

Alternative Models for International Tax Policy

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I. Challenges to the Current System

The current international tax system is under pressure. Both from a theoretical perspective and from a policy point of view criticism has arisen in international tax circles over the last decades. Yet this criticism itself does not show a coherent nature. Rather, we witness the build-up of a wave being fed from different inflows. Taking a closer look one can identify at least three major areas where the fight for the future of international taxation is evolving:

1. Source versus Residence

The first conflict area concerns the divide of tax jurisdiction between residence countries and source countries. The existing international tax regime shaped by the OECD Model Convention starts from the assumption that the residence country of an individual or a corporation holds the right to tax mainstream business profits and other income unless the Convention says otherwise¹. This is particularly highlighted by the fact that income from cross-border commercial activities is only taxable in other jurisdictions if the taxpayer has set up a permanent establishment (PE) there². Following the OECD Model's traditional definition, this PE threshold will typically be passed in countries where the taxpayer has either set up a production unit (manufacturing, research and development etc.) and in countries where the taxpayer has set up a distribution unit (sales office etc.). But the simple delivery of goods and services across the border does not – following the OECD Model Convention – give rise to income taxation in the market country³.

This outcome is corroborated by the fact that source taxation of income arising in permanent establishments is restricted to the share of the overall profit which can be attributed to the specific function (manufacturing, distribution etc.) performed by this permanent establishment. To give an example: The opening of a sales office in a consumer country does not lead to the allocation of the overall business profit arising from these sales to that jurisdiction: Rather, the consumer country is entitled to tax the profit margin that can be allocated to the functions performed by the sales office⁴. The larger slice of the profit will be taxed where the headquarters resides and where the production is performed.

The systematic preference for the country of residence with regard to mainstream business income is further reinforced by the treaty provisions on the taxation of interest and royalties (Art.11, 12 OECD Model) which allocate taxing rights to the residence country of the owner of the financial instrument or the intangible and which tend to reduce withholding taxation in the country where the debtor is located or where the intangible is employed⁵.

This is the starting point for a world-wide debate on the question whether source taxation should be strengthened and residence taxation should be attenuated. The debate revolves around general top-

¹ *Rosenbloom/Brothers* (2015) p.760.

² Art.7 par.1 OECD Model DTC; Art.7 par.1 US Model DTC.

³ IMF (2014) para 8.

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⁵ *Rosenbloom/Brothers* (2015) p.760; *Schön, Devereux/Vella* (2014) p.451; the current state of empirical research on the downward trend of withholding taxes is laid out by IMF (2014) Appendix V.

ics – dividing taxing rights between production countries and market countries – and specific topics – in particular the technical details of what has been called the gradual “erosion” of the permanent establishment threshold. Major examples of this incremental decline include the introduction of different concepts of “Service PEs”⁶ under the OECD Model Tax Convention or the UN Model Tax Convention and the most recent reform of the permanent establishment threshold under Action 7 of the BEPS Action Plan⁷.

In recent years, this borderline between source and residence has attracted increased attention following the “virtualization” of the distribution line. Given the fact that “digital presence” in a market as such does not imply the creation of a permanent establishment, profits derived by multinationals from offering goods and services in the digital marketplace are not substantially taxed in the consumer country at all⁸. This contributed to the evolution of the OECD’s BEPS project which took the digital economy as a major reason for rethinking the current international tax order⁹.

This “source vs. residence” debate is largely related to the current predominance of industrialized countries (in particular: OECD countries) vis-à-vis developing countries and emerging economies under the existing model¹⁰. The widespread call for strengthening source taxation is therefore meant as a political initiative to increase participation of those countries in the global tax base. As far as new conflicts within the community of industrialized countries come into play, they rather relate to the possible extension of tax jurisdiction on the basis of “digital presence”¹¹ which is mostly exploited by powerful U.S. players on the Internet.

2. Ownership and Contracts versus Economic Reality

Secondly, insofar as taxing rights are granted to the residence country of a corporate taxpayer, this implies that categories like “ownership”, “contracts”, “funding” and “risk-taking” play a major role for international tax allocation. This becomes visible in the fact that under Art.11 and 12 of the OECD Model Convention and the US Model Convention income from financial and intangible capital is primarily taxed where the owner of this financial and intangible capital resides, decides on the allocation of funds and assumes the risk to lose the invested capital. But also for mainstream commercial income it is evident that the contractual allocation of asset ownership, financial funds and business risk to specific taxpayers has major consequences in the tax world. This situation is largely seen to be exploited by multinational enterprises as it enables them to arrange for the contractual allocation of business profits within the firm to separate units – including units located in tax havens¹². While the powers under Art.9 par.1 OECD Model Convention can be employed by tax authorities to adjust pricing of intra-group transactions according to the arm’s-length-standard, this does not call into question the business enterprises’ fundamental option to allocate asset ownership and contractual rights and obligations for tax purposes¹³.

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⁸ IMF (2014) para 11 and Appendix II.

⁹ OECD (2013a) p. ; OECD (2013b) p. ; European Commission (2015a), Introduction.

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¹¹ OECD (2013a) p.7; OECD (2013b) p.10.

¹² Graetz (2016) p.187 et seq.

¹³ IMF (2014) para 46 et seq.; *Devereux/Vella* (2014) p.456.

It seems fair to say that the combined effect of residence taxation, separate accounting for group members and the recognition of contractual arrangements within the group creates a scenario where the tax base can be moved on purpose to low-tax jurisdictions¹⁴. To give just one major example: fat capitalization of a small business unit in a tax haven can make a huge difference for the effective tax rate of the overall group as the (normal and sometimes also the super-normal) returns to that capital will be primarily subject to tax in that unit's tax-friendly residence country¹⁵.

This matter has been raised extensively in the context of the current BEPS debate. The *cantus firmus* of the official BEPS documents is that international taxation of multinational enterprises should reflect "economic reality"¹⁶. This is clearly aimed at reducing or removing the incentive to locate funds and assets in a low-tax jurisdiction without locating economic substance in that jurisdiction as well¹⁷. In its recent communication on "Corporate Income Taxation in the European Union" the European Commission has signed up to this perspective on international corporate taxation¹⁸.

This "ownership" vs. "economic activity" debate must not be confused with the aforementioned debate about "source" versus "residence". While the source/residence game is played to a large extent between production countries and market countries (e.g.: US-based internet firms vs. European consumers or European car manufacturers vs. emerging economy buyers), the ownership/economic activity game is played between production/market countries on the one side and tax havens (including large countries entertaining preferential tax regimes) on the other side. To put it differently: Both production countries and market countries have (to a certain extent) an interest to close down tax havens¹⁹ but the closure of a tax haven by changing international tax rules does not give the answer to the question where the taxing right should go: to the production country or to the market country.

