incorporate. Again, recent studies have found that the differences in taxes between unincorporated and incorporated businesses have an economically significant impact on this decision.<sup>87</sup> There are many other margins of business decisions which are affected by taxation, and we will not summarize all of the empirical literature here. Other margins include the choice between different methods of production—for example, between using more labour or more capital, or between different types of asset; whether to retain earnings in the business or to distribute them to the owners; whether to outsource or insource intermediate goods and services in the supply chain; and how aggressively to seek to minimize tax liabilities by shifting income to lower taxed jurisdictions. In addition to affecting these behavioural choices, taxes can also distort competition between businesses, if one business faces a higher effective tax rate than another.

Whilst all of these distortions due to taxation imply the existence of an excess burden, estimating the excess burden itself is more difficult, because it may be difficult to assess the cumulative impact of multiple, interacting distortions. However, under certain conditions, the excess burden of a tax can be inferred from an estimate of the sensitivity of the taxable profit to changes in the tax rate.<sup>88</sup> Intuitively, this is because at the margin, the agent should aim to equalize the marginal cost of raising her pre-tax profit with the marginal benefit of the additional post-tax profit. A marginal change in the tax rate affects the pre-tax profit, and the

<sup>84</sup> Feld et al (2013).

<sup>85</sup> Devereux et al (2018).

<sup>86</sup> De Mooij and Keen (2016). The very largest banks appear to be much less responsive to taxation.

<sup>87</sup> See de Mooij and Nicodème (2008); Liu (2014); and Devereux and Liu (2016).

<sup>88</sup> This approach is originally due to Feldstein (1995, 1999). Strictly, these are the *marginal deadweight costs*—that is, the effect on these costs of a small change in the tax rate. For a review, see Saez et al (2012).

impact of this on the choice of pre-tax income can be used to estimate the marginal excess burden.

This approach has been used primarily in the context of determining the optimal marginal rates of tax on personal income. However, the approach has also been applied to taxes on the profit of small businesses in the UK with an estimate of a substantial marginal deadweight cost of up to 29% of tax revenue.<sup>89</sup> Even if this is a high estimate, and even if it is smaller for larger businesses, this does suggest that policy makers should take economic efficiency into account in choosing tax policies.

We should note, though, that these distortions to economic behaviour create costs which are borne by society as a whole. In an international context, an individual country may nevertheless benefit from a distortion. For example, if country A induces a business to relocate from country B to A by reducing its taxes, then A may gain, even if costs of production are higher in A and therefore there is an excess burden for the world as a whole. This potential conflict between global and national welfare maximization underlies our concern that the tax system should be incentive compatible, as discussed in Chapter 2.

#### 4.1.2 Economic efficiency and tax avoidance

The changes brought about by the BEPS project do not address these distortions; that was not the project's goal. On the contrary, it is likely that distortions to real activities will *increase* as a result of BEPS. Before the BEPS project, certain planning strategies allowed profit to be shifted to low tax countries without having to locate substantial real activity there. As we have seen, post-BEPS, the same broad strategies may be available but only if a greater level of functions and activities is located in the low tax countries. For example, to achieve desired transfer pricing outcomes, senior decision makers might have to relocate to low tax countries post-BEPS. One can predict that companies will meet such requirements if the tax savings outweigh the costs.

Certain planning strategies may simply not be available following the implementation of the BEPS project proposals, resulting in companies having to move their real activities to achieve the same tax result. An example arises from Action 5 of the BEPS Action Plan which addresses patent box regimes. These regimes essentially offer preferential rates on returns generated by IP. Action 5 seeks to counter situations where IP is produced through R&D activity undertaken in country A, but is subsequently transferred to country B, which offers a patent box regime. The aim of the BEPS measure was to align taxing rights with economic activity (the R&D). But this means that businesses will have an incentive to move their R&D facilities to the country offering the patent box.

<sup>89</sup> Devereux et al (2013).



More broadly, to the extent that the changes brought about by BEPS have made the tax regime more robust to profit shifting, multinationals that wish to lower their global tax charge may have to do so by relocating their real activities to low tax jurisdictions. As the regime becomes more robust to profit shifting, it is likely to create greater distortions to real business decisions.

## 4.2 Fairness

Fairness dominates public, political, and even some academic debates on international tax reform. In Chapter 2, we set out the difficulties in evaluating corporation tax systems on the basis of fairness. We do not repeat these points here; instead, we make two broad observations on criticisms of the existing system that have been made based on ‘fairness’.

