9. Countdown for the Classic Principles of Corporate Income Taxation?

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1. Background

The larger businesses operate on a global scale. They may do it the traditional way by having subsidiaries in most of the important markets in order to sell goods or services in the local markets. Depending on their products, businesses may increasingly no longer need local subsidiaries, as a substantial part of the goods may be distributed via internet sales.

The laws of the different countries are restricted to the respective territory. Consequently, tax laws and the level of tax burden of the different jurisdictions around the globe still vary substantially. In a globalized business world, it is therefore becoming more and more complex for globally operating multinationals to maintain highest compliance standards and to ensure that they bear their fair share of taxes in all jurisdictions they operate in. Simultaneously, it can be observed that tax audits around the globe have become more frequent, in depth and sometimes the tone has become quite aggressive. This might be fueled by budget restraints following the financial crisis or also by increased transparency after implementation of the Country-by-Country Reporting. The increasingly aggressive tax environment may be evidenced by the two following examples:

- The Indian tax authorities took the position that an indirect transfer by Vodafone of an Indian subsidiary would be subject to capital gains tax in India. Vodafone appealed that decision through all the courts in India. Finally, the Supreme Court of India rendered its decision in early 2012, stating that the indirect transfer of an Indian subsidiary should not be subject to capital gains tax under the applicable laws. The Ministry of Finance India then amended the respective section in the tax law, stating that shares in any foreign company shall be deemed to be situated in India, if such interest derives its substantial value from assets located in India. The government did not stop at this amendment of interpretation, but made it effective retrospectively from 1962!
- Approximately in 2009, the Danish tax authorities “SKAT” started rigorously assessing withholding tax on cross-border payments to related treaty resident entities. The argument was, that if the latter entities are using the funds received to make payments to related parties, resident in third countries, SKAT would need to look at the “ultimate beneficial owner” of the funds. In other words, if e.g. a Danish entity pays a dividend to its Luxembourg parent company who uses the funds received to pay interest to an offshore entity, then the Danish withholding tax is a final cost. On March 1, 2018, the Advocate General published its Opinion, which was in favor of the taxpayers. On February 26, 2019, the Court of Justice of the European Union rendered its decision by basically approving SKAT’s view.

One may now argue that these are extreme cases. However, the difficulty for the tax practitioner is that the structures were implemented at least ten years ago. The tax landscape has changed dramatically in between, and the courts are now using today’s lenses in order to decide cases implemented more than 10 years ago. Now what happened in-between?

2. Changing the Tax Landscape

Base erosion and profit shifting (BEPS) refers to tax avoidance strategies that according to the Organization for Economic Co-operation and Development (OECD), aim at exploiting gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations. The OECD can only stipulate a political consensus of its member states. In order to achieve the stated goal, the BEPS project has to bridge the gap between the local laws and the fact that businesses operate on a global scale. Logically, this could be achieved by providing some form of harmonization between the different laws. However, in the tax sphere, there are two schools of thought to create a level playing field.

One asking for “objective” criteria. A good example for such rules is included in the 1996 US-Swiss treaty. In Art. 22, there is a cascade of objective tests, as to whether a certain structure is set up for sound business reasons or not. In the negative case, the structure is deemed to be set up for what is commonly referred to as treaty shopping purposes and access to treaty protection is not available.

The other school of thought is asking for “soft” or subjective criteria. Those are usually in some form of General Anti Avoidance Rules. As the term “general” stipulates they are intended to cover all the transactions that could be considered as problematic, either currently or in the future. The idea has of course its merits, but may be tricky for numerous reasons. One, that the burden of proof is shifted to the tax payer so in case that the tax authorities deem a transaction to be an avoidance scheme, it is the obligation of the tax payer to convince the tax administration that this is not the case. Relevant court cases indicate that this may be quite a time-consuming exercise and that the tax payer may need to appeal through all the levels of the different courts.