3. Theory of the Firm versus Separate Accounting/Arm's Length Standard

Thirdly, academic writers more and more rally behind the proposition that the framework established by national legislation and international treaties on separate accounting and arm's length transfer pricing within multinational firms has outlived its use-by date²⁰. They point to the fact that between companies held under common control any contractual risk arrangements as well as the existing debt-equity distinction and also the allocation of asset ownership should not play a meaningful role²¹. This is not only due to the existence of strategic options for multinational enterprises to allocate income between group members at will for tax purposes. Rather, the whole rationale of setting up an integrated multinational firm relates to the value of organizational synergies and long-term hierarchical relationships vis-à-vis on-the-spot transactions with independent market partici-

¹⁴ OECD (2013a) p.33 et seq.; *Fleming/Peroni/Shay* (2015) p.696 et seq.

¹⁵ For an overview of the empirical literature see *Yeoh* (xxxx) p.44 et seq.

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¹⁷ *Saint-Amans/Russo* (2016) p.236, 240.

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¹⁹ *Crivelli/de Mooij/Keen* (2016) find that developing countries suffer more from BEPS-related profit shifting than from tax-driven changes in the real economy.

²⁰ *De Wilde* (2016a) p.182

²¹ For the opposite view see: *Schoueri* (2016) p.692 et seq.

pants²². Against this theoretical background, arm's length pricing is not only regarded by these writers to be difficult to apply and easy to exploit but fundamentally and conceptually flawed²³.

Many academic critics of the current system therefore plead for a move towards unitary taxation of multinational enterprises on the aggregate profit of the group which will then be divided up between the involved countries not by reference to individual corporate entities but by formulaic apportionment²⁴.

This criticism, which is derived from general assumptions about the economic theory of the firm is basically independent from the above-mentioned political conflict between source countries and residence countries and it is also independent from the debate as to what extent multinational firms are able to game the existing system given the relevance of "ownership" and "contracts".

Nevertheless, consolidation of business income within the group and formulaic apportionment relating to economic "factors" will have an effect on those issues as well. To give some examples:

- Any group-wide consolidation of profits will wipe out the effect of intra-group dealings including the debt/equity choice and contractual risk allocation.
- Moreover, if the factor formula employed for the apportionment of the overall group profit between jurisdictions leaves out ownership in and location of financial assets and intangibles, taxing rights will tend to align more with "real" persons, assets and transactions present and performed on the ground²⁵.
- If and to the extent to which the factor formula includes a sales factor, taxing rights will move from production countries to market countries, while developing countries will predominantly benefit from a move towards a labor factor²⁶.

Against this background, a move towards consolidation and formulaic apportionment would have multiple (politically important) effects from the perspective of tax allocation between jurisdictions.

One additional aspect deserves to be mentioned: Consolidation and formulaic apportionment do not cover all issues of international tax allocation as the impact of any rules prescribing formulaic apportionment does not reach beyond the boundaries of the taxable corporate group. As far as taxable events between independent firms are concerned, the introduction of formulaic apportionment would not entail any change of tax allocation rules and the long-standing controversy between source and residence countries would live on for the time being. To give an example: The taxation of royalties derived by a European high-tech firm from an independent manufacturing company in a developing country would follow the classical allocation to the country of residence.

²² For a recent defense of arm's-length pricing regarding synergies see: *Peng* (2016) p.378.

²³ For a more nuanced view see IMF (2014) para 48: As firm size should expand to the point where internal transactions are on the margin as efficient as external transactions It makes sense to assess the tax outcome of internal transactions under a market-based approach.

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²⁶ IMF (2014) para 69.

II. Misconceptions on Residence and Source

1. The Concept of Residence

Taking a closer look, the concept of “residence” as a starting point for the taxation of individuals and corporations is employed in the international debate in two very different ways:

- On the one hand it refers to the jurisdiction to which a natural or legal person shows personal allegiance, leading to the right of that jurisdiction to tax their income on a world-wide basis²⁷. This personal allegiance can be established by nationality – as the U.S. prescribes both for individual and corporate taxpayers – or it can be established by residence – meaning long-term physical presence of individual taxpayers or the ongoing activity of the corporate board or the corporate headquarters of a firm in a specific jurisdiction²⁸.

The economic significance of this concept of residence is continuously diminishing – at least with regard to corporate entities²⁹. Firstly, the nationality or residence of a company less and less reflects the nationality or residence of its shareholders³⁰. This makes it difficult to justify corporate taxation on a residence basis as a backstop for individual taxation. Secondly, corporate residence can be shifted around at low cost – as currently shown in the U.S. controversy on inversions. It is therefore prone to tax planning strategies undermining the impact of corporate taxation at large. Moreover, multinational enterprises are able to exploit residence-based taxation not only with regard to the taxability of the parent company but to a much larger extent with regard to the residence of subsidiaries as current rules allow for different places of residence for different companies belonging to the same multinational group while deferring taxation of the subsidiaries’ profits at the parent level until these profits will be distributed.

In the end, depending on the respective organizational choices, the “personal allegiance” of the involved separate taxpayers might differ at all three levels: shareholders, parent companies and subsidiaries will often be resident in three different countries. These mismatches lead to further issues of international tax policy which are well known under the headings of “deferral”, “CFCs” and “repatriation”. In several recent papers, a prominent group of U.S. academics has therefore pleaded for a fresh start: to link the corporate residence (under tax law) to the physical presence of the majority of the corporation’s shareholders or the location of a controlling parent company³¹. This is not only meant to reduce leeway for strategic tax planning but also to reinforce the role of the corporate income tax as a prepayment of the individual income tax of the shareholders.

It is hard to say whether corporate residence in the traditional sense is still a meaningful concept under these assumptions. Its remaining purpose in the international tax world seems to be the provision of a back-up for residual world-wide taxation of corporate income otherwise taxed nowhere³². This is of particular importance when source countries decide to levy no or only very low taxes on

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²⁹ Schön (2009); Shaviro (TLR); Kane (2015) p.313; Rosenzweig (2015) p.477 et seq.; IMF (2014) para 11; Shaviro (2014) p.32 et seq., 65 et seq.

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³¹ Fleming/Peroni/Shay (2014) p.21 et seq.; Fleming/Peroni/Shay (2015) p.718.

³² Graetz Schön

corporate income – in particular tax havens. But this back-up function and its value should not be confused with the role of “residence” in the ongoing large-scale conflict between residence countries and source countries.

- In this grander picture the notion of residence taxation is oftentimes employed to refer to the jurisdiction where headquarter activities are located, assets and risks are administered and – following traditional business models – a major part of production (manufacturing) takes place. A familiar example is a parent company registered in an industrialized country where simultaneously the headquarters, the R&D units and the major production facilities are present. Again, residence taxation grants precedence to this industrialized country. But this kind of “residence” is a misnomer as it does not refer to personal allegiance in its technical meaning. It rather refers to specific “sources” of income like “significant people”, “assets” and “production” located in the residence country³³.

