Irish Tax Institute

Response to OECD Consultation on

Addressing the Tax Challenges of the Digitalisation of the Economy

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1. About the Irish Tax Institute

The Irish Tax Institute is the leading representative and educational body for Ireland's Chartered Tax Advisers (CTA) and is the only professional body exclusively dedicated to tax.

The Chartered Tax Adviser (CTA) qualification is the gold standard in tax and the international mark of excellence in tax advice. With over 5,000 members in Ireland, along with the Chartered Institute of Taxation UK and The Tax Institute of Australia, we are part of the 30,000-strong international CTA network and a member of *CFE Tax Advisers Europe*, the European umbrella body for tax professionals.

Our members provide tax education and expertise to thousands of businesses, multinationals, and individuals in Ireland and internationally. In addition, many hold senior roles within professional service firms, global companies, Government, Revenue, state bodies and the European Commission.

After 50 years, the Institute remains deeply committed to the role it can play in education, tax administration and tax policy in Ireland and in building an efficient and innovative tax system that contributes to a successful economy and society. We are also committed to the future of the tax profession, our members and our role in serving Ireland's taxpayers and best interests in a new international world order. Our *Irish Tax Series* publications and online database *TaxFind* are respected and recognised as Ireland's most extensive tax information sources.

Irish Tax Institute - Leading through tax education.

2. Executive Summary

The Irish Tax Institute welcomes the opportunity to contribute to this consultation on addressing the tax challenges of the digitalisation of the economy.

The consultation document outlines the proposals currently under discussion by members of the Inclusive Framework, to address the tax challenges arising from the digitalisation of the economy.

The consultation document sets out a two-pillar approach to consider;

(i) revised profit allocation and nexus rules and

(ii) a global anti-base erosion proposal to address remaining Base Erosion and Profit Shifting (BEPS) concerns, using two interlocking rules;

  a. an income inclusion rule, and

  b. a tax on base eroding payments.

Undoubtedly, the rapid digitalisation of the economy has created challenges for international tax rules. We recognise that further changes are necessary to the international tax framework to ensure that countries can reach a stable global consensus on how and where companies should be taxed.

To date, 128 countries have joined the Inclusive Framework and have committed to implementing the internationally agreed BEPS standards. EU Members States are also in the process of implementing measures to counteract BEPS as part of the EU Anti-Tax Avoidance Directives, ATAD[1] and ATAD 2[2].

It is worth noting that both the BEPS Action 1 Report and the European Commission Expert Group on the Digital Economy, both determined that it was difficult, if not impossible to ringfence the digital economy or have a special tax regime for 'digital' companies. Nonetheless, the challenges of digitalisation have led to uncoordinated and unilateral measures being enacted or contemplated by members of the Inclusive Framework, which have been a significant factor in the global push for a consensus-based solution to the tax challenges of the digitalisation of the economy.

We note that the proposals in the consultation document do not represent a consensus view of the Inclusive Framework. Each of the proposals pose significant challenges and decisions on whether to adopt any of the options should be guided by the Ottawa taxation framework principles[3] of neutrality, efficiency, certainty and simplicity, effectiveness and fairness and flexibility.

It is critical that whatever consensus is reached on changing the international tax framework, it continues to reflect and is aligned as closely as possible with the core principle underpinning the BEPS project that profits are taxed where the underlying substantial economic activity takes place and value is created. Many of the proposals appear to move away from that core principle.

[1] Council Directive (EU) 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the internal market

[2] Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries

[3] Electronic Commerce: Taxation Framework Conditions – A report by the Committee on Fiscal Affairs, 8 October 1998, https://www.oecd.org/ctp/consumption/1923256.pdf

Furthermore, any agreed solution should strike an appropriate balance and not disproportionately prejudice smaller and developing economies that seek to attract and rely on substantive foreign direct investment in order to develop their economies.