It is obvious that it may be quite difficult to come up with rules that would satisfy the needs of the exponents of both different schools of thoughts. Accordingly, the proposals suggested by the OECD need to provide for different options to get the buy-in of the member states. Then there is the difficulty that the proposals need to be transformed into local laws. In other words, it is inherent to that process that there will be differences between the way the measures are implemented in the respective countries. In order to test the hypothesis, let us focus on the two BEPS actions that have gained substantial momentum over the past few months as well as a remarkable proposal of the EU:

2.1 BEPS Action 1

BEPS Action 1 addresses the challenges for international taxation created by the spread of the digital economy. It is acknowledged that because the digital economy is increasingly becoming the economy itself, it would not be feasible to ring-fence the digital economy from the rest of the economy for tax purposes because of the persuasive nature of digitalization. However, the OECD is of the view that certain business models and key features of the digital economy may exacerbate BEPS risks. In the OECD’s February 13, 2019, consultation document, a two-pillared approach to the issues is outlined. In the first part, the rules how to determine the connection between a business and a tax jurisdiction (nexus) and how much profit should be allocated to the business conducted there are addressed. The second part of the OECD's approach would address remaining BEPS challenges by proposing a minimum tax and a tax on base-erosion payments. The final consensus outcomes are expected to be presented by the end of 2020. In the interim, the European commission suggested to the member states to introduce a Digital Service Tax ("DST"). However, the proposal was not approved by all the member states. Nevertheless, some of the European countries have now announced to introduce a DST e.g. France with effect retrospectively as of January 1, 2019; Italy with effect as of January 1, 2019; Spain most likely with effect retrospectively as of January 1, 2019; UK most likely with effect as of April 2020. It remains to be seen, whether or not other countries will follow and what the key features of the tax may be.

2.2 BEPS Action 12

Under BEPS Action 12, "promoters" are supposed to report "aggressive tax planning". In the context with "promoters" it must be noted that there is a cascading of who needs to report. It must also be noted that the term "aggressive tax planning" needs to be interpreted in the broadest sense of the word. The OECD has defined some "hallmarks" (categories) that deem a transaction to be "aggressive tax planning". So cross-border planning based on a "confidential paper" or a reference to standardized transfer pricing, e.g. the use of safe haven rates may deem a transaction to be "aggressive tax planning". Generally, it may be the advisors, however, in case that they are bound by attorney client privilege, it may be the taxpayer that has to report.

The EU came up with a proposal to the member states to introduce Mandatory Disclosure Rules (commonly referred to as DAC6) that became effective as of June 26, 2018. The rules need to be transcribed into national law by December 31, 2019, and to be effective at the latest as per July 1, 2020. Poland was the first country of the EU that introduced the national law effective as of January 1, 2019. The rules are much more restrictive than DAC6, i.e. the scope of reportable transactions is much broader. In the interim, other countries have drafted proposals such as Germany, Sweden, the Netherlands and others.

As mentioned above, the practitioners have an obligation to report since June 26, 2018. So, one has to report in-scope transactions albeit most of the rules have not yet been finalized. So essential questions are not entirely clear yet, e.g.: What is an arrangement? Who needs to report to whom? In case that safe haven rules are used, what if those change, would that qualify as a new arrangement? By this background, it is imperative for multinationals to closely follow the developments in the different countries. Non-compliance with DAC6 regulations would result in penalties.

2.3 Common Consolidated Corporate Tax Base (CCCTB)

The Common Consolidated Corporate Tax Base (CCCTB) is a proposal for a common tax scheme that was developed by the European Commission. It was first proposed in March 2011. CCCTB provides a single set of rules for how groups being headed by an EU company should calculate their EU tax base. An apportionment formula allocates the taxable income to the EU member states based on the factors assets, labor and sales. Under the CCCTB, the EU countries would continue to have their own corporate tax rates. The original proposal stalled, largely due to objections from countries such as Ireland and the UK. In June 2015, the Commission announced that they would submit a relaunched CCCTB proposal in 2016. The proposals may have its merits, however, it seems to us that the implementation may be quite difficult, as it requires e.g. harmonized reporting throughout the group. Apart from that, the CCCTB is disputable as it ignores the arm's length standard, in particular factors like investments, IP ownership, functions and risks. In short, it seems to us that the CCCTB is somewhat over-engineered.

3. Conclusion

As a result of the latest developments, it seems that we say goodbye to some of the pillars upon which the international tax principles are founded. The minimum taxes may apply irrespective of whether or not there is income or whether the income attributable to a certain location is at arm's length. So it is not only the arm's length principle, it may even be that the corporate income taxes are at jeopardy if we consider the developments regarding the DST that may apply irrespective of whether income is generated at a certain location or not. That leads to the question of the future of corporate taxation.

The drivers behind the BEPS project are to align the place of the economic activity, i.e. where value added of a company is actually created, with the place where taxes are being paid. In order to achieve this goal, it is key that the involved countries and organizations act in concert. Uncoordinated unilateral measures substantially increase compliance risks and costs for the tax payer. It may also lead to more dispute cases, compromising legal certainty. Such scenarios are also not in the interest of the different countries, as it absorbs lots of resources and may not guarantee additional revenue.

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