In this context, the conceptual divide between “residence countries” and “source countries” has to be understood rather as a heuristic divide between different groups of “source countries”³⁴: those countries where business units providing central functions and high level upstream production are located and those countries where business units providing low-level routine production and a substantial customer base for goods and services are to be found. The policy question of whether residence or source is the right starting point for taxing rights addresses a conflict between countries providing different source factors for the aggregate business income of the taxpayer. The main task for international tax policy consists in finding a way to allocate business income to those factors and the respective countries.

2. The Concept of Source

While the foregoing analysis leads to the interim conclusion that from a policy perspective source carries more weight than residence, the concept of source itself is riddled by its own flaws and misunderstandings³⁵. Source refers – as traditional wisdom has it – to “the physical presence of labor and/or capital” in a jurisdiction³⁶. But the very notion that income can be “sourced” to or in a specific jurisdiction clashes with the fundamental assumption that income as such is not a spatial concept but a personal concept which refers to the overall accretion of net wealth in the hands of a specific taxpayer³⁷. This is not only a conceptual but also a practical problem coming up every time when the source of income has to be located³⁸. In this respect it has been acknowledged that there is hardly any income generated by a firm in a cross-border context which owes its existence to simply one jurisdiction. Establishing taxation by tracing the “origin”³⁹ of income is by far not a pre-ordained process.

To give some examples: The source of income from sales and services can be ascribed both to the production country and to the market country. The source of income from financial capital can be ascribed both to the residence country of the creditor and the residence country of the debtor – and

³³ *Vogel*

³⁴ *Vogel*

³⁵ *Shaviro* (2014) p.36 et seq.

³⁶ IMF (2014) para 8.

³⁷ *Ault/Bradford ; Kane* (2015) p.313, 323 et seq.; *Shay/Fleming/Peroni* (2002) p.

³⁸ *Devereux/Vella* (2014) p.453 et seq.

³⁹ *Kemmeren*

arguably to the country where the capital is invested. Income from the exploitation of intangibles can be traced to four places: where the intangibles are created, where they are acquired and owned, where they are employed for manufacturing and where the manufactured goods are sold under the protection of intellectual property law⁴⁰. Against this background, allocation of taxing rights cannot simply follow a “natural” order of source country entitlements⁴¹. Rather, the notion of source itself is merely a heuristic concept which allows tax experts to discuss and delineate the distribution of taxing rights between countries⁴².

This distribution can be built on different premises all of which lead to different kinds of source taxation. Traditionally, a large group of experts wants to justify a country’s taxing rights by referring to the public goods provided by that country for the generation of the taxable income – including social goals of redistribution or access to local customer markets⁴³. But it is hard to develop any meaningful relationship between the benefits enjoyed and the income generated in a specific jurisdiction (in particular when the enterprise as a whole or the local business unit is in a loss situation)⁴⁴. And current international tax practice on source taxation does not seem to follow the conceptual framework of the benefit principle in a systematic fashion at all⁴⁵.

Other approaches to conceptualize source taxation look to administrative practicality (which pleads against taxing remote income and favors taxing local income as the latter can be ascertained by tax authorities without excessive costs) or even “brute force” which links a taxing right to the actual territorial power of a given state to enforce a tax claim⁴⁶. Last but not least, an efficiency-oriented theory of source might look to the existence and traceability of location-specific rents as special items of income which can be taxed without deterring inbound investment and economic activity⁴⁷.

Whatever the merits of these different justifications for source taxation may be, it remains to be said that all theoretical assumptions about the nature and origin of business income do not have any legally binding consequences for the taxing powers of the involved states⁴⁸. Under international customary law each state is entitled to tax any income which bears some “genuine link” to its jurisdiction⁴⁹. This is an extremely wide concept which hardly sets any limits to the taxing rights exercised by a state and which clearly does not provide a clear-cut mechanism of apportionment once two states can show that they have a legitimate claim to tax a given item of income.

3. Conclusion on Residence versus Source

We can conclude the following:

- Residence corporate taxation in its current sense has to be understood as a back-up providing residual world-wide taxation of business income not taxed elsewhere. Its main impact re-

⁴⁰ Lokken, Schön, Fleming/Peroni/Shay (2015) p.708 et seq.; Kane (2015) p.341; Graetz (2016) chapter 4, p.207 et seq.

⁴¹ Ault, Schön, Kane

⁴² Kane (2015) p.322 et seq.

⁴³ Shay/Fleming/Peroni (2002).

⁴⁴ Schön Graetz (2016) chapter 3, p.117; Shay/Fleming/Peroni (2002) refer to non-discrimination.

⁴⁵ Shay/Fleming/Peroni (2002) p.

⁴⁶ Kane (2015) p.326, 339.

⁴⁷ Kane (2015) p.354.

⁴⁸ Schön

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fers to items of income for which no meaningful source taxation is established in another jurisdiction.

- Source taxation has a wider meaning than commonly used in the international tax policy debate. It can refer to all sorts of factors which have an impact on the generation of business income. Yet there is no self-evident benchmark for the allocation of income to countries whenever different factors contribute in different ways to the overall corporate profit.

In the end, countries will have to decide politically to what extent they exercise their taxing power – be it unilaterally or on the basis of bilateral or multilateral arrangements between countries. To that end, they will take into account both the enhancement of efficiency and the generation of public revenue. They will have to decide to what extent they are willing to extend the tax burden on cross-border business in order to increase their public budget and to what extent they will defer to the pressure of tax competition and lower the tax burden in order to attract foreign investment.

In the context of tax competition one further has to accept the fact that some countries which claim taxing rights over a given source of income have freely decided not to use their taxing power to establish an effective tax burden and to generate public revenue thereby. Allocation of taxing rights to a country does not automatically result in taxation by that country. The much-deplored non-taxation of outflowing interest and royalty payments is to a large extent due to a strategically considered waiver of the right to levy a withholding tax by source countries which are willing to attract the inflow of capital and intellectual property. But this does not call into question their entitlement to act otherwise. The same analysis holds true for the allocation of taxing rights between production countries and market countries: Market countries who command a large customer base have to form a political judgment on whether it seems useful and practical to extend source taxation to income from inbound sales and services. In this context they will consider the question of whether levying a substantial VAT on inbound sales and services is sufficient to participate in the taxable value of cross-border flows of goods⁵⁰. Last but not least it cannot be disputed that tax havens largely build their “business model” on claiming taxing rights over the income of foreign-owned companies – but not taxing them at all.

III. Responses

1. Overview of Reform Proposals

In recent years, several proposals have come up to meet the challenges laid out in the preceding part of this chapter. Some of these proposals focus on the U.S. situation while others show a clear relationship to the EU framework. Some of them try to take a global view, including work done by OECD. It goes without saying that the goals of these proposals are informed by their background: some try to assert world-wide taxation from a U.S. perspective, others try to implement a tax framework compatible with the principles of the European Internal Market, some proposals try to cater to the fiscal interests of emerging and developing economies.

