THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

Emerging developments in International taxation

- Comprehensive study

By K R Girish BSc .,LLB.,FCA

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International taxation - Introduction

Most countries have a self-contained tax code that levied tax on Global income earned by its residents. In addition to it, tax is also levied on non-residents on income sourced within the country.

The tax treaties or Double Taxation Avoidance Agreements ('DTAA's') have a combination of both source as well as residence form of taxation.

Although there existed domestic tax provisions and DTAA's intending to tax income arising from international transactions in the right manner it was observed that certain tax planning strategies were adopted to exploit gaps in the tax rules to make profit 'disappear' for tax purposes or to shift the profit to locations where there is little or no real activity, but where taxes are low.

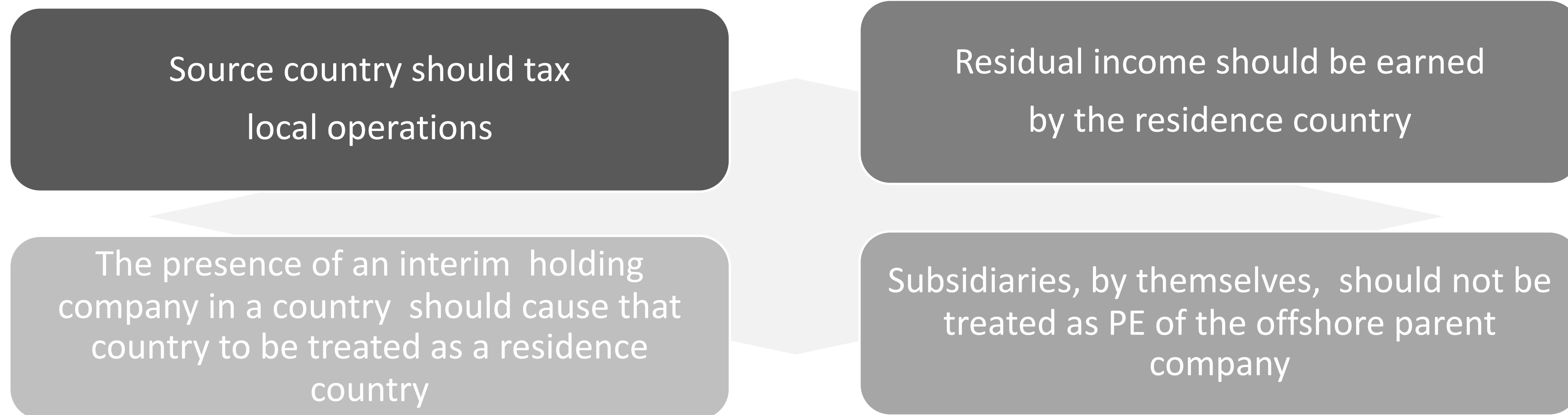
This triggered requirement to revisit the tax policies framed Globally, to ensure that tax revenues are rightly triggered and shared in a manner most optimal to the state of Residence and the state of Source (recently, with thriving e-commerce, 'state of Market' is also considered for attributing revenue).

International taxation - Brief history

- Model bilateral tax treaty developed by International Chamber of Commerce
- League of Nations (‘LoN’) issued final model convention with a combination of Source and residence based taxation
- OECD Developed model convention between developed countries
- UN developed model conventions between Developed and Developing countries
- Emergence of Digital Commerce
- Development of action plans to address BEPS
- Development of Multilateral Instrument

Model conventions

The following foundational principles laid down by LoN became the basis for model treaties, the Organisation for Economic Co-operation and Development (‘OECD’) Model and the United Nations (‘UN’) Model.



The OECD drafted an acceptable model treaty for the developed countries. The pattern of OECD model was kept as a source document for drafting the UN model and modifications were made with an intention to address developed and developing countries concern of losing its right to levy tax on certain categories on income.

BEPS

Over the past few years, world has seen a wide range of cross-border tax planning techniques that exploit gaps in the tax rules to make the profit ‘disappear’ for tax purposes or to shift the profit to locations where there is little or no real activity, but where taxes are low.