First, some strands of criticism are compelling, but are more accurately or usefully formulated in terms of other criteria used in this book. For example, companies are often criticized for not paying their ‘fair share of tax’ because they lower their tax payments through tax avoidance. It is more useful to reformulate this as a criticism of the existing system for not being sufficiently robust to tax avoidance. Another example is that the existing system unfairly allows multinationals to pay lower rates of tax than small domestic businesses, and highly digitalized businesses to pay lower rates of tax than traditional businesses. The EU Commission, for example, argued that ‘[t]he system is unfair and there’s no level playing field as traditional companies tend to carry a heavier tax burden than digital ones.’<sup>90</sup> The quintessential example here is of the small local bookshop paying a higher tax rate than large multinationals selling books online. The Commission’s criticism is formulated both in fairness and efficiency terms; however, the latter is less vague and, to our mind, more useful. By allowing large digital multinationals to pay lower rates of tax than small domestic traditional businesses, the existing system creates a real economic distortion. Whether this is unfair depends on the incidence, and ultimately the progressivity, of the tax.

Second, although, as noted in Chapter 2, ‘fairness’ does not provide a very useful guide for allocating taxing rights among countries, there certainly is a politically powerful belief that the allocation under the existing system is ‘unfair’. Indeed, the OECD itself recognized at the start of the BEPS project that ‘a number of countries have expressed a concern about how international standards on which bilateral tax treaties are based allocate taxing rights between source and residence countries.’<sup>91</sup>

<sup>90</sup> EU Commission (2018a).

<sup>91</sup> OECD (2013b), p. 11.

This criticism is often focused on the regime favouring developed over developing countries—at times classified as ‘residence’ and ‘source’ countries. The UN Model, which is intended for adoption between developed and developing countries, was drawn up with this in mind. This model ‘generally favours retention of greater so called “source country” taxing rights under a tax treaty—the taxation rights of the host country of investment—as compared to those of the “residence country” of the investor. This has long been regarded as an issue of special significance to developing countries . . .’<sup>92</sup> It should be noted that the terms ‘residence’ and ‘source’ appear to be used here in a broad economic meaning; the idea seems to be that relatively wealthy investors located in a developed country may be financing economic activity in a developing country. A perceived emphasis on residence country taxation in the existing system (through the treatment of passive income) then favours the developed country over the developing country. Of course, this is only partially true, given the ability of many multinational companies to ensure that their passive income arises in low tax jurisdictions. In this case, neither the ‘source’ nor ‘residence’ country is able to fully tax the underlying income.

As noted, the BEPS project was not meant to—and did not—address perceived problems of fairness. However, the procedures followed in drawing up the BEPS recommendations furthered perceptions that the design of the regime was led by a small group of developed countries and was thus unfair. Some steps were taken for non-OECD/G20 countries to input their views while the BEPS recommendations were being developed, and they were invited to join the project—through the Inclusive Framework—once the final reports containing the recommendations had been drafted. But developing countries were invited to join the project *after* the rules had been agreed by a group of countries with different concerns and needs. This criticism has been addressed in the latest round of possible reforms—current proposals are being discussed among more than 130 countries that constitute the Inclusive Framework and the goal is to achieve a consensus-based solution. This is clearly an improvement; however, due to resource constraints, there are concerns about the extent to which many of the countries that currently participate in the Inclusive Framework can do so in an adequately informed and meaningful manner.

A more recent line of criticism—with a number of strands—has arisen following the advent of digitalization. One strand is that market countries are not receiving their ‘fair share’ of tax revenue because in the digital age companies are able to sell to consumers located in a country without incurring corporation tax liability there. Another strand is that ‘fairness’ demands that countries where digital users are located should be allocated some taxing rights over the profit of certain highly digitalized businesses which are in part generated by exploiting users’ contributions. This issue is discussed in Section 5.

<sup>92</sup> United Nations (2017), para. 3.