A limited group of these proposals deserves close analysis as they attempt to solve some – but not all – of the problems described so far. From a systematic point of view it makes sense to identify five different avenues for international tax reform:

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- The first option is to leave the international tax order basically unchanged while introducing some adjustments which aim at minimizing harmful tax competition and aggressive tax planning. The motto for this policy movement is “aligning taxation with value creation”: this is the option put forward under the BEPS work of OECD⁵¹. Following the OECD’s Action Plan on BEPS, there will be no fundamental rearrangement of international taxing rights (i.e. the “source-residence” divide will live on) and there will be no mandatory cross-border consolidation of a multinational’s profits (i.e. intra-group dealings will still be recognized for tax purposes). But in comparison to existing tax practice, artificial arrangements will tend to be disregarded following the battle-cry to “align taxation with value creation”.

- The second option is to strengthen residence-based taxation of corporations on a world-wide basis. This option is widely discussed in the U.S. as the existing U.S. tax system is largely built on the principle of capital export neutrality and world-wide taxability of business profits. Some authors have even considered lifting “deferral” for foreign profits in full, thus giving rise to world-wide current U.S. taxation of all corporate income generated within the framework of a U.S. based multinational group. Within the political debate, several proposals deserve closer scrutiny: One reform proposal – originally developed by *Harry Grubert* and *Rosanne Altshuler*⁵² – pleads for a worldwide minimum tax on the current profits derived by groups under the control of a U.S. parent. It was partly taken up by the Obama Administration in their 2016 draft budget⁵³. Another reform proposal – put forward by *J. Clifton Fleming Jr.*, *Robert J. Peroni* and *Stephen E. Shay*⁵⁴ – aims at establishing a minimum tax on active income derived by foreign CFCs. *Daniel Shaviro*⁵⁵ – to mention a third option – proposes to lift deferral and to scrap the foreign tax credit for foreign source income of U.S. corporations; in his view, the division of taxing rights between the residence country and the source country shall be effected by lowering the tax rate on foreign source income and by making the foreign tax deductible for domestic tax purposes.

- The third option is to introduce profit consolidation for multinational companies beyond the limits of separate legal entities within the group and beyond the borders of taxing jurisdictions. The overall result would be allocated to the involved jurisdictions under a politically agreed formula based on factors like assets, payroll/workforce and sales. This option goes back to long-standing practice employed by individual U.S. States. Against this background, formulary apportionment has also been championed for international tax reform by a substantial group of U.S. tax academics⁵⁶. The European Commission’s proposal for a Common (Consolidated) Corporate Tax Base of which an updated version has been published in 2016⁵⁷ is currently the most prominent attempt to establish formulary apportionment for international taxing rights.

- A fourth option consists in a combination of traditional transfer pricing methods and formulary apportionment. A couple of proposals⁵⁸ aim at a “residual profit split” or a “residual profit apportionment” according to which profit allocation to individual group companies should follow the traditional model of separate accounting and arm’s length pricing to a limited extent, in particular when it

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⁵² *Grubert/Altshuler*

⁵³ *U.S.*

⁵⁴ *Fleming/Peroni/Shay*

⁵⁵ *Shaviro* (2014) p.

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⁵⁸ *Schreiber, Avi-Yonah/Clausing*; see IMF (2014) para 72 – 73.

comes to remuneration of routine functions performed by those individual business units. Only the “residual” profit derived from synergy rents, risk-taking and financial instruments should be allocated under a formula, e.g. by applying a sales-only factor to it.

- The most advanced reform model has been put forward in the context of the United Kingdom’s *Mirrlees Review* under the flag of the “destination-based cash flow tax”⁵⁹ (DBCFT) which combines features of a sales-based corporate income tax, in particular deductibility of wages, with features of a VAT, in particular full deductibility of investment expenditure and border adjustment for imported goods and services.

Both the “residual profit split” and the “DBCFT” will be discussed at length in subsequent chapters. The analysis presented in this chapter will therefore focus on the merits and deficiencies of the first three lines of thinking – the theory behind BEPS, the strengthening of world-wide income taxation and the introduction of wide-reaching formula apportionment. In order to assess these proposals it seems necessary to clarify the requirements which a comprehensive proposal for international tax reform should meet. These benchmarks are not easy to define, given the different political expectations. Nevertheless, it makes sense to lay out some of these.

2. Benchmarks for International Tax Reform

a) Efficiency

aa) Non-Distortionary Taxation (Neutralities)

A starting point for the evaluation of policy proposals on international tax reform is their impact on efficient allocation of resources. To a large extent, this perspective refers to the goal to reduce “deadweight losses” resulting from distortionary taxation. In the past, these assessments have been made having regard to different types of “neutralities”. Traditional thinking has put the choice between capital export neutrality (CEN) and capital import neutrality (CIN) in the foreground⁶⁰. In recent years, capital ownership neutrality (CON) has joined this venerable couple as a benchmark for international tax reform⁶¹. Most recently, market neutrality (MN) has been invoked in order to assess the impact of tax rules on the economy of consumer market countries⁶².

But these are not the only dimensions which have to be taken into account. There are additional neutralities which play a role here as well, e. g. neutrality as to the legal form of a business (important if international tax reform shall not be implemented just for corporate entities⁶³) or neutrality as to debt or equity finance (important as current international tax rules are criticized for creating a detrimental “bias” in favor of debt financing⁶⁴). Moreover, both individuals and corporations command a (limited) discretion where to reside which should not be distorted by tax incentives or disin-

⁵⁹ *Auerbach/Devereux*

⁶⁰ *Shaviro* (2014) p.121 et seq.; it should be noted that both CEN and CIN start from an undisclosed hypothesis: a clear distinction between the jurisdiction where the investor is located and the jurisdiction where the investment is located. This distinction has become less reliable as the concepts of “residence” and “source” show less and less meaning in the real world (*Schön*, IMF (2014) Appendix VII.

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centives⁶⁵. Another dimension concerns the choice between “outsourcing” and “insourcing” of parts of a firm’s value chain: It is evident that following the introduction of formulary apportionment for all profits generated within the boundaries of a multinational group, the decision of the firm’s management whether to “make or buy” certain goods and services will be impacted by tax considerations⁶⁶. In scholarly writing, it has been laid out at length that it is not possible to achieve all kinds of neutrality simultaneously⁶⁷; still these concepts provide a useful framework to evaluate the merits of a given proposal.