Certain large profile MNE’s apparently were paying less than their “fair” share of taxes. This scenario of shifting profit that has resulted in loosing tax revenue for several Governments is referred to as BEPS (Base Erosion and Profit Shifting).

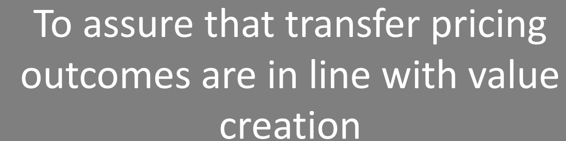
Conservative estimates indicate annual losses of anywhere from 4 to 10% of global corporate income tax revenues, i.e. USD 100 - 240 billion annually.

The G20 finance ministers along with the OECD developed and released its final report with 15 action plans.

Action Plans recommended under BEPS targeted to ensure that every state gets its fair share of tax based on the operations undertaken

BEPS – Action plans

- **Action 1**: Address the tax challenges of the digital economy
- **Action 2**: Neutralise the effects of hybrid mismatch arrangements
- **Action 3**: Strengthen CFC rules
- **Action 4**: Limit base erosion via interest deductions and other financial payments
- **Action 5**: Counter harmful practices more effectively, taking into account transparency and substance
- **Action 6**: Prevent treaty abuse
- **Action 7**: Prevent artificial avoidance of PE status
- **Action 8**: Intangibles
- **Action 9**: Risk and capital
- **Action 10**: Other-high-risk transactions



- **Action 11**: Establish methodologies to collect and analyse data on BEPS and actions to address it
- **Action 12**: Require taxpayers to disclose their aggressive tax planning arrangements
- **Action 13**: Re-examine transfer pricing documentation
- **Action 14**: Make dispute resolution mechanism more effective
- **Action 15**: Develop a multilateral instrument

Taxation of Digital Economy (BEPS Action Plan 1)

With the increase in use of digital platform to conduct business, the tax provisions had to be revisited to determine the taxing jurisdiction of this business model.

The traditional PE concept does not envision or encompass the existence of a nexus between intangible business activities and foreign markets.

Action Plan 1 introduced the concept of "significant economic presence ('SEP') in any country to establish "nexus" in a virtual environment in absence of a physical presence in such source country for the purposes of taxing digital profits

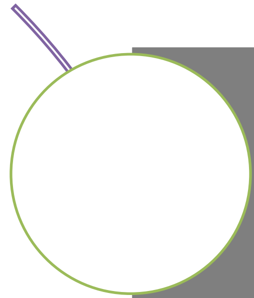
Difficult to ring-fence business model?

Online advertisement, app store, online payment, cloud computing, etc.

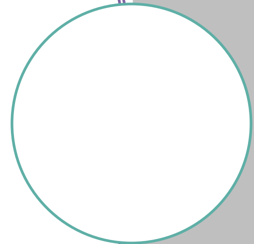
The unified approach discussed in subsequent slides have proposed much broader reach than highly digitized business

Taxation of Digital Economy (BEPS Action Plan 1)

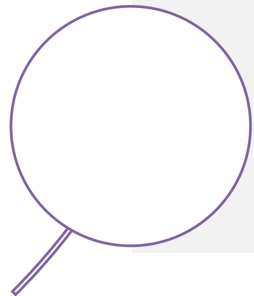
Options recommended under BEPS action 1



Modifying the existing Permanent Establishment rule to provide whether an enterprise engaged in fully de-materialized digital activities would constitute a PE, if it maintained a significant digital presence in another country's economy.



A virtual fixed place of business - in the concept of PE i.e., creation of a PE when the enterprise maintains a website on a server of another enterprise which is located in a tax jurisdiction and undertakes the business through that website.



Imposition of a final withholding tax on certain payments for digital goods or services provided by a foreign e- commerce provider or **imposition of equalisation levy** on consideration received by a non-resident from a resident or from a non- resident having PE in other contracting state for certain digital transactions.