### 4.3 Robustness to avoidance

Concern over the regime's susceptibility to tax avoidance is long standing and most eloquently evidenced by the incessant waves of anti-avoidance legislation adopted by countries over the years. Anecdotal evidence of the tax avoidance strategies employed by multinationals abounded in the run up to the start of the BEPS project, and some arcane strategies even made it into the mainstream media. There have also been a number of empirical estimates of the scale of profit shifting, as well as how far it could be attributed to specific channels, such as within-group debt.<sup>93</sup>

The OECD/G20 BEPS project put the scale of BEPS at between 4% and 10% of worldwide corporation tax revenues—between \$100 billion and \$240 billion.<sup>94</sup> A paper from the International Monetary Fund (IMF) put the estimates somewhat higher, at around 1% of GDP for OECD countries and 1.3% of GDP for developing countries.<sup>95</sup>

Two recent papers reviewed the academic literature estimating the size of the avoidance by multinational companies.<sup>96</sup> They both emphasize the difficulties in identifying the scale of such avoidance, and describe the different techniques that have been used, based on both macroeconomic and firm level data. They also report considerable uncertainty about the scale of such activity; Riedel (2015) reports a wide range of estimates from 5% to 30% of taxable profit and concluded that '[i]t is thus too early to draw final conclusions on the quantitative importance of international tax avoidance activities'. That conclusion still holds.

Another recent paper conducted a meta-analysis of twenty-seven empirical studies that have been undertaken.<sup>97</sup> An important part of this analysis was to identify how and why estimates differed between studies, and between different types of business and profit shifting. Notwithstanding the variation in estimates, however, overall, taking into account the influences of study design and confounding factors, the average effect identified was a semi-elasticity of pre-tax profit of about -0.8. That is, reported profits decrease by a little under 1% if the international tax rate differential increases by one percentage point.

A still more recent paper used UK tax return data to investigate the differences in corporation tax paid by UK affiliates of non-UK multinational companies and comparable domestic companies, and found that the former group

<sup>93</sup> See, for example, Desai et al (2004).

<sup>94</sup> OECD (2015f). But this BEPS Action 11 report—showing empirical foundations for assumptions about tax planning—was vague in its conclusions. Tørsløv et al (2018) estimate worldwide revenue loss to be at the top of this range, at 10%.

<sup>95</sup> Crivelli et al (2016).

<sup>96</sup> Dharmapala (2014) and Riedel (2015). See also Beer et al (2018).

<sup>97</sup> Heckemeyer and Overesch (2017).

had on average a twelve percentage point lower ratio of taxable profit to total assets.<sup>98</sup> 60% of this difference was explained by the fact that a much higher proportion (50%) of the former group report zero taxable profits compared to the latter group (20%).

The uncertainty around these estimates is neatly illustrated by an academic debate ongoing at the time of writing. Blouin and Robinson (2020) have argued that some estimates of profits shifting are significantly overstated due to researchers' misunderstanding of the accounting treatment of indirectly owned foreign affiliates in the US international economic accounts data. They suggest a correction to address this misunderstanding which, in one example, reduces an estimate of US corporate tax revenue lost to profit shifting from 30–45% to 4–8%.<sup>99</sup>

At first glance some of these figures might appear underwhelming, thus making the extensive political and media attention given to this issue appear disproportionate. They should also caution politicians against inflated revenue expectations from tightening the existing system. However, these estimates ought to be treated with great caution due to the inherent difficulty in both defining avoidance and measuring the revenue loss it generates.

Whatever the overall empirical estimates, however, tax avoidance remains of critical importance. First, the revenues lost might be significant for particular countries—such as developing countries—that rely more heavily on corporation tax than others. Second, weakness to avoidance has a negative impact on a tax system's overall performance under the other criteria set out here. It creates a significant welfare loss as highly trained individuals, in both the private and public sectors, engage in a never-ending, unproductive cat and mouse game; it leads to escalating complexity and administrative and compliance costs; and it undermines public confidence in the tax system as a whole. The costs of a porous international tax system thus go significantly beyond the direct revenue loss.

Profit shifting ought to have become harder as a result of the proposals emanating from the BEPS project and other contemporaneous unilateral measures. Anecdotal evidence appears to confirm this, as a number of prominent multinationals are reported to have changed their tax structures in response to these measures.<sup>100</sup> Reports by the OECD,<sup>101</sup> the EU Commission,<sup>102</sup> and others<sup>103</sup>

<sup>98</sup> Bilicka (2019).

<sup>99</sup> See Clausing (2020) for a response.

<sup>100</sup> See, for example, 'Facebook, in Accounting Change, Could Pay Millions More in British Taxes,' *New York Times*, 4 March 2016.

<sup>101</sup> OECD (2018b), Chapter 3.

<sup>102</sup> EU Commission (2018b), pp. 26–7.