But there is one strong additional point to take into account: One should always bear in mind that the search for a “neutral” tax does not automatically show the way to the allocation of the resulting revenue between the involved countries⁶⁸. Capital export neutrality can be achieved by residence-only taxation (giving the whole revenue to the country of residence) but also by granting a (unilateral) tax credit for foreign source taxes as long as the source tax does not surpass the residence tax (sharing the revenue between the involved jurisdictions). Neutrality as to debt and equity can be achieved *via* a comprehensive business income tax (allocating all financial income to the source country) and *via* an allowance for corporate equity (leaving taxation of all financial income to the financier’s residence country). Tax politicians will not leave out this issue in order to achieve an efficient system.

bb) Choices regarding “real activity” versus choices regarding “finance, contracts and accounting”

When it comes to the taxation of multinational business it should not go unnoticed that there exist two different “categories” of choices for taxpayers which affect international tax policy. There are choices which affect in the first place the real economic situation of a firm (and consequently its tax situation), while other choices only affect its tax situation⁶⁹:

- On the one hand, international tax law affects the decision where to set up a company, where to locate certain investments and activities and where to supply goods and services to a customer base. These decisions involve “real economic activities” in a broader sense. It is very clear that one should strive for a tax framework which leaves these decisions largely untouched as any “deadweight costs” affecting the real economy have a disadvantageous effect on overall efficiency and welfare.
- On the other hand, international tax law affects the decision where to report income, i.e. where to locate profits and other elements of the tax base without changing the underlying real activities. These choices come into play when firms exploit the leeway granted to them by the current transfer pricing rules under the arm’s length standard. They also play a major role when firms allocate ownership in real and financial assets to separate companies within the overall group or when they benefit from non-uniform tax treatment for intra-group debt and equity (in particular for hybrid financial instruments).

While the first type of decision creates effects both for the real economy and for public revenue, the second type of decision has a rather small impact on the real economy (e.g. the cost of setting up a

⁶⁵ *Shay/Fleming/Peroni* (2002) p.

⁶⁶ *Schön*

⁶⁷ *Graetz* (2016) chapter 3, p.94 et seq.; *Weisbach*

⁶⁸ IMF (2014) Appendix VII.

⁶⁹ IMF (2014) para 14: “real responses” versus “profit-shifting responses”.

letterbox company in a tax haven or the cost of paperwork involved by creating intra-group contracts) but it can have a large impact on public revenue in the involved jurisdictions. The size of these “spillovers” is hard to underestimate⁷⁰. It is self-evident that in an ideal international tax world there would be neither a tax incentive where to invest or to operate nor would there be an election available for taxpayers where to report income.

cc) Global Welfare and National Welfare

The world of international tax policy is full of both partial and comprehensive proposals for international tax reform which try to address the above-mentioned challenges. Some of these, in particular work done under the auspices of OECD, take a global approach, trying to improve global welfare beyond national boundaries⁷¹. The Institutions of the European Union follow a similar approach⁷², reaching out beyond the borders of the European Union towards third-country in “promoting tax cooperation and common standards on as wide a geographical basis as possible”⁷³. Others, most prominently the recent U.S. proposals on international tax reform, predominantly aim at national welfare⁷⁴.

It is unclear which benchmark should be chosen. On the one hand, scientific modeling tends to try to achieve an outcome that is beneficial for humankind in general; on the other hand one should not forget that national governments act autonomously and independently and have a keen interest to further national welfare (in order to be re-elected by their constituency). They will not easily sacrifice investment or revenue shares in order to increase global welfare. Against this background, proposals for international tax reform should be tested for being “incentive compatible”⁷⁵, meaning, that countries’ governments should be able to see a clear benefit from adapting a certain strategy of unilateral or multilateral tax measures. This will include coordinated measures if and insofar as global interests and per-country interests can be aligned.

To a large extent, this boils down to the age-old antagonism between tax competition and tax coordination: countries will only join the bandwagon of tax coordination if they can expect an improvement of their national welfare⁷⁶. Tax havens are a case in point: If tax coordination simply leads to loss of revenue for these jurisdictions without any compensation their governments shall have no real interest in furthering tax coordination. A similar view can be taken with regard to the above-mentioned conflict between different source countries: a re-allocation of taxing rights which simply transfers revenue from one country to another country (e.g. by extending source taxation) will hardly be the self-evident outcome of an agreement between self-interested governments. Coordination or even harmonization of tax systems will only result when countries regard a coordinated state of play to be superior to outright tax competition from their own country’s perspective⁷⁷. The outlook for

⁷⁰ IMF (2014) para 23; according to *Crivelli/de Mooij/Keen* (2016) p.284, 292 et seq., there is limited evidence that developing countries suffer more from profit shifting to tax havens than from tax-driven behavior in the real economy.

⁷¹ OECD (1998) para 4; OECD (2013a) p.9.

⁷² European Commission (1997) para 10 – 11; European Commission (2016) para 1.

⁷³ European Commission (2009) para 5.

⁷⁴ *Shay/Fleming/Peroni* (2002) p.xx: „The broadest objective of the U.S. income tax system is to advance the welfare of U.S. citizens and resident individuals.“; concurring *Graetz* (2016) chapter 3, p.98 et seq.; *Shaviro* (2014) p.107 et seq.; *Kane* (2015) p.326.

⁷⁵ *Devereux/Vella* (2014) p.452.

⁷⁶ *Keen/Konrad*

⁷⁷ This is the mantra consistently promoted by OECD (xxx) and the European Commission (xxx).

such global coordination may be dim⁷⁸ and an overly strict coordination among a subset of countries may lead to a lack of competitiveness when compared to outside jurisdictions⁷⁹.

Against this background it makes sense to strive for global welfare only to the extent that it can be shown that national governments will see it in the interest of national welfare as well to follow this line. They will look for creating a “competitive” framework for attracting investment and they will try to raise as much public revenue as possible. The benchmark should be an “incentive compatible” overall system.

dd) Efficiency and Revenue

This means in the first place that governments will have to consider to what extent tax reform improves efficiency (e.g. by reducing incentives for relocation of investment and activities and by reducing incentives for strategic tax planning) and to what extent tax reform affects revenue (i.e. the capacity of the government to enhance overall national welfare by the production of public goods and by redistribution)⁸⁰. To a certain degree, this balancing act is not amenable to scientific evaluation.

- Firstly, it is not possible to make a meaningful (general) statement on the value of the public sector as opposed to the private sector, i.e. the social value of public goods and redistribution as opposed to the social value of private income. It is up to the mechanisms of democratic government to deliver a decision on the value of a high tax burden/large public sector or a low tax burden/small public sector for society at large.
- Secondly, while the impact of different rules and principles for international taxation on public revenue and economic efficiency are widely studied, it is much harder to relate those outcomes to each other: the question whether a country should sacrifice efficiency for revenue or vice versa is in the end a political question. To give an example: Source countries will not easily give up their taxing rights (and thus all revenue from inbound investment) in order to enable residence countries to apply worldwide income taxation, thus achieving capital export neutrality in an undistorted manner⁸¹. Academic research will therefore only be able to show to national governments the benefits and drawbacks of specific tax instruments but will not provide an answer for striking a balance between these two goals.

Last but not least it should be taken into account that while the existence of a tax burden is of high importance for the decisions made by business, the allocation of public revenue flowing from this tax burden between the involved governments is not necessarily relevant for the taxpayer⁸². Thus, a coordinated approach between countries can be furthered by de-linking the efficiency-oriented set-up of the tax system from the revenue-oriented allocation of the taxes paid (e.g. by establishing a “clearing-system” between the involved jurisdictions).

b) Fairness

The global political debate on taxation currently circles around the concept of “fairness” which has – to a certain extent – superseded the traditional concept of “equity” as a substantive political con-

⁷⁸ IMF (2014) para 75 et seq.