Digital Taxation

Concept of Virtual PE

OECD Task Force

Five options were specifically considered on Digital Economy:

1. Modifications to the exemption from PE status
2. Creation of a ‘significant digital presence’ PE
3. Varieties of a ‘virtual’ presence PE
4. Withholding tax on digital transactions
5. Consumption tax options

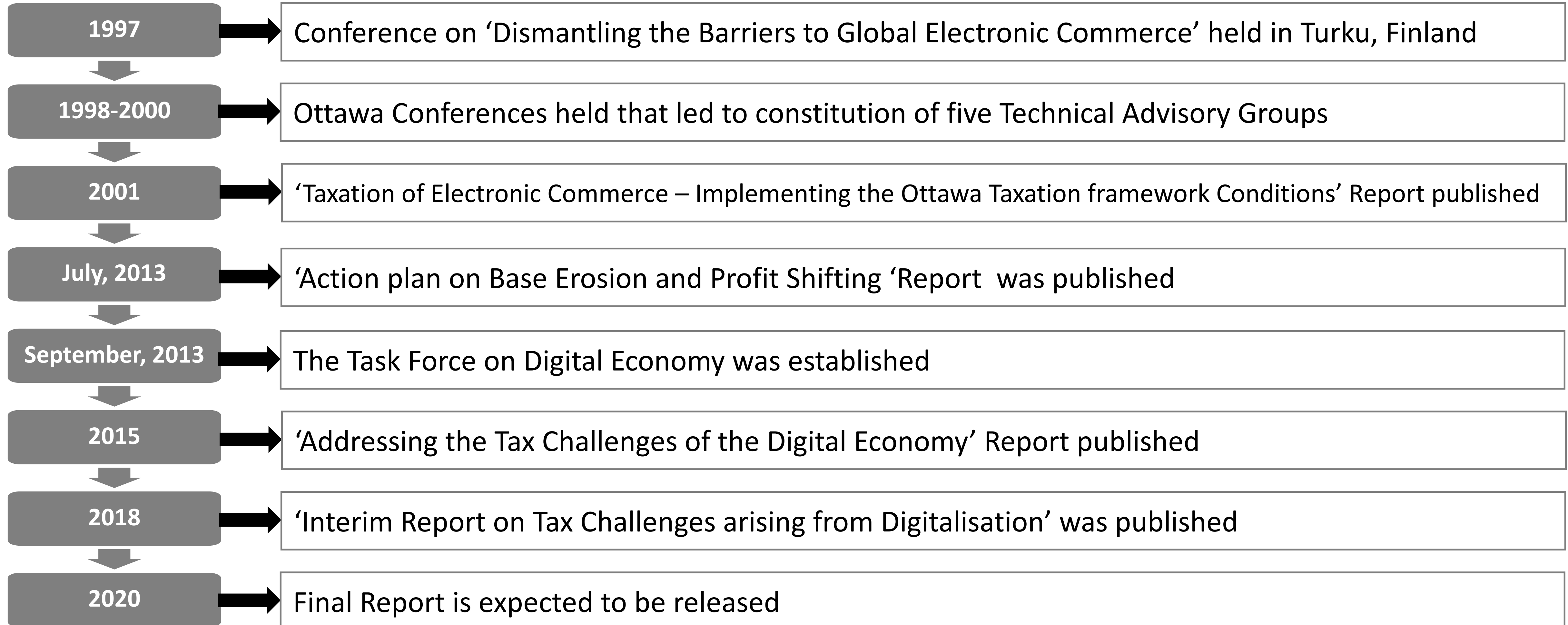
French Task Force

The activities of digital companies lack ‘points of stability’ required to create a PE.

The task force proposed that the concept of PE be redefined to encompass ‘permanent virtual establishment’ under which once a foreign enterprise’s **turnover in a jurisdiction have reached a certain level**, the foreign enterprise would be *deemed* to have a PE in the jurisdiction

Digital Taxation

OECD' efforts in taxing Digital Economy



Digital Taxation

OECD's proposal of taxing digital economy

Allocation of taxing rights and profits in the digital economy is divided under two segments:

Pillar One deals with allocation of taxing rights to market and user jurisdictions

Pillar Two focuses on Global minimum taxation

Pillar One essentially treats the entire world as one '**unified**' entity and allocates profits based on source market jurisdictions. This new approach under pillar one would broadly cover **consumer-facing businesses**, even if they are not highly digitalized.