The proposals envisage solutions that could go beyond the arm's length principle and put forward the possibility of using approaches, including formulary apportionment of profits attributable to either user participation or marketing intangibles. The arm's length principle, which has been developed by the OECD over many decades, is a core element of the international tax framework that is comprehensively applied and understood by both businesses and competent authorities and should be retained insofar as possible.

Whilst there may be some justification to extend current transfer pricing rules and the arm's length principle, to recognise a portion of the residual profits to be allocated to value that may exist in user or market jurisdictions, such value must be objectively measurable, and it must be possible to benchmark it.

It would also be important to consider that many countries have already enacted unilateral measures that impose tax on a gross basis. In our view, any consensus approach agreed by the Inclusive Framework, to address the tax challenges of the digitalisation of the economy, should also address those unilateral measures, in an effort to limit the risk of double or indeed, multiple taxation. We believe that countries taking part in the process should give a commitment to removing such unilateral measures, when implementing the globally agreed solution that is reached by the Framework.

Within the EU and in many countries around the globe, BEPS measures, such as Country-by-Country Reporting, Controlled Foreign Company (CFC) rules, interest limitation rules, anti-hybrid rules and updated OECD transfer pricing guidelines have either only just been implemented or are still in the process of implementation. Until the overall BEPS package and ATAD requirements have been fully implemented by countries, it is not yet possible to assess the full impact of these far-reaching changes on the international tax system and whether they have achieved the desired behavioural impact in an ever-increasing digitalised economy.

In an EU context, the global anti-base erosion proposal could potentially be incompatible with the EU fundamental freedoms and principles expressed in EU law, unless such measures are targeted at wholly artificial and non-genuine arrangements and do not apply to 'low taxed entities'[4] which generate profits from real and substantive economic activities.

The proposals contained in the consultation document are likely to result in differences in implementation across adopting countries and will inevitably lead to double taxation and greater uncertainty for businesses operating internationally. In order to reduce tax uncertainty for businesses operating across multiple jurisdictions, where the Pillar 1 proposals result in a reallocation of profits currently arising to entities within multinational groups, the measures should only be adopted if they include mechanisms to reduce the tax base of entities where profits legally arise and are reallocated to other entities under the Pillar 1 proposals.

[4] 'Low taxed entities' in this context refers to an entity whose income is subject to a low effective tax rate in the jurisdiction of establishment or residence and payments to an entity that are subject to an effective rate at or above a minimum rate (yet to be determined), per the OECD Consultation Document on *Addressing the Tax Challenges of Digitalisation of the Economy*, 13 February 2019, pages 25-26.

As these measures are likely to involve allocations that have multilateral and not just bilateral impact, new and distinct dispute resolution mechanisms are required to ensure that there is a clear mechanism to resolve multilateral disputes. This should be jointly developed by both developed and developing jurisdictions working together, to ensure that a common, well understood, dispute mechanism can be implemented in practice.

In light of the increased compliance burden for companies, we believe that consideration should be given to the appropriateness of such measures for smaller and less well-developed businesses. We suggest that such measures should be confined to larger multinational enterprises that would be better placed to deal with the heightened complexity of a new framework.

In conclusion, we believe an internationally agreed tax framework is essential to facilitate cross border trade and investment. The Institute strongly supports reform of the international tax system that is sustainable in the long-term and encourages the Inclusive Framework to achieve an early consensus on the way forward regarding the revision of profit allocation rules under Pillar 1.

Given the extent of the BEPS measures which are still being implemented by members of the Inclusive Framework and the EU, in addition to the ongoing work on preferential tax regimes and the operation of the EU list of non-cooperative tax jurisdictions ('The EU Blacklist'), we believe adopting a longer-term perspective would be more appropriate to fully understand any remaining BEPS concerns. Therefore, in these circumstances, the requirement for a global minimum tax rate proposed under Pillar 2 is not yet evident in our view.

Instead, consideration could be given to building upon the existing work of the Forum for Harmful Tax Practices, regarding preferential tax regimes[5] and the EU Blacklist, as a possible way of reaching a global consensus on measures related to 'undertaxed' payments.