⁷⁹ IMF (2014) para 79; *Schön Keen/Konrad*

⁸⁰ *Graetz* (2015) p.553; IMF (2014) para 33 (for developing countries).

⁸¹ *Shay/Fleming/Peroni* (2002) p. ; *Graetz* (2016) chapter 3, p.118.

⁸² *Kane* (2015) p.324.

straint to national and international tax policy. Promoters of “fairness” largely criticize two elements shaping the current international tax order: The first element is “unfair” tax competition between states which is said to dismantle the power of policy makers in individual countries to enforce their views on efficiency, public revenue and redistribution⁸³. The second element is “aggressive tax planning” by corporate entities which are criticized for not contributing their “fair share” to the public weal⁸⁴.

As this notion is mostly used by politicians and non-governmental organizations and less by academics, it remains rather vague and shows a tendency of overstating its point. Taking a closer look at the “fair share” which multinational enterprises are expected to contribute to public revenue, there are at least four different dimensions along which this concept is employed:

aa) Fairness, Ability-to-Pay, and Worldwide Income Taxation

A time-honored emanation of “fairness” refers both to the notion of equality of taxpayers and to traditional concepts of distributive justice as applied within a given group of taxpayers⁸⁵. In this sense, the current situation is regarded to benefit large multinationals to the detriment of individual taxpayers⁸⁶.

The notion of fairness in the context of equality requires a benchmark against which to measure the relative fairness of the tax burden. According to traditional wisdom this benchmark is the ability-to-pay principle which pleads for full taxation of all income derived by individuals under a linear or progressive tax rate. From an international perspective, this approach is clearly linked to the concept of world-wide income taxation as the ability-to-pay of an individual taxpayer does not differ depending on the geographical source of this income⁸⁷. This line of thinking can be translated into the corporate world. It is fair to say that as long as the corporate income tax is meant to fulfill the role of a “proxy” or a “backstop” for individual income tax, the ability-to-pay principle should prevail in the corporate tax arena as well⁸⁸. To a certain extent, this plea for “equal treatment” goes hand in hand with the plea for neutrality as a feature of an efficient tax system⁸⁹.

The problem lies in the fact, that the allocation of taxing rights between residence countries and (different) source countries cannot be derived logically from the necessity to tax individuals according to their “ability-to-pay”. The only conclusion that can be drawn from this sort of “fairness” argument for the international allocation of taxing rights might be that all income wherever generated should be taxed once (but not more than once)⁹⁰. To give an example: It has been said that the implementation of world-wide income taxation on a residence-basis only would achieve equal treatment of taxpayers according to their respective ability-to-pay and thus achieve “fairness”. But this approach clashes with the legitimate interests of source countries to levy taxes on income generated in their territory.

⁸³ *Dagan* (2013) p.57 et seq.

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⁸⁵ *Dagan* (2013) p.60.

⁸⁶ European Commission (2015a), Introduction.

⁸⁷ Shay/Fleming/Peroni (2002) p.: Abandoning source taxation does not lead to fairness.

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⁸⁹ *Grubert* (2005) p.155.

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Moreover, the aim of full and equal taxation clashes with other legitimate interests. Even if the country of residence grants a foreign tax credit for source taxes, any world-wide income taxation of corporations (which involves “topping up” of local taxes) reduces the leeway for source countries to attract outside investment by offering a beneficial tax environment, therefore interfering with another element of fairness: inter-nation fairness as explained below⁹¹. Equal treatment of taxpayers is therefore a helpful concept in the domestic situation but it does not address the fundamentals of international tax policy.

bb) Labor versus Capital

Secondly, the plea for “fair” taxation refers to the age-old rivalry between taxation of labor and taxation of capital which itself bears a certain resemblance to the conflict between the well-off and the less well-off. Multinational enterprises are regarded to be in the hands of capital owners: in this view, a low tax burden on multinationals translates into a low tax burden on capitalists as opposed to people living off labor income, in particular the firm’s employees⁹².

Anybody who regards redistribution between individuals to be one ultimate goal of taxation will therefore be tempted to reduce tax advantages for the corporate sector if these are not substituted for by an additional tax burden at the level of individuals (e.g. a substantial net wealth tax covering corporate shareholdings or a mark-to-market taxation of capital gains in shareholdings etc.). Opponents of this view point to the positive effects capital investment has for the economy as a whole: Not only fully industrialized countries but also developing countries can expect tangible benefits for their workforce in attracting outside capital investment offering jobs and welfare increases for the labor factor⁹³. Thus, a low tax burden on capital investment might in the end contribute to welfare for the working classes – as has been shown by proponents of the “dual income tax” which grants a systematic preference to capital income⁹⁴. The outcome largely depends on specific characteristics in a given economy – e.g. the mobility of capital and the elasticity of the demand for labor.

cc) Local Companies versus Multinational Corporations

Thirdly, the concept of “fairness” refers to the rivalry between large multinational companies and small and medium-sized local companies⁹⁵. The mere fact that multinational companies have (relatively cheap) access to international tax arbitrage is regarded as being “unfair” compared to their smaller brethren who simply cannot afford (given economies of scale) to embark on similar strategies. This issue goes beyond the general requirement to achieve equal treatment for taxpayers; it is widely seen as a feature of unfair competition in the market. A famous example refers to Amazon based in the U.S. competing with local booksellers in European countries: While local booksellers are subject to full taxation in their home jurisdiction, Amazon benefits from being able to steer its local distribution network from abroad without creating a taxable presence in the market country.

Establishing a level-playing field for competing businesses is a well-understood concept and the application of the arm’s length standard to the control and adjustment of intra-group dealings of multinationals is traditionally meant to achieve just that: equal treatment of local independent companies

⁹¹ *Pistone* (2013) p.277 et seq.

⁹² OECD (2013b) p.8; European Commission (2015a) p.5.

⁹³ *Dagan* (2013) p.70.

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⁹⁵ OECD (2013a) p.8, 50; OECD (2013b) p.8; European Commission (2015a), Introduction.

and local subsidiaries of international corporate groups⁹⁶. But it should be recognized that neither the existing international tax order nor the traditional efficiency standards for international tax policy focus on equal treatment of corporate taxpayers from the perspective of the market country. Both capital export neutrality and capital import neutrality factor in the location of the taxpayer and the location of his investment, and capital ownership neutrality looks to the link between a given business and its owner. In particular capital import neutrality is meant to achieve equal treatment for foreign and local investors in the country where they set up a business – but not necessarily in the country where they sell their products later on.