<sup>103</sup> HM Treasury (2017), para. 3.3: 'The significance of the BEPS project should not be underestimated. There is clear evidence that its recommendations, along with the unilateral action undertaken by the UK through the Diverted Profits Tax, are having a discernible impact on multinational groups' behaviour and the viability of complex tax planning structures that unfairly reduce UK tax receipts.'

have also claimed that these measures have had an impact, albeit some reports acknowledged that it is still ‘early days’<sup>104</sup> and that ‘implementation gaps’ do exist.<sup>105</sup>

But the critical question is *how much* more robust the system has become as a result of these changes. Have the changes made a moderate or a significant difference? It is too early to answer this question empirically and doing so through persuasive empirical work will be extremely difficult anyway. However, there are reasons to believe that the existing system remains somewhat vulnerable to tax avoidance.

First, there are implementation gaps; thus far the measures proposed in BEPS have not been adopted in full universally. Second, countries retain discretion in implementing the measures proposed in BEPS and, therefore, even when measures are implemented they might take a weak form. Third, certain new or enhanced anti-avoidance rules knowingly allow a degree of profit shifting. For example the BEPS proposed interest deductibility rules cap—but do not forbid—deductions for interest payments. Fourth, critical features of the system remain deficient—notably transfer pricing rules.

The continued weakness of transfer pricing rules is implicitly acknowledged by the introduction of rules—such as the ‘modified nexus approach’ introduced through Action 5 of BEPS—that would be unnecessary if transfer pricing rules were trusted fully. It is also acknowledged expressly by the OECD with respect to some issues. For example, the OECD recently noted that:

An increasingly heavy reliance on intangibles may also pose challenges to the existing tax framework. The BEPS Project has significantly contributed to re-aligning income from intangibles with value creation, notably by putting greater emphasis on real economic activities (e.g., Action 5, Actions 8–10), and by taking a more holistic approach to the review of cross-border transactions. Nonetheless, it may still often be very difficult to determine how to allocate income from intangible assets among different parts of an MNE group.<sup>106</sup>

Fifth, a number of countries have sought to respond to tax planning through separate taxes, such as the UK’s and Australia’s Diverted Profits Taxes. The increasing resort to digital services taxes can also be partly explained by the difficulties faced by countries in taxing certain highly digitalized businesses. Searching for solutions outside the framework of the existing system betrays the difficulty in finding a solution within the system.

<sup>104</sup> OECD (2018c), p. 90.

<sup>105</sup> EU Commission (2018b), p. 27.

<sup>106</sup> OECD (2018c), p. 170.

Finally, soon after the completion of the BEPS project a fresh set of proposals were put forward, partly to address profit shifting opportunities.<sup>107</sup> At the time of writing, these proposals are being considered by the OECD/G20 Inclusive Framework. The main objectives of the Global Anti-Base Erosion (GloBE) proposal, in particular, include curbing profit shifting (and tax competition). The BEPS project clearly did not satisfactorily address profit shifting, and it is not clear that this round of reforms will do so either. These proposed reforms are discussed further in Section 5.

It is worth emphasizing again that the existing system's vulnerability to avoidance is a direct consequence of its fundamental structure. Cross-border within-group transactions are still the building blocks for determining the overall tax paid by multinationals, and these are by their very nature open to manipulation. The vulnerability of the system also arises from another of its fundamental features. It taxes companies where mobile factors are located, including where its internal lending is made and its IP is held. The number and strength of anti-abuse rules to address the consequences of these fundamental features of this regime can be increased. But they can only be addressed comprehensively by changing the fundamental features directly.

#### 4.4 Ease of administration

The existing regime imposes high compliance costs on businesses and collection costs on tax authorities.<sup>108</sup> Many aspects of the regime are highly complex. This complexity partly results from rules that are necessary to implement the particular features of the regime. For example, the concept of the permanent establishment is fundamental for the source-based tax that is permitted under the existing system, but this requires complex profit attribution rules.

Significant complexity also results because of the need to address tax avoidance under the existing system. The plethora of complex rules that are necessary for this purpose include transfer pricing rules, interest limitation rules, and CFC rules. It is worth reiterating that this ever-growing body of rules is not the product of overly active rule makers—it is necessary to address avoidance opportunities arising from the fundamental structure of the existing system. A system in which cross-border within-group transactions—that are easy to create and manipulate—determine

<sup>107</sup> OECD (2019a).