[5] OECD (2019), *Harmful Tax Practices - 2018 Progress Report on Preferential Regimes: Inclusive Framework on BEPS: Action 5*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, paragraph 6

3. Pillar 1: Revised Profit Allocation and Nexus Rules

Pillar 1 considers fundamental changes to the current profit allocation rules and taxing rights of user and market jurisdictions, to recognise the potential value created by business activity in such jurisdictions, without having a physical presence in the market jurisdiction.

In our view, any potential solution should focus on the economic link between the user or market jurisdiction and the value created. In arriving at a solution, it would be vital that international tax principles that have evolved over decades are not forgotten or discarded in the process.

The solution should remain consistent with the OECD's long-standing approach to the international tax framework that corporation tax is payable where the underlying substantial economic activity takes place and value is created. Indeed, the importance of this is acknowledged in paragraph 5 of the consultation document, which states that any potential solutions must be "*consistent with the principle of aligning profits with underlying economic activities and value creation."*

The proposals envisage solutions that could go beyond the arm's length principle and put forward new mechanisms to allocate profits including a form of global formulary apportionment in the case of profits attributable to either users who have contributed value or marketing intangibles. This would signify a change in direction from work previously undertaken as part of the BEPS project and the updated OECD Transfer Pricing Guidelines, which have centred on allocating profits to where significant functions are located.

In the absence of developing a new global infrastructure for corporate tax, it would be extremely difficult for businesses and tax administrations to practically apply the suggested methodologies put forward in the consultation document on a multilateral basis and could result in a never-ending plethora of double taxation disputes. Without a radical reform of the existing international dispute resolution mechanisms to provide for a new dispute resolution mechanism which can operate on not just a bilateral basis (as for current dispute resolution mechanisms) but on a multilateral basis, the proposals could ultimately act as barriers to trade and investment.

The method for allocating profits under the 'user participation' proposal and the alternative under the 'marketing intangibles' proposal is based on a profit split. Under the proposed method, a taxpayer's global tax base would first be identified and then routine activities would be remunerated, so that the residual profit could be identified. From there, the residual attributable to user participation or marketing intangibles would be identified and finally, that part of the residual would be split between user and/or market jurisdictions. Each step in that process, from agreeing the global tax base to splitting the identified residual between countries must be agreed on a multilateral basis.

Currently, no global infrastructure exists to enable any of these determinations to be made. To progress either of these proposals, the next step would be to develop an approach for agreeing all of these elements of the profit split, which would require countries to invest in that global infrastructure and respect the outcomes.

It is worth noting that the fact that user or market created value is not currently taxed in the user/market jurisdiction does not necessarily mean that the profits attributable to it are not taxed, but rather the right to tax those profits under the current tax framework rests elsewhere. This means that changes to the taxation of user created value is unlikely to generate more tax revenues overall. We suggest that any framework should provide for a reduction in local tax base for entities that would otherwise be taxed, for example, in the jurisdiction of residence, on profits allocated to and taxable in the market jurisdiction.

3.1 User Participation

The user participation proposal contemplates that soliciting the sustained engagement and active participation of users is a critical component of value creation for certain highly digitalised businesses and most significant in the case of business models of social media platforms, search engines and online marketplaces.

In our view, the user participation proposal is directed at a narrow number of highly digitised business models and potentially attempts to ring-fence the digital economy. This would appear to be contrary to the findings set out in the 2015 BEPS Action 1 Report[6], which recognised that it would be difficult, if not impossible, to ring fence the digital economy from the rest of the wider economy for tax purposes.

Given the pace of change of technology and transformation of the digital environment over the last decade, it is likely that designing new measures around such a narrow range of existing highly digitised business models could become outdated very quickly and contribute to ongoing uncertainty in scope of application for business.

We believe that measures which are too narrowly focussed may not be able to adapt to future technological advancements by businesses operating internationally and adequately address business models yet to evolve. This is important to consider, as any solution agreed must be sustainable in the long-term and consistent with the principle of aligning profits with underlying economic activity and value creation. Otherwise, policymakers could face the same prevailing concerns and challenges of digitalisation to the international tax system in the near future.

