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INTERNATIONAL ACCORDS ON TAX, BUT WHAT WILL HAPPEN NEXT

The BEPS project has made significant progress internationally and in domestic implementation in many countries - but in recent times its objectives have been forced to change and there is uncertainty as to whether or not the initial aspirations will be fully met.

As we approach the end of the year, it is time to take stock of where we are on the global corporate tax changes that have been grabbing press attention over the year.

Achievements to date

Those behind the BEPS project at the OECD are to be congratulated for masterminding the different parts of the project and, more importantly, mustering support initially from industry and the professions, alongside tax authorities from the different jurisdictions. That feels like old news now, but we shouldn't underestimate the efforts that went into global treaty changes through the MLI, the concerted attack on hybrids and some major transfer pricing changes in OECD guidance.

Political approval for pillars one and two

But the work did not stop there: pillars one and two have been the words and figures on many people's lips over the past couple of years.

The OECD is not out of the woods yet (the US may prove to be a stumbling block), but international political approval in the summer was the culmination of a truly impressive administrative and political effort - particularly to get countries like Ireland, which have used a low corporate tax rate as part of the package to attract an array of multinational giants to establish real businesses and create employment in Ireland, to go along with pillar two.

There has obviously, however, been some mission creep as these political machinations have been taking place. The initial aspirations, particularly on pillar one, are not necessarily reflected in the final output.

Changes in pillar one

The biggest change, of course, has been in relation to pillar one. That started life as an attempt to tax profits of companies trading digitally into a jurisdiction without having a physical presence there (some obvious household names come to mind).

As a concept, this had particular political resonance in jurisdictions where ordinary retail shopping businesses were carrying the burden of local taxation but seeing their businesses badly effected by digital sales, particularly during the pandemic and lockdown. The US, on the other hand, saw this as a blatant attempt just to tax some of their biggest and fastest growing names, their national champions if you will.

Those who attacked the proposals as unprincipled could, however, be answered by pointing to the fact that any jurisdiction (like any medieval marketplace) spends money creating infrastructures for traders in its country to use or take advantage of. Modern infrastructure assets are obviously different from those needed in medieval days, but there was justification (as well as public and political support) in arguing for a tax (or 'access fee') to be paid by those who benefited from the use of that infrastructure (be it roads, rail transport or internet infrastructure) for their financial benefit.

Is digital taxation a tariff and does that matter?

The response that levying what was, in essence, an access fee made digital taxes look like tariffs would no doubt still have been argued out in world trade processes (the WTO) if pillar one, which many people were supporting on the basis that otherwise countries would have started (as some already had) to do their own thing in an uncoordinated way, had not lurched in a different direction.

A changed pillar one

Pillar one has now turned itself into a modified version of attributing residual profit in a business or supply chain not to the IP and know-how generating parts of the business but, to a significant extent, to the consumption jurisdictions on the basis that profits would not be made without sales (this is a cause that has been championed by Mike Devereux from the Oxford Business School for some years).

At first sight, the revised approach to profit attribution looks persuasive - but it flies in the face of much of the previous thinking on international taxation that profits should be taxed where they are really generated by assets or people on the ground.

Many have said that having a tax system which rigidly attributes profits on a formulaic basis to a particular jurisdiction will produce certainty, but it will, of course, also produce a certainly wrong answer in most cases.

If you look at distributor margins in an arm's length world (where many distributors are independent), you do not come up with the sort of numbers that pillar one will lead to when implemented.

The answer to this, of course, is that the new proposals are not intended to set an arm's length rate for distributor profits, but they are trying to recognise that anyone trading internationally is using their name, IP, business and infrastructure etc. to make profits in the jurisdiction in which profits or goods are being sold, and it is right to recognise that, in the modern world, those profits should, to a significant extent, be treated as arising in the jurisdiction in which local value has been created and is being exploited. You should recognise a marketing intangible locally.

In a sense, this is like extra-territorial tax discussions that have taken place in the past where the asset being exploited (like land or mineral exploitation rights) is located in the jurisdiction seeking to tax or where an offshore sale of shares reflects value in local market goodwill (for example, in the various Indian controversies in that area). If you want to test that, ask yourself whether someone selling an international business would be able to get away with *not* doing a non-compete covenant in the major jurisdictions in which it was previously making significant sales.

Digital sales taxes

In the meantime, recognising the local political pressure and also the fact that pillar one has shifted its direction or emphasis, many jurisdictions (including the UK) are looking at local digital sales taxes (almost like an additional amount of VAT) that recognise the public and political pressure to level the retail playing field. Whether that again leads to competitive chaos remains to be seen. The experience to date seems to be that such taxes are passed on to consumers so the market players can view them with indifference until their competitive advantage starts to be eroded.