<sup>108</sup> For the UK in 2018–19, HMRC estimate the cost of collecting corporation tax to be 60 pence for every £100 collected in revenue. This has fallen gradually from 78 pence in 2013–14. The comparable cost of personal income tax was 72 pence in 2018–19, mainly for self-assessed income, down from 93 pence in 2013–14. The cost of collecting VAT fell slightly from 60 pence in 2013–14 to 58 pence in 2018–19. See HM Revenue and Customs (2018/9) and earlier years. Shaw et al (2010) cite alternative estimates of compliance costs for corporation tax. These are considerably higher than HMRC costs, ranging from 1.5% to 2.2% of revenue collected.

the overall tax paid by a multinational, requires extensive anti-avoidance rules to police it. The constant need to add to, and update, these rules increases complexity, administrative and compliance costs, and makes the system increasingly uncertain.

The BEPS project appears to have aggravated the problem. For a start, in some countries, the BEPS Actions have been implemented through extraordinarily complex legislation. The UK, for example, implemented Action 2 on hybrid mismatch arrangements through legislation which is seventy pages long and which is accompanied by 390 pages of guidance, and it implemented Action 4 on interest deductibility through legislation which is 156 pages long, accompanied by 489 pages of guidance.

More broadly, the necessity to take a closer account of economic reality (and the necessity to take into account tax treatment in other countries) will greatly burden the players, in business and in tax authorities. Under the pre-BEPS regime there was—at least theoretically—the option for a country to tax the local subsidiary of a large multinational on the basis of what it does and earns in its country. Under the post-BEPS regime it seems necessary to establish a worldwide network of information and enforcement, starting with exchange of information between tax authorities and detailed country-by-country reporting by multinationals.

The costs imposed by the increasing complexity of the system should not be underestimated. There is a real danger that the system comes crashing down under the weight of rules that increase in length and complexity year after year. Anecdotal evidence suggests that even well-resourced countries struggle to apply certain rules that are integral to the system, including profit attribution and transfer pricing rules. But an international tax system should also be judged on how poorly-resourced countries are able to run it. Due to its complexity, few would argue that this system is fit for use by such countries (including some EU Member States). As will be seen in the next section, the complexity of the system is likely to increase rather than decrease in coming years.

#### 4.5 Incentive compatibility

In this chapter we have seen that under the existing regime companies are taxed where mobile factors are located, including, for example, where production takes place and where IP is located. They thus have an incentive to shift their real activities (e.g. production) and profit (e.g. that generated by IP) to low tax countries. In turn, countries have an incentive to attract real activities and profit by lowering their tax rates but also through other measures, including narrowing their tax base and weakening their anti-avoidance rules. The fundamental structure of the existing system thus creates the conditions and incentives for countries to compete

with one another. Overall, this destabilizes the system itself and threatens its long-term viability.

The impact of competition among countries can be seen most clearly in the fall in headline corporate tax rates over time, illustrated in Figure 1.2 of Chapter 1. This fall is dramatic, but it tells only part of the story. Competition is even more intense among countries over factors that are particularly mobile, including IP. This has resulted in the proliferation of patent box regimes offering lower tax rates for income from IP. IP is clearly more mobile than other factors, which explains why competition over this factor is even more intense.

Competition through other measures is less clear. Many countries have broadened their base in recent years through less generous depreciation allowances, thus worsening their competitive position. But some countries also improved their competitive position by narrowing their base through structural measures, for example by moving from a ‘worldwide’ to a ‘territorial’ system of taxation (or, more precisely, by exempting certain forms of foreign source income), which is particularly important when it comes to attracting headquarter functions and by introducing notional interest deductions (these are similar to deductions under the Allowance for Corporate Equity, discussed in Chapter 2).

Countries also compete by not introducing common anti-avoidance measures or introducing lax versions. For example, countries may improve their competitive position for attracting headquarters by maintaining weak corporate residence tests and not introducing (or introducing lax) CFC and interest deduction limitation rules. Countries’ ability to compete through this channel may be more limited following the BEPS project and related developments. For example, EU Member States are obliged by the Anti-Tax Avoidance Directive to adopt exit taxes, CFC rules, switchover rules, interest deduction limitation rules, and general anti-avoidance rules.<sup>109</sup> However, to the extent that countries maintain some discretion in the implementation of these measures, competitive factors create an incentive to implement them—and BEPS measures more broadly—in the weakest manner possible.