Valid concerns also exist that ringfencing the digital economy in this way could result in the creation of a dual tax system affecting businesses competing in the same markets, which could distort competition in those markets.

The proposal also presents difficulties in terms of establishing the link between user participation and quantifying the value derived from such participation. It would be necessary to have an objective measurement to value user participation in order to determine profits attributable to it.

Therefore, we consider that a precondition for implementation is that it should first be clarified how businesses can benchmark the proportion of the residual profit of the global enterprise, which relates to the value contributed by user participation and the proportion which relates to other intangible assets. Whilst raw data may be derived from user

[6] OECD (2015), Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

participation, it could be difficult to establish the value of the data in its raw and unprocessed form, where all the people functions in extracting the value from that data are carried on elsewhere.

The user participation proposal suggests a move away from existing OECD transfer pricing methods and the arm's length principle. We can see no clear rationale for such a fundamental shift in the existing corporation tax framework. We believe that the arm's length principle is a core element of the international tax framework that is comprehensively applied and understood by both businesses and competent authorities and should be retained.

In the event that the user participation proposal is adopted, applying the arm's length principle would ensure there is an objective measurement of the value of user participation, to determine the proportion of profits attributable to it and provide a starting point for identifying a methodology for allocating such profits between jurisdictions.

3.2 Marketing Intangibles

We agree that *"the digital economy is increasingly becoming the economy itself"*[7], with the impact of digitalisation observed across a range of business sectors. In our view, the marketing intangibles proposal is much wider in scope than the user participation proposal, as it is not confined to highly digitised business models. It could apply to the wider global economy but must be solely focussed on identifying and allocating profits that are attributable to market factors. Considering the early stage of this proposal, the impact on specific business models remains unclear.

Essentially, it appears that the marketing intangibles proposal encourages more income to be allocated from the jurisdiction with the entrepreneurial risk to where the consumer is located. While there may be some justification for extending the arm's length principle and current transfer pricing rules to recognise a portion of the residual profits of the global enterprise of multinationals operating internationally to be allocated to value that may derive from the market jurisdiction, such value must be objectively measurable, and it must be possible to benchmark it.

Paragraph 47 of the consultation document proposes that a cost-based approach may be a potential method for allocating some of the residual profits to marketing intangibles. However, it is important to consider that companies frequently invest funds in new products and R&D, with little or no return on that investment, for example, where there is research of a potential new product line which ultimately does not go to market.

We have concerns that a cost basis does not adequately reflect the very different returns arising to multinational companies from different business sectors and even different lines of products and services within the global enterprise. We consider that a design principle for allocating profits from marketing intangibles should be that investment in market development cost is remunerated and that losses (e.g. in the early stages of developing a new market), as well as residual profits are allocated. It should not be the case that only profits are allocated, with losses remaining borne by the residence jurisdiction.

[7] ibid

Non-routine returns (profits) derived from investment by multinational companies in creating and exploiting production or trade related intangibles, such as, expenditure incurred on R&D, in the commercialisation of scientific and technological developments and in driving production efficiencies and service enhancements, should be taxed within the entities that made and managed that investment. It should not fall within the scope of a new framework for allocation of profits from marketing intangibles.

We acknowledge that it may be very difficult to distinguish between the value attributable to the multinational enterprises' investment in trade-related intangibles (e.g. in production efficiencies and R&D functions) and its marketing intangibles. For example, when a pharmaceutical company develops a new drug, whilst the company brand may be recognisable in a given market, it is the effectiveness of the active ingredient that is the product of R&D investment, which is the key determining factor of that drug's success. Chapter VI of the 2017 OECD Transfer Pricing Guidelines explicitly recognise that the intangibles can become intertwined in this way.