Contrary to this, the new standard of competitive fairness pushed by OECD and the European Commission relates to equal treatment of foreign business and local business vis-à-vis the customer base in the market place (similar to the efficiency concept of market neutrality). This market-oriented view of competitive fairness has risen in prominence due to digitalization, which allows cross-border selling without physical presence to a much larger extent than before. But it should be borne in mind that any attempt to move equality and efficiency towards market neutrality would plead for a move towards a destination-based corporate income tax, a step not easily taken by most industrialized countries. This is one of the reasons why the BEPS project did not achieve a common approach to taxation of profits arising in the digital economy.

dd) Inter-Nation Equity

Last but not least, the concept of “fairness” is used in order to recalibrate the allocation of revenue between different countries, in particular between developed and developing countries⁹⁷. Statistical evidence shows that the corporate income tax contributes to a large extent to public revenue in the developing world⁹⁸.

This notion of inter-nation equity⁹⁹ or inter-nation fairness leaves behind issues which are related to efficiency and competitiveness¹⁰⁰. Rather, inter-nation fairness alludes to a multiplicity of perspectives which can be taken in this respect:

- to the “benefit theory” of taxation, which tries to forge a link between the enjoyment of public goods by a taxpayer in a given country and the amount of tax to be paid on that behalf¹⁰¹;
- to the exploitation of location-specific resources which seem to rightfully “belong” to one state¹⁰²; this justification is regularly employed when the impact of international tax on resource-rich developing countries is at stake.
- and to the plea for international redistribution under which rich countries are invited to waive taxing rights in order to allow poor countries to increase their public revenue¹⁰³. This approach is particularly important for those very poor countries which cannot convincingly

⁹⁶ OECD ; *Schoueri* (2015) p.695.

⁹⁷ IMF (2014) para 1.

⁹⁸ IMF (2014) para 5; *Crivelli/de Mooij/Keen* (2016) p.

⁹⁹ *Musgrave/Musgrave* (1972).

¹⁰⁰ For a recent account see: *Infanti* (2013).

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¹⁰² *Pistone* (2013) p.278.

¹⁰³ *Skeptical Graetz* (2016) chapter 3, p.119.

justify tax claims with regard to the offering of valuable public goods or the existence of valuable natural resources.

ee) A “Single Tax Principle”?

In the context of the BEPS project, the notion of “fairness” in international taxation has become strongly related to the newly established “single tax” principle. Coordinated efforts around the world shall ensure that each and every item of corporate profit is taxed at least once¹⁰⁴. This principle requires Member States to agree on the one-time taxation of every piece of business profit without making a clear statement as to who should tax the profit. Phenomena like “double-non-taxation” or “stateless income”¹⁰⁵ shall go away for good (while protection against double taxation remains on the agenda). This is particularly aimed at tax planning techniques employed by large multinationals to shield their profits against any tax burden, a strategy regarded “unfair” both with regard to regular taxpayers and when competing against local business.

On the other hand, the “single tax principle” is not primarily a means to further inter-nation equity as it leaves open which state is going to levy a tax on a given economic or legal event. This brings about problems with regard to the incentives of countries to cash in the revenue and it brings about problems with regard to the merits of tax competition. A case in point is the notion that U.S. multinationals shall no longer employ tax haven structures for their European activities which they currently use to simultaneously erode the European tax base and to enjoy deferral with regard to the U.S. tax base. It is basically unclear whether the U.S. or one of the European countries should tax these profits in the end and it is basically unclear why they should do so¹⁰⁶: The U.S. government might regard the use of tax havens as a means to improve the competitive situation of U. S. multinationals vis-à-vis their European competitors. The European governments might regard waiving source taxation by allowing the deductibility of payments to foreign companies including tax haven entities as a means to attract foreign direct investment.

The current unwillingness of many states to sign up to a multilateral instrument which would force them to tax specific items of income shows that the merits of cooperation are not yet clearly visible to them.

ff) Conclusions on Fairness

Taken together, these elements of “fairness” are hard to operationalize. The plea for equal treatment of taxpayers in general according to their ability-to-pay does not give an answer to the question of how to allocate taxing rights between countries. The fundamental conflict between taxation of labor and taxation of capital goes to the heart of income taxation in general, in particular the choice between traditional income taxation and a direct consumption tax, but it is also fundamentally shaped by international tax competition. The conflict between large and small business entities cannot be disputed as a fact but it will live on as long as there remain disparities between domestic and foreign tax rules regarding income measurement and tax rates. Last but not least, the allocation of public revenue between countries is largely framed by competition between fiscal states which individually have to assess the trade-off between attracting investment and raising revenue in the long run.

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¹⁰⁵ *Kleinbard* (2011).

¹⁰⁶ *Shaviro* (2014) p.7.

If there is one element germane to all these different facets of “fairness” it is the fundamental skepticism vis-a-vis tax competition and the wish to empower the states to set and enforce tax rules as they wish without being constrained by economic pressure from private agents, in particular from multinational business entities¹⁰⁷. To put it differently: Those who plead for “fairness” typically also plead for strong government. Against this background, achieving fairness will require large-scale coordination of taxing rights by states and – to a certain extent – also large-scale harmonization of tax rates.

c) Administrability and Compliance

Last but not least, any proposal for international tax reform has to be implemented both by local tax authorities and by domestic and international business. Both face huge constraints with regard to the amount of human and financial resources they can devote to the administration of the system. To a large extent, many proposals will not work without greatly improved and intensified cross-border cooperation between tax authorities. Insofar, there are two different kinds of obstacles to establishing a new world wide system: financial constraints regarding the mere cost of compliance on both sides of the tax return and political constraints regarding the willingness of governments to process and to share information and to enforce tax claims on a mutual basis.

3. Aligning Taxation with Value Creation

a) The Evolution of a Principle

The first major proposal for international tax allocation to be discussed in this chapter is the OECD/G20 Action Plan on BEPS which circles around the notion that taxation should relate to “economic activity”. But an assessment of the BEPS Action Plan is not a straightforward exercise. This is due to the fact that this Action Plan does not contain a comprehensive “model” for a new international tax system. Rather, the Action Plan tries to address a bundle of issues which are perceived as detrimental from a tax policy perspective as they provide the basis for “aggressive” tax planning, distort competition between large and small enterprises and allow multinationals to avoid paying what is perceived as their “fair share” of tax. Nevertheless, it seems possible to identify some general traits common to the particular items of the Action Plan, which culminate in the quest to “align taxation with value creation”.

The history of this major exercise can be traced back to the OECD’s widely influential report on “harmful tax competition” published in 1998¹⁰⁸. In this report, OECD went beyond its traditional remit of technical work on double taxation and addressed an emerging issue of international tax policy: the interaction between fiscal competition among states and corporate tax planning. It arose from a growing awareness of globalization’s impact on the international tax landscape, bringing both benefits (furthering economic efficiency and fiscal discipline) and risks (distorting business decisions and enabling tax avoidance)¹⁰⁹. In particular, the divide between “sound” and “harmful” tax competition gave rise to close examination. In this context, the OECD came to the conclusion that “harmful” tax practices include those which are either operated by “tax havens” or “ring-fenced”¹¹⁰ in favor of foreign investors and which grant preferential treatment to highly mobile tax bases like financial assets

¹⁰⁷ *Dagan* (2013) p.63 et seq.