Under unified approach, the total group profits will be the starting point, bifurcated into routine and deemed non-routine profits. The ALP principle will still be applicable to derive the routine profits, whereas the formulary apportionment (mainly using sales threshold) will be used to determine the share of 'market jurisdictions' in deemed non-routine profits.

This new proposal of nexus rule based on revenue threshold is in line with SEP provisions

Digital Taxation

Practical challenges under the Unified Approach

Determining Global profits of a MNE, being the starting point

MNC's can resort to tax avoidance by diverting revenue and profits to other tax heaven SPV's in the certain scenarios like:

- There could be scenarios where the regulations in the Country of Market does not require audit of accounts; or may be consolidation of accounts are not required.

- It is also not necessary that published net profits of the MNC are free from manipulation.

It may be difficult for the tax authorities in country of market to ascertain that.

Further, there are various profits figures reported, such as operating profits, EBITDA, etc. There is no clarity on which profit needs to be considered.

Digital Taxation

Practical challenges under the Unified Approach

Complexities in the formulary approach

Under the formulary approach, Amount A is sought to be determined after deducting fixed percentages with variances for industry. Further, Amount B and Amount C together shall allocate arm's length return based on the existing TP principles.

Allocation based on residual profits after deducting routine returns only (i.e. Amount A) may include a portion of the profits that have been taxed as Amount B or Amount C which shall result in double taxation of such non-routine profits.

Allocation of non routine profits to market jurisdictions

Amount A proposes to re-allocate a portion of the deemed residual profit arising from non-routine activities of MNE's, thereby, saving the allocation of the profits attributable to the routine business activities, to be taxed through the traditional PE based nexus rule.

However, each company, business and market may have different estimates for routine and non-routine profits, which will also keep changing. Higher fixed rate of routine profits set by the country of residence may not be accepted by the other countries. In such case, there is high chance that after carving out routine profits, there may not be enough non-routine profits left to be distributed among the market jurisdictions.

Digital Taxation

Challenges in the concept of consumer facing business

Customer can include business customers and not just end-users

In such case, could a customer facing business be covered under existing approach?

Facebook has no revenue from consumer facing business. It has only costs and thereby, no profits. The only revenue model is from advertisers and businesses who take data from Facebook. This is a B to B transaction, and a customer facing business rather than a consumer facing business.

Could a business model that provides market platform be covered under this approach?

Amazon place an argument that it does not run a consumer facing business, instead it only provides a marketing platform?

Multilateral Instrument (BEPS Action Plan 15)

As an approach to implement the action plans recommended under BEPS, it was decided that multilateral instrument ('MLI') would lay down a common platform which can be opted by countries to be applied alongside existing tax treaties.

To implement BEPS action plans, changes to model conventions were not sufficient. Further, renegotiating network of over 3000 treaties were also difficult. Hence, there required a common platform

Facilitates swift implementation of BEPS recommendations to tax treaties

Synchronised modification of bilateral tax treaties across the World

Measures included

Hybrid mismatch arrangements (Action 2) and treaty abuse (Action 6), strengthened definition of permanent establishment (Action 7) and measures to make mutual agreement procedures (MAP) more effective (Action 14), including provisions on MAP arbitration

Tax treaties covered

- Parties can choose tax treaties to be modified by the MLI
- Parties remain free to make subsequent amendments to their modified tax treaties through bilateral negotiations

Multilateral Instrument

Depending on the position taken under MLI by a country, DTAA's with it shall get modified. Certain prominent clauses are:

- The minimum standard under BEPS Action 6 to **tackle treaty abuse**, i.e. insertion of new Preamble and the Principle Purpose Test (PPT) in the DTAAs shall be achieved;

- The minimum standard under BEPS Action 14 relating to the **mutual agreement procedure** shall be implemented;

- **Artificial avoidance of Permanent Establishment** (PE) status through commissionaire arrangements and similar strategies would be prevented. Avoidance of PE formation through specific activity exemptions and splitting up of contracts would also be prevented;

- Avenues leading to **avoidance of capital gains** from alienation of shares / interests deriving value principally from immovable property would be plugged;

- Certain **dividend transfer** transaction that are intended to lower withholding taxes payable on dividends artificially would be prevented.