Critically, any proposed solution should recognise, notwithstanding a predominant market position, that certain industries must continually and consistently invest in technology and R&D in order to ensure that they can continue to provide the necessary assurance to their customers that they remain leaders in their industry. Non-routine returns relating to such innovative production-related intangibles and associated entrepreneurial risk, should not be allocated to market jurisdictions.

Any basis for allocating profits from marketing intangibles should also consider expenditure on marketing and business development in a new marketplace. Any methodology should also provide for start-up losses relating to a marketplace, which can occur when developing new markets for products and services.

Consideration should also be given to the potential knock-on effect that measures designed to allocate profits relating to marketing intangibles for direct tax purposes could have on the pricing of goods and services for indirect tax purposes.

Existing pricing models adopted by multinational companies for flows of goods and services intra-group are generally based on transfer pricing principles that reflect the arm's length principle or concepts of open market value, which currently take account of factors including value driven by marketing intangibles. The pricing methodology is typically adopted by multinational groups across the board for all tax heads. How would the basis applied for pricing for imported goods for say, customs, VAT and other sales taxes be adjusted for a revised direct tax basis adjustment under the marketing intangibles proposal?

The administration of the marketing intangibles approach could give rise to significant additional compliance burdens for businesses and would undoubtedly result in double taxation in multiple jurisdictions for multinational companies carrying on business in more than one jurisdiction. Given the increased compliance burden for companies, we believe that consideration should be given to the appropriateness of such measures for smaller and less well-developed businesses.[8]

[8] The USA Supreme Court in the case of *South Dakota v. Wayfair, Inc., 585 U.S. (2018)* in determining whether a "substantial nexus" test was met took into account the fact that the relevant legislation included safe harbour provisions for those who transacted only limited business in the state.

We consider that, at a minimum, SME's should be excluded from scope as it can be foreseen that the complexity of the measures could present an additional barrier to growth for scaling businesses already faced with the barriers posed by the complexities inherent in international trade. We suggest that such measures should be confined to the largest of multinational enterprises, who should be better placed to cope with the complexity of a new framework.

The issue of double taxation would be difficult to address under the current bilateral tax treaty system. Moreover, the dispute resolution mechanisms that competent authorities currently have in place, which are focused on dispute resolution in a bilateral context, could not effectively deal with the level of additional disputes for measures which are inherently multilateral in nature.

Without a radical reform of the global tax infrastructure and the current dispute resolution mechanisms, double taxation disputes are likely to result in increased costs for businesses and where profit margins are small, they could ultimately impact decisions on whether to invest or indeed trade in a given jurisdiction.

Therefore, measures designed to allocate profits relating to marketing intangibles should also include a mechanism to deduct such profits from the tax base of those entities where they currently arise and are legally due, in order to reduce the risk of double taxation and limit the scope for disputes.

3.3 Significant Economic Presence

This proposal contemplates the allocation of profits to a significant economic presence, potentially based on a fractional apportionment method, which would apportion the tax base by taking account of certain factors (i.e. sales, assets and employees and potentially users where they meaningfully contribute to the value creation process.)

It is not evident from the consultation document that the expanded definition of nexus for a significant economic presence is limited to highly digitised businesses, which can operate in a local market through the remote delivery of services via online platforms, without having a physical presence.

If the definition extends beyond highly digitised businesses that do not have a taxable physical presence in the market jurisdiction, then there is a significant risk that the adoption of a formulary apportionment basis for profit attribution would result in non-routine returns on innovative production-related intangibles described above, being allocated to a market jurisdiction. In that context, the significant economic presence proposal is likely to surface tax sovereignty concerns, similar to those regarding the EU proposals for a Common Consolidated Corporate Tax Base (CCCTB).

We have concerns that it would not be possible to reach consensus on appropriate nexus factors and their relevant weightings, which would result in a reasonable estimation of multinational profits attributed to market-based factors that would yield a reasonable calculation of market-related profits, across a myriad of business sectors.