Clearly, countries have competed along some dimensions but not others, and they have competed with different intensities. The UK provides an interesting example here. It has competed aggressively by slashing its headline tax rate, introducing a patent box regime, exempting foreign source dividends and foreign branch profits, introducing favourable features in its CFC regime, and—for many years—operating limited rules restricting interest deductibility. On the other hand, it introduced the Diverted Profits Tax, a unilateral anti-avoidance measure that had a negative impact on its competitive position and at the time of its introduction

<sup>109</sup> Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, as amended by Council Directive 2017/952 of 29 May 2017.



was unique to the UK. It was also a front-runner in adopting BEPS measures, including interest deductibility rules, despite having previously advertised the absence of such rules as a competitive advantage.

So even countries that are openly willing to compete do not compete consistently through all channels. Does this mean competitive pressures do not actually threaten the viability of the existing system? Some broader issues have to be addressed to answer this question.

First, it is sometimes argued that the fall in the headline corporation tax rate should not be a concern given that revenues from corporation tax have remained relatively stable. However, revenue in previous years is not a meaningful target in itself. A stronger formulation of this argument is that the corporation tax is still capable of raising significant revenues despite falling rates. A number of factors might explain the stable revenues, including an increase in corporate profitability and an expansion of the tax base.<sup>110</sup> But the ability of the corporation tax to raise significant revenues if these other factors change does not detract from the negative impact competition has on the tax's revenue-raising ability. To continue raising significant revenues for years to come in the face of falling rates, profitability has to keep rising or the tax base has to keep expanding. The latter can occur through definitional changes, though eventually a point will be reached when it can no longer be regarded as a tax on profit.

Second, it might be argued that public and political preferences will prevent corporate tax rates falling beyond a certain point. But countries with such preferences would suffer the consequences of being at a competitive disadvantage for investment from a tax perspective. Countries can choose not to give in to the competitive pressures generated by the existing system, but they cannot extricate themselves from them. Some countries are better placed to weather such a disadvantage than others, but in the long run, it seems unlikely that many countries could withstand the economic forces generated by competition.

Third, it might be argued that competition on rates will be curtailed at some point because the benefit of moving real activity and profit to low tax countries decreases when the differences in rates between traditionally high tax countries and low tax countries become relatively small. If, in the extreme case, companies can shift their profits to jurisdictions with a zero tax rate on profit, then the relevant difference is just the tax rate avoided in the high tax country. As this high tax rate falls, then the gains from shifting to the tax haven fall. This would to some extent relax the downward pressure on the tax rate in the high tax country.

Furthermore, the gains of moving to a low tax country might at some point be outweighed by the costs, including, higher compensation for managers who would have to relocate, higher monitoring costs, less robust legal systems, lower skilled

<sup>110</sup> For contributions on this question see, for example, Devereux et al (2004); de Mooij and Nicodeme (2008); and Creedy and Gemmill (2010).

work forces, and even higher political and reputational risk. Tax competition clearly does not take place in a vacuum, and, therefore, account should be taken of the non-tax factors that also contribute to a country's ability to attract investment. As long as a country's non-tax benefits outweigh the disadvantage of its higher tax rate it should be able to maintain its higher tax rate.

This suggests that an equilibrium could be reached where some countries maintain positive tax rates, to some extent offsetting the benefits of the non-tax factors they offer. However, three points caution against such a conclusion. First, the non-tax factors would have to be unique to a single country to prevent competition among countries also enjoying similar non-tax factors; that is, the profit would need to be location-specific. Second, it seems more plausible that some countries would be able to maintain taxes on specific activities—such as software development—in which they could offer such non-tax factors. But we are concerned with a general tax, which could affect businesses that did not make use of such factors. Third—and critically, given the discussion in the preceding section on ease of administration—as rates drop, at some point revenues may be outweighed by the high administrative costs of running such a complex tax. At this point countries would have an incentive to simply abandon the tax altogether, at least in its current form.

Finally, it might be argued that coordination could halt—or at least slow down—this competitive process. The BEPS project showed that some coordination is possible, but it also showed it can have limits. Coordination was not achieved over certain actions—most notably CFC rules and the response to digitalization—even among the limited and relatively homogenous group of countries in the OECD/G20. And some countries broke ranks during the process itself by implementing unilateral measures with similar goals—the UK and Australia's Diverted Profit Taxes being obvious examples. Most importantly, certain fundamental issues were not even on the table for discussion: modifying the allocation of taxing rights among residence and source countries and, of course, tax rates.

The partial coordination achieved by the BEPS project might even intensify competition in other dimensions. To the extent that the BEPS project narrowed certain profit shifting opportunities, companies may have to move their real activities to favourable tax jurisdictions to obtain their desired tax outcomes. But then countries may compete even harder through the tax system to attract real activities because of the positive spillovers they can bring. Furthermore, to the extent that countries' ability to compete through the tax base—through no, or weak, anti-avoidance rules—have been curtailed by the BEPS project, countries that wish to compete may have to do so even more aggressively through their tax rate instead.