Unilateral measures

Australia

Broaden the definition of Significant Global Entity (SGE) that will impact Multinational anti-avoidance law and Diverted Profits Tax, Integrity laws, CbC reporting and General Purpose Financial Statements

Argentina

Resolution for regulating and reporting payment of the withholding tax on the distribution of profits by Permanent Establishments

Chile

Approved the tax reform bill that would define Permanent Establishment in domestic law following the OECD criteria

Unilateral measures

Korea

Tax reforms 2020 includes provisions in line with the patents registered outside Korea that are used in domestic manufacturing or production activities in Korea, which will be deemed to be Korean source of Royalty income by recasting such payments as royalties for the use of 'other similar properties or rights' under the Korean Corporate Income Tax Law.

Morocco, Luxembourg

CbC reporting requirements introduced

France

Transposition into French domestic law of the anti-hybrid provisions provided by EU Anti-Tax Avoidance Derivatives designed to tackle hybrid instruments as well as hybrid entities

Unilateral measures

India

1. Introduction of Equalisation Levy to be levied on the amount of consideration for specified services received or receivable (in excess of INR 1 lakh in PY) by a non-resident payee not having a PE in India

2. Introduction of “Significant economic presence” that constitutes “Business Connection” under the Indian Income Tax Act - to tax business models that do not require physical presence or any agent in India

3. OECD regards CFC rules as being important in tackling BEPS and has made a series of best practice recommendations in relation to the ‘building blocks’ of an effective CFC regime. Place of Effective Management (PoEM) regulations have been introduced under the Indian tax law through which a foreign company will be considered as a resident and be subject to tax in India is typically a characteristic of anti-abuse measure recommended under CFC

4. CbC reporting requirements

General Anti-Avoidance Rules

Globally, there is constant debate over the issue of tax avoidance. The term '**tax avoidance**' is understood as arranging business affairs with the object of obtaining tax advantage while prima facie fully intending to comply with the law in such respect.

Considering these continuing difficulties of classifying transactions as being acceptable within the framework of law or not, a need is being felt to move towards a structured approach to address the issue of avoidance both from a legal and economic point. In analysing the substance vs. form of a transaction, the question arises whether one needs to look at the **legal or the economic substance**.

Judicial precedents in most countries have held that, if a taxpayer has multiple avenues available to structure his transaction, he is free to choose the most tax-efficient avenue, provided a level of commercial justification for the same exists, and **tax is not the only reason**.

General Anti-Avoidance Rules

International recognition to the concept of GAAR

International agreements are to be interpreted in ‘good faith’. In case any international agreement/treaty leads to unintended consequences like tax evasion or flow of benefits to unintended person, it is open to the signatory to take corrective steps to prevent abuse.

Vienna Convention

The OECD leaves it to the individual countries to introduce anti-abuse legislation, which they consider, could be applied without interference by the Model Convention or the bi-lateral tax treaty between the countries inter-se. However, the OECD Commentary on Article 1 of the Model Tax Convention also clarifies that a general anti-abuse provision in the domestic law in the nature of ‘substance over form rule’ or ‘economic substance rule’ would not be in conflict with the treaty

OECD

General Anti-Avoidance Rules

Global Developments

Judicial interpretation on GAAR has also evolved in various jurisdictions over a period of time. Some of the international developments on GAAR are provided below:

Australia

Australia's GAAR was introduced in 1981. From 2016, these provisions were expanded to include the Multinational Anti-Avoidance Law which deals with the avoidance of Permanent Establishment ('PE') status. It was further expanded to include a Diverted Profits Tax

Canada

Canadian federal tax laws have contained GAAR provisions since 1988. A taxpayer is entitled to structure affairs so as to minimize tax within the confines of the law. However, tax planning (or tax minimization) must be contrasted with tax evasion, which may render the taxpayer liable to fines or imprisonment

Germany

German Tax Code introduced GAAR provisions in 1977. In 2008, it was amended to clarify the three important features that decide the applicability of GAAR.