Paragraph 53 of the consultation document proposes that the tax base could be determined by applying a global profit rate of a multinational group to the revenue generated in a particular jurisdiction. The BEPS Action 1 Report[9] did not pursue such an approach because it presented several difficulties, given the domestic laws of most countries use profit attribution methods based on the separate accounts of a permanent establishment, rather than fractional apportionment.

Paragraph 54 of the consultation document suggests that other simplified methods of allocating profit could also be considered, such as the modified deemed profits methods described in section 7.6.2.3 of the BEPS Action 1 Report.[10] We would have reservations over the operability of this approach and indeed, the Action 1 Report recognised that there could be serious challenges with applying such methods:

> *"However, for large MNE groups with complex structures operating in many lines of business, applying multiple industry-specific presumptive profit margins to the same significant economic presence presents several practical challenges. Another challenge relates to the comparability of digital and traditional business models when considering the applicability of such deemed profit margins. Many digital business models have a different cost structure than traditional business models, such that adjustments to margins found in this context are very likely to be required. In addition, application of deemed profit methods in this context may be considered as a substantial departure from current international standards, resulting in a tax liability even where there are no actual profits generated through the significant economic presence."*[11]

Paragraph 55 of the consultation document suggests the imposition of a withholding tax as a collection mechanism and enforcement tool. Withholding taxes that operate at present in the international tax regime generally apply to passive income from capital investment such as dividends, interest and royalties. They apply to gross payments, often at a low rate. In these cases, the gross payment is generally a reasonable approximation to the profit arising from the asset, as the costs that are directly involved in generating that income would be low.

However, applying a withholding tax to gross payments for goods and services is an entirely different matter, as the expenses involved in generating this type of income would be much higher. In fact, a lot of digital businesses operate on very low profit margins or indeed are actually in a loss-making position. This is particularly true in the case of start-up and small businesses, investing in their ambition to operate as a global firm and trying to break into new markets. While larger companies may have the scale to trade through and absorb the imposition of such taxes, smaller companies could be impacted most by them.

From and EU perspective, the imposition of a withholding tax by a Member State may be contrary to the EU fundamental freedoms, if it exempts entities that are resident in a Member State but applies it to comparable entities that are not resident in the same Member State.[12]

[9] OECD (2015), Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, page 112, paragraph 288.

[10] OECD (2015), Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

[11] OECD (2015), Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, page 291, paragraph 291

[12] Article 49 of the Treaty on the Functioning of the European Union and judgment of the Court of Justice of the European Union in the case of *Emerging Markets Series of DFA Investment Trust Company v Dyrektor Izby Skarbowej w Bydgoszczy*(C-190/12)

4. Pillar 2: Global Anti-Base Erosion Proposal

The Global Anti-Base Erosion proposal outlined under Pillar 2 is intended to address remaining BEPS concerns, using two interlocking rules, namely, an income inclusion rule and a tax on base eroding payments.

The member countries of the Inclusive Framework have committed to implementing the BEPS standards. In addition, EU Member States are in the process of implementing ATAD[13] and ATAD2.[14] Until the overall BEPS package and ATAD measures have been fully implemented by countries, the full effect of these far-reaching changes to the international tax system will not be known and whether they have achieved the desired behavioural impact. Certainly, early indicators in the 2018 OECD Interim Report[15] are that the BEPS measures are having a significant impact on tax structuring decisions of multinational groups.

Part of the Inclusive Framework's work under Action 5 of the BEPS project relates to the identification of preferential tax regimes. Peer reviews are undertaken to identify features of regimes that can facilitate BEPS and therefore, have the potential to unfairly impact the tax base of other jurisdictions.

The most recent progress report published by the Inclusive Framework contains details of the agreement by the Forum on Harmful Tax Practices of a new standard for substantial activities requirements within no or only nominal tax jurisdictions. The purpose of the new standard is to ensure a level playing field between those introducing substantial activities requirements in preferential regimes, with those offering a general zero or almost zero corporate tax rate.[16]

In addition, the objectives of the EU Blacklist[17] are closely aligned with those of the BEPS project, which are to increase transparency and encourage compliance with anti-BEPS measures.