At the time of writing there is renewed optimism towards countries' willingness to coordinate, even going considerably beyond the coordination achieved in the BEPS process. The GloBE proposal mentioned in Section 4.4 is being considered,

partly to slow down or stop tax competition among countries. Of course, if countries agree not to compete and adhere to this agreement then competition—by definition—will be stopped. But reaching and maintaining such an agreement requires significant political and technical challenges to be overcome. The next section discusses this and the related reform that is currently being discussed.

## 5. Post-BEPS reform

### 5.1 Proposed reform

The goal set for the BEPS project was challenging but also politically attainable: making it harder for profit to be shifted to low tax jurisdictions if no real economic activities were located there. Countries where real activities are located could largely agree on measures to achieve this, even if, as seen above, the measures agreed upon are now deemed not to have been sufficiently effective.

Addressing dissatisfaction over the existing allocation of taxing rights is much harder. It requires agreement amongst countries that believe they have claims to tax the income in question. The BEPS project left this ‘long-term issue’ open, and it was not surprising that some countries sought further reform so soon after the BEPS project was concluded. It was also not surprising that this arose in the context of digitalization, as digitalization exacerbates and exposes even more clearly the problems plaguing the existing system.<sup>111</sup>

Consensus was not reached on how to address the challenges posed by digitalization under BEPS Action 1. Work continued on this issue after the BEPS Final Report was published in 2015, but an Interim Report in 2018 revealed that—despite the opposition of influential countries—the debate had opened to include consideration of reforming the system as a whole.<sup>112</sup> The outline of the proposed reform became clearer in later documents, published in February, May, October, and November 2019, respectively.<sup>113</sup> Reform is being considered under two pillars. Pillar I consists of a change to the allocation of taxing rights to allocate more rights to ‘market countries’; that is, where consumers—and possibly users of services provided by some highly digitalized businesses—are located. Pillar II—the GloBE proposal—focuses on the remaining BEPS issues and seeks to develop rules that would provide jurisdictions with a right to tax back where other jurisdictions have

<sup>111</sup> See Devereux and Vella (2017).

<sup>112</sup> One group of countries argued against further reform and another, including the UK and France, argued for reform targeting certain highly digitalized businesses. A third group, which included the US, argued that: ‘the ongoing digital transformation of the economy, and more generally trends associated with globalisation, present challenges to the continued effectiveness of the existing international tax framework for business profits. Importantly, for this group of countries, these challenges are not exclusive or specific to highly digitalized business models.’ OECD (2018c), para. 391.

<sup>113</sup> OECD (2019a, 2019b, 2019c, 2019d).

not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation.’<sup>114</sup> This Pillar consists of an income inclusion rule (a minimum tax) and a tax on base-eroding payments.

## 5.2 Comment

At the time of writing, these proposals are being considered by the OECD/G20 Inclusive Framework, with a view to reaching a consensus-based solution by 2020. We do not consider these proposals at length here,<sup>115</sup> not least because it is not at all clear whether any agreement will be reached, and, if it is, what it will be. We limit ourselves to some general comments.

First, much will turn on the exact nature and detail of the agreed reform. This will determine how the resulting system performs under our five criteria.

Second, the proposals under Pillars I and II would be overlaid on top of the existing system. This is not a proposal to reform the existing system in a coherent and comprehensive manner. Instead, the existing system with its problems and complexity will be kept in place and these reforms—which will be complex in their own right—will be bolted on top. It is safe to predict that this programme of reform will increase the system’s overall complexity.

Third, the proposed move towards a destination basis of taxation under Pillar I could—in theory—bring benefits in terms of efficiency, robustness to avoidance, and incentive compatibility, as discussed in Chapter 4. However, the move in this direction is very partial and it is not part of a comprehensive and coherent reform. Both these factors mean that the overall impact of this reform in practice is hard to predict with confidence.

Fourth, Pillars I and II move the existing system in two opposite directions, possibly simultaneously. We have set out four possible locations for taxing multinational companies: the residence of shareholders, the residence of the parent company, and the origin and destination countries. As explained in this chapter, under the existing system multinational companies are primarily taxed in the origin countries, though may also be taxed in the location of the residence of the parent company. The BEPS project, which embraced the value creation principle, moved the system more firmly towards an origin basis. Pillar I would now move the system towards the destination country, whilst Pillar II would move it towards the location of residence of the parent company. The combined reform would leave the system in an even more incoherent and unprincipled state than it currently is.