General Anti-Avoidance Rules

China

The Enterprise Income Tax Law (EITL), which came into effect on 1 January 2008, includes a general anti-avoidance provision. GAAR regulations define a tax benefit as a reduction, exemption or deferral of an amount of EIT that otherwise would be payable

Singapore

Singapore's GAAR is contained in Section 33 of the Income Tax Act since 1988. GAAR does not apply to any arrangement carried out for bona fide commercial reasons and does not have its main purposes the avoidance or reduction of tax.

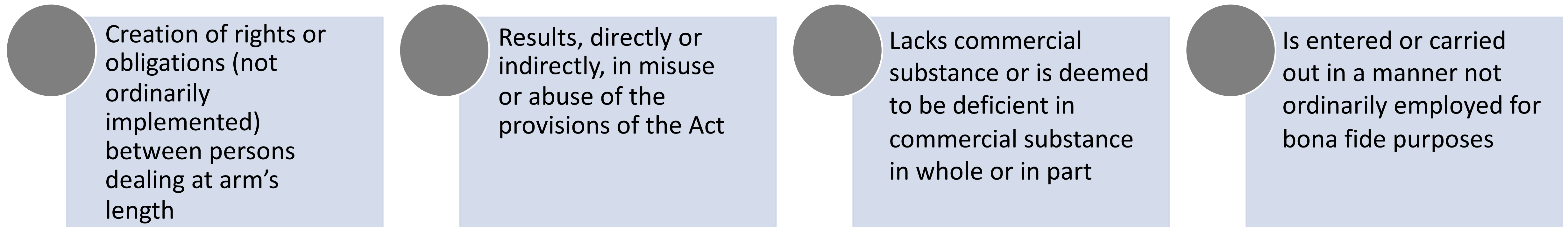
United Kingdom

The GAAR has effect in relation to any tax arrangements entered into on or after 17 July 2013. An arrangement is a "tax arrangement" if, having regard to all the circumstances, it would be reasonable to conclude that the obtaining of a tax advantage was the main purpose, or one of the main purposes, of the arrangement.

General Anti-Avoidance Rules

India

Anti-tax avoidance law, GAAR was framed as a tool for checking aggressive tax planning, applicable for transactions entered into from 1 April 2017 onwards. In addition to the *main purpose of obtaining tax benefit*, certain additional conditions to trigger an Impermissible Avoidance Arrangement (IAA) that triggers GAAR are:

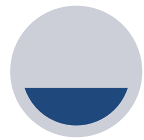


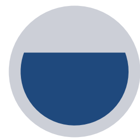
In the even of trigger of GAAR, the transaction could be disregarded, re-characterised, the residential status of a person could be reconsidered, treaty benefit could be denied, corporate structuring could be disregarded, income/ expense could be re-allocated, etc. by the tax authorities.

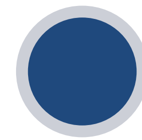
Note: When a particular consequence is applied in the hands of one of the participants of IAA, a corresponding adjustment in the hands of another participant will not be allowed.

Concluding thoughts

- The Unified approach on nexus and profit allocation and the key design elements of the global minimum tax, BEPS action plans and MLI intends to attain the right allocation of taxable income among various jurisdictions, namely:


Country of Source


Country of Residence


Country of Market

This is now sought by restricting a Country's right to tax its own residents by application of tax agreements. Further, anti-abuse provisions such as GAAR focuses on curbing tax avoidance and taxing the right amount of income earned as per the provisions of Law

- At best, OECD's unified approach can be taken as a good working document, but it may not appropriate the fair share of revenues to market/user jurisdictions., a concern raised by Developing Countries

- Also, the split between routine and non-routine profits would result in low tax incidence in Developing countries. So, what is suggested is to avoid such complex solutions which most of the Developing Countries may not be able to support.

Instead of this top-down formulaic approach, the OECD could have retained revenue received from Country of Market as the base and proposed application of a percentage of withholding tax as a simple approach. Further, Country of Residence could also provide credit of taxes paid in Country of Market.

Thank You!