Anti-BEPS rules should not dictate where business is carried on. World Trade Organisation principles state that barriers should not be put in place where there is substance to trading arrangements which exist in a given jurisdiction. Any potential solution must strike the appropriate balance and not disproportionately prejudice small and developing economies who seek to attract and rely on substantive foreign direct investment in order to develop their economies.

Indeed, five EU Finance Ministers in their letter to the US Secretary of the Treasury on 11 December 2017 regarding US tax reform, highlighted the impact anti-BEPS measures that are not targeted at abusive arrangements, can have on the trade and investment environment:

[13] Council Directive (EU) 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the internal market

[14] Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries

[15] OECD (2018), *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, page 106.

[16] OECD (2019), *Harmful Tax Practices - 2018 Progress Report on Preferential Regimes: Inclusive Framework on BEPS: Action 5*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, paragraph 6.

[17] The EU list of non-cooperative tax jurisdictions

> *"However, we have strong concerns if this is done via measures that are not targeted on abusive arrangements as this would impact on genuine business activities. This may lead to distortions in the international tax consensus as well as the trade and investment environment."*[18]

With a view to managing compliance burdens, any new rules should only be effective where a global company is of a particular size and therefore well established.[19] Otherwise, the operation of any new measures could potentially become a barrier to innovation and development of new markets.

Given the extent of the measures which are still being implemented by countries of the Inclusive Framework and the EU and the ongoing work on preferential tax regimes and the EU Blacklist, it would appear adopting a longer-term perspective would be more appropriate, in order to fully understand any remaining BEPS concerns.

This is particularly the case where the proposed measures appear to address issues that have already been tackled. For example, Controlled Foreign company (CFC) rules, which have just been adopted by all EU Members States are designed to achieve the same objective as the income inclusion rule now being proposed. In these circumstances, the requirement at this stage for the measures proposed under Pillar 2 is not yet evident in our view.

However, in any case, should a global anti-base erosion measure be implemented, it would be an imperative for it to target wholly artificial arrangements and not apply to 'low taxed entities'[20] whose profits arise from genuine economic activity. This approach would be in keeping with the core principles of the BEPS project to ensure that profits are taxed where economic activities take place and value is created and would adhere to the principles which have been clearly expressed in EU law.

4.1 Income Inclusion Rule

The income inclusion rule proposes that income of a foreign related entity would be included in the taxable base of the controlling entity, where the income was subject to low effective taxation.

In an EU context, any proposed income inclusion rule would have to be compatible with the EU fundamental freedoms[21] and the principles expressed in EU law.[22] The Court of Justice of the European Union has determined that any taxing provision which seeks to impose additional taxes by one Member State on the profits of an entity established in another Member State will be contrary to EU law, unless such measures are targeted at wholly artificial and non-genuine arrangements and are limited in scope to profits arising in a company which does not carry on real and substantive economic activities.

[18] Letter from Mr Peter Altmaier, Mr Bruno Le Maire, Mr Philip Hammond, Mr Pier Carlo Padoan and Mr Cristóbal Montoro Romero to Mr Steven Mnuchin on 11 December 2017. https://www.scribd.com/document/366895201/Letter-from-six-EUfinance-ministers-to-US-Treasury-Secretary

[19] The USA's Base Erosion and Anti-Abuse Tax (BEAT) measures are only effective where a company has revenues greater than USD$500m.

[20] Low taxed entities' in this context refers to an entity whose income is subject to a low effective tax rate in the jurisdiction of establishment or residence and payments to an entity that are subject to an effective rate at or above a minimum rate (yet to be determined), per the OECD Consultation Document on *Addressing the Tax Challenges of Digitalisation of the Economy*, 13 February 2019, pages 25-26.

[21] Freedom of establishment, free movement of services and free movement of capital as contained in Articles 49, 56 and 63 of the Treaty on the Functioning of the European Union (TFEU)

[22] Court of Justice of the European Union decision in *Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue,* Case C-196/04

As a consequence of this decision, any anti-abuse measure, such as an income inclusion rule targeting profit shifting to “low tax jurisdictions”[23], should only apply to wholly artificial arrangements and not to “low taxed entities”[24] that have generated profits from genuine economic activities.