Pillar two is different

Pillar two can be dealt with more simply. Cynics have been saying now for a little while that pillar two was the big countries with higher corporate tax rates seeking to bully smaller jurisdictions who were using tax to gain a competitive advantage in seeking new business.

International state aid?

But is tax competition wrong? The concept of state aid within Europe is justified and understandable. You cannot have an international trading platform where governments intervene and seek to skew competition between domestic and international businesses in their market. The EU is not a fiscal union, but preventing unfair international tax competition in that way is certainly one of its legitimate roles.

Is this all down to domestic deficiencies?

Couldn't the little economies also say that if the big economies felt that they were not collecting their fair share of tax because the little economies were allowing multinationals to shift profits *artificially* to their jurisdictions, then that could be dealt with by the big economies simply tightening up their CFC and transfer pricing rules and procedures?

So the debate on what role substance plays and the question where profits were *really* being generated should have been the battle ground. Like the UK CFC rules, profits that were genuinely being generated locally should be left alone, it was argued.

A mechanical solution

In the end, this is not how things have turned out: the exclusions for locally generated profits are not founded in reality but in low value formulae. That is likely to make little economies feel that their bids to generate local activity and employment by including a lower tax rate in the package designed to even up the competitive advantage that large economies have at the outset is not being fairly recognised. Ireland, which is a brilliant case study for competitive taxation, was, it seems, a very reluctant signatory to the accord.

Is tax competition dead?

It certainly should not be: tax will very rarely be the only reason why a multinational establishes itself or moves assets to particular jurisdictions. There will be many parts of the package (like local infrastructure, planning requirements, quality workforce etc.) that will influence that. Tax can certainly be a negative force or, at the other end of the spectrum, a swing factor, but it will very rarely be more than that where a real business decision is being made.

What happens next?

There is clearly a lot of work still to be done. Both pillars involve formulae that will have a major effect on the outcome for jurisdictions signing up to implementation. Big numbers will follow small changes.

Even the most optimistic are not expecting all these issues to be resolved quickly; it would not be surprising if implementation is delayed until 2023 or beyond.

The jurisdiction that people will look at most keenly is the US. In the first round of BEPS actions, it was quick to satisfy itself that little needed to be done in the US because the US system already accommodated the actions proposed. On pillar one, the US has an interesting balance between the effect on its multinational base and what additional US taxes will be generated because it is one of the largest consumer markets in the world. The US will also need to be satisfied that its regime for attributing overseas passive profits back to the US (GILTI) is taken into account in the pillar two rules.

Tax abuses/competition

In the meantime, the OECD is to be congratulated (along with other bodies who have been involved) in creating a world framework where tax abuses by shifting profits to low tax jurisdictions with little substance to support the shift now seems largely to be under control. So, pillar two is beginning to look like a solution to yesterday's problems. Pillar two is beginning to look like a solution to yesterday's problem

On tax competition, anybody who doubts whether that can be benign should take a look at Ireland's history and the employment and educational benefits that have been caught in the train of creation of an attractive inward investment package. When this started, the UK had a different approach, giving large capital incentives but then taxing profits at 52% – the idea that they would get more than half the benefit of the establishment of a profitable business clearly did not appeal to the large multinational investors who went across the Irish Sea.

By the 1980s, when overseas motor manufacturers (like Nissan) began to establish themselves in the UK, the UK corporate tax rate was approaching the 30% level.

What the OECD says about pillar two is that it is intended to *moderate* tax competition. It is obviously seeking to put a 15% floor on corporate tax rates around the world. 25% is the level at which, rather surprisingly, the UK has established itself for the future. Time will tell whether that holds.

Tax administration

Time will also tell as to what happens on the tax administration front – there have been many complaints recently that the HMRC governance process encourages those dealing with enquiries to be cautious, and it is only a short step from there to being negative. Balance needs to be found in the way that enquiries are handled. As has been recognised, the DPT profit diversion facility (under which participants effectively do their own enquiry and present the results to HMRC for approval) provides a useful comparator as to how things should be done. One reason for that must be the collaborative way of working that the facility encourages – but the other could well be that taxpayers setting out their own facts and position quite clearly is a much more efficient starting point than HMRC trying to work that out by a question and answer process.

There is a lot still to be done on many fronts - the OECD team will be with us for a while.

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