<sup>114</sup> OECD (2019b), p. 6, and OECD (2019d).

<sup>115</sup> For comments on the ‘Programme of Work’, see Schön (2019). For comments on Pillar II see Devereux et al. (2020).

Fifth, Pillar II seems to depart quite dramatically from the principles and policy expounded throughout the BEPS project. Throughout this process it was explained that ‘no or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it.’<sup>116</sup> Pillar II is clearly premised on the view that no or low taxation is a cause of concern.

Consider BEPS Action 5 which addressed patent box regimes. Agreement on this action was found, first by the UK and Germany and then the other participants in the BEPS process, on the understanding that taxing revenues from IP at the favourable patent box rate was unobjectionable as long as the revenues were taxed in the country where the IP was developed (the ‘modified nexus approach’). The principles underlying Pillar II are in direct opposition to this understanding; indeed, under these principles low taxation is per se a cause of concern even if the income being taxed arises from real economic activity. It might be possible to introduce carve outs for patent box regimes that comply with the modified nexus approach, but this would not be consistent with the principle of Pillar II, and it would threaten the robustness and integrity of the regime.

Also, as intimated in the previous comment, taxing in the location of the parent company does not align with any reasonable notion of the ‘value creation’ principle. This is a surprising and an apparently unprincipled *volte face* given the fervour with which many involved in the debate repeated that taxing in the location in which value is created is, and should be, the principle that underpins the international tax system.

Sixth, its proponents believe that Pillar II could slow down or even stop tax competition, at least for effective tax rates below an agreed threshold.<sup>117</sup> However it would require very robust and highly coordinated rules (including on a tax rate) to be agreed universally.<sup>118</sup> One problem is that countries might ask for carve outs that allow them to use the corporate tax system to support specific industries. But—as noted above—carve outs would substantially weaken the system. A more general problem is that Pillar II seems inconsistent with incentive compatibility. Countries would not have an incentive to agree to such coordination if they believe they can gain by refusing to cooperate. Of course, arms can be twisted politically to force (certain) countries to join, or other consideration could be offered in return for a cooperation on this issue. However, cooperation of this kind makes it even more important to design robust and highly coordinated rules. Otherwise, countries that have agreed to cooperate might still find ways of undermining these rules when implementing or administering them domestically. Furthermore, incentives to defect by leaving the agreement will remain and might be enhanced at some

<sup>116</sup> OECD (2013b), p. 10.

<sup>117</sup> See, for example, Englisch and Becker (2019).

<sup>118</sup> See Devereux et al. (2020).

point in the future by domestic economic and political considerations. It is not clear if it is possible to design a system that can be robust to one, or a group, of defectors. Overall, bringing competition to a halt and stabilizing the existing system through Pillar II appears to be a tall order.

Seventh, Pillar I also appears to be unstable. In future years, countries that are currently pressing for taxing rights to be allocated to market countries may feel unsatisfied with the allocation reached under this reform. If they believe it is in their interest, they might reopen the allocation question or they might take unilateral action to enhance their taxing rights as a market country, for example through taxes on the revenues earned by certain businesses in their own market.

## 6. Conclusions

This chapter has argued that the existing system for taxing international profit is economically inefficient, susceptible to avoidance, extremely complex, and hence very costly to run. Furthermore, competition continues to put downward pressure on effective tax rates, thus threatening the system's viability in the long run. Even given its extensive deficiencies, simply allowing the system to waste away under the influence of competitive forces is not a good outcome. Recognition of these deficiencies should instead be followed by clear-headed and principled reform.

At the time of writing reform is in fact being considered. If this package of reform is agreed, much will depend on its precise design. It could potentially lead to a system that constitutes an improvement under our criteria relative to the existing system. On the other hand, this package of reform will be layered on top of the existing system and is thus likely to come at the expense of even more complexity. Furthermore, countries may have an incentive to undermine the post-reform system through unilateral action.

The long-term viability of the existing system is not guaranteed, even if agreement is reached amongst countries engaged in the current process of reform. All in all, it would be preferable to move to a more coherent and principled international system of taxation that is not incapacitated by complexity. And it would also be preferable to move to a system that countries acting in their own interest, have an incentive to join, rather than undermine, through unilateral defection. We examine two such systems in Chapters 6 and 7.