4.2 Tax on base eroding payments

The consultation document proposes that a deduction would be denied for a payment to a related party, if that payment is not subject to an effective tax rate at or above a minimum rate.

To complement the undertaxed payments rule, the consultation document also proposes a ‘subject to tax’ rule to be adopted, which would deny treaty relief for certain payments if the income was not sufficiently taxed in the country where the income was generated.

We believe that the existing BEPS measures regarding hybrid mismatches, interest limitation rules and CFC rules already address situations where there is a risk of base erosion arising from payments between related entities and should be given the time to see the full effect of their implementation, before introducing any further new measures.

Furthermore, any proposal to deny a deduction because the tax rate is lower in another jurisdiction is likely to be contrary to the EU fundamental freedoms[25] where the recipient is resident in an EU Member State. For example, the proposed rules regarding withholding tax on interest, dividends and royalties are likely to give rise to free movement of capital issues. EU Members States have the sovereign right to set their own tax rate.

Paragraph 107 of the consultation document states that the ‘subject to tax’ rule could be limited to payments between related parties and a broader scope could be explored in respect of payments to which Articles 11 to 13 (Interest, Royalties and Capital Gains) of the OECD Model Convention applies. If the rules are intended to address remaining BEPS concerns, then they should only apply to cross-border related party transactions. Payments between unconnected parties, acting at arm’s length in the normal course of business should not be relevant for the purposes of a ‘subject to tax’ rule.

The meaning of subject to tax should also recognise that a payment can be effectively taxed not just at the level of the immediate recipient but also upon a parent entity, for example, if included in profits taxed under a CFC regime or a similar regime which taxes subsidiaries on a worldwide taxation regime or under a regime similar to the income inclusion rule.

The subject to tax rules propose to permit jurisdictions to deny treaty benefits. This could result in a counterparty jurisdiction opting not to make a corresponding adjustment in cases where a transfer pricing adjustment has been made by a treaty party, because that counterparty jurisdiction considers the upward adjustment to be inadequately taxed.

[23] ‘Low tax jurisdiction’, in this context, refers to payment that was subject to an effective tax rate at or above a minimum rate (yet to be determined), per the OECD Consultation Document on *Addressing the Tax Challenges of Digitalisation of the Economy*, 13 February 2019, pages 25-26.

[24] Low taxed entities’ in this context refers to an entity whose income is subject to a low effective tax rate in the jurisdiction of establishment or residence and payments to an entity that are subject to an effective rate at or above a minimum rate (yet to be determined), per the OECD Consultation Document on *Addressing the Tax Challenges of Digitalisation of the Economy*, 13 February 2019, pages 25-26.

[25] Freedom of establishment and freedom to provide services in the Single Market.

This approach would go against the arm’s length principle, the outcome of which would appear to be double taxation, where taxpayers are the subject of a transfer pricing adjustment in a ‘low tax jurisdiction’.[26]

Furthermore, the proposal that Article 7 (Business profits) of the OECD Model Convention could be disapplied in cases where the income of a company is not taxed at a sufficient rate could lead to not just, double taxation, but multiple taxation, as it would appear to give countries the right to tax corporate income that does not have any nexus with their jurisdiction.

In addition, the complexity in designing a minimum tax rate in a global context cannot be underestimated. Any disparity in the implementation of such measures will inevitably lead to double taxation, for example as outlined above, where countries fail to take account of tax already paid at different levels (e.g. tax paid under CFC rules or under the GILTI regime in the US).

[26] ‘Low tax jurisdiction’, in this context, refers to payment that was subject to an effective tax rate at or above a minimum rate (yet to be determined), per the OECD Consultation Document on *Addressing the Tax Challenges of Digitalisation of the Economy*, 13 February 2019, pages 25-26.