¹⁰⁸ OECD (1998).

¹⁰⁹ OECD (1998) para 23, 37; European Commission (2009) para 1.

¹¹⁰ OECD (1998) para 62.

and services. Contrary to this, a country's strategy to create a generally friendly tax environment which even-handedly benefits foreign and local investors and does not distinguish between different kinds of taxable activity has to be accepted as part of sound tax competition.

One of the elements which OECD held to be a key factor to identify a "tax haven" engaged in harmful tax competition for taxable activities was

"the absence of a requirement that the activity be substantial, since it would suggest that a jurisdiction may be attempting to attract investment or transactions that are purely tax driven (transactions may be booked there without the requirement of adding value so that there is little real activity, i.e. these jurisdictions are essentially "booking centres")"¹¹¹.

Nevertheless, the report conceded that

"the determination of when and whether an activity is substantial can be difficult. For example, financial and management services may in certain circumstances involve substantial activities. However, certain services provided by "paper companies" may be readily found to lack substance"¹¹².

The theory behind this distinction seems to be that tax competition for "real" activities is sound while tax competition for "financial and services" activities is harmful. Moreover, the report seems to assume that any shifting of "real" economic activities will anyway be primarily determined by non-tax reasons which are fully acceptable given the overall goal of increasing global welfare by furthering cross-border factor allocation. But

"if the preferential tax regime is the primary motivation as to where to locate an activity, this may indicate that the regime in question is potentially harmful"¹¹³. (...) "Where activities are not in some way proportional to the investment undertaken or income generated, this may indicate a harmful tax practice".¹¹⁴

This distinction between "good" competition for substantial activity and "bad" competition for purely tax driven arrangements was taken up in many places, in particular in the tax policy work of the European Union. When the European Member States agreed on the "Code of Conduct for Business Taxation" in 1998 which introduced both a standstill and a rollback for "harmful tax measures" it was established that any assessment of potentially harmful fiscal practices should be based on (inter alia)

"whether advantages are granted without any real economic activity and substantial economic presence within the Member States offering such advantages"¹¹⁵

Similar references can be found in the jurisprudence of the European Court of Justice on the Member States' right to fight abusive tax planning. While the relocation of "real" activities within the Internal Market is protected under the fundamental freedoms (in particular the freedom of establishment), any "artificial arrangement" lacking economic substance like the setting-up of a "letterbox company" in a tax-friendly jurisdiction or tax-driven transfer pricing arrangements can legitimately give rise to defensive measures by Member States¹¹⁶. Building on this theory¹¹⁷, the European Commission pushed for a fight against "aggressive tax planning", in particular "artificial capital flows and movements of taxpayers within the internal market" which "harm its proper functioning as well as erode

¹¹¹ OECD (1998) para 52.

¹¹² OECD (1998) para 55.

¹¹³ OECD (1998) para 84.

¹¹⁴ OECD (1998) para 83.

¹¹⁵ European Council, Code of Conduct (1998) para B.3.

¹¹⁶ Cadbury Schweppes, SGI; Schön (2007).

¹¹⁷ Schön (2007).

Member States' tax bases"¹¹⁸. In recent years, the European Commission has extended this mission for "good tax governance"¹¹⁹ to Non-EU countries. Again, the Commission regards fiscal measures by tax havens and other third countries to be harmful if (e.g.) if (inter alia)

"advantages are granted without any real economic activity and substantial economic presence within the Third Countries offering such advantages"¹²⁰.

Following the international call for increased attention to the phenomenon of "base erosion and profit shifting" and encouraged by the G20 to provide answers and solutions, OECD gave a fresh start to this line of work in 2013. While the starting point was slightly different – harmful tax competition between states was moved to the background and aggressive tax planning by multinationals moved to the foreground – OECD observed that

"there are a number of studies and data indicating that there is increased segregation between the location where actual business activities and investment take place and the location where profits are reported for tax purposes. Actual business activities are generally identified through elements such as sales, workforce, payroll and fixed assets".¹²¹

These findings seem to correspond to the fact that globalization and technological progress have enabled multinational corporations to set up their corporate structure on a global level, including world-wide matrix management organizations, integrated value chains and centralized functions¹²². At the same time, intangible and financial assets can be moved around at will and the supply of cross-border sales and services hardly meets any economic or legal obstacles. In its 2013 Action Plan on Base Erosion and Profit Shifting 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."¹²³

The Action Plan further lays out which features of the current international tax system contribute to the option for multinationals to benefit fiscally from the separation between taxation and economic activity. These include in particular the availability of treaty benefits for intermediate corporations lacking economic substance (Action 6), an outdated concept of the permanent establishment which invites artificial avoidance of the PE status (Action 7), traditional transfer pricing rules which are not in line with "value creation" (Action 8 – 10), a lack of transparency of value chains within multinational enterprises (Action 13). Limitations to deductions arising from debt (Action 4) shall contribute to a linkage between an entity's net interest deductions and the taxable income generated by its economic activities"¹²⁴. Within the context of the ongoing abolition of harmful tax practices (Action 5), the demand to align taxation with real economic activity has guided the evolution of the "nexus approach" for R&D benefits which requires a genuine link between the availability of advantageous tax treatment for intellectual property (IP boxes) and the creation of this intellectual property in the same jurisdiction¹²⁵. The implementation of the full BEPS package is therefore explicitly meant to

¹¹⁸ European Commission (2012a) Preamble, para 5; European Commission (2012b), Preamble para 7.

¹¹⁹ European Commission (2009).

¹²⁰ European Commission (2012b) Recommendation para 3.b)(c).

¹²¹ OECD (2013a) p.20.

¹²² OECD (2013b) p. 7.

¹²³ OECD (2013b) p.13.

¹²⁴ OECD (2015) p.14 Action 4.

¹²⁵ OECD (2015) para 14 and p.14 Action 5.

“better align the location of taxable profits with the location of economic activities and value creation”¹²⁶.

b) Anti-Avoidance Rule or Substantive Source Rule?

aa) Economic Reality and Anti-Avoidance Rules

When one tries to identify the underlying goal of this crusade for “economic reality” and “value creation” one finds two strands of thinking which show some resemblance in the outcome but are not fully compatible as a matter of principle.

The first strand refers to the traditional concepts of “avoidance” and “abuse” which have been employed in national tax laws extensively and which have led both the European Commission¹²⁷ and the OECD¹²⁸ to recommend to national legislators the introduction of a “General Anti-Avoidance Rule”. These time-honored concepts of avoidance and abuse are linked to the much-deplored divide between reported income and economic reality as can be shown by the evolution of the “substance over form” doctrine in some jurisdictions and the related requirement of a “commercial purpose” to be found in some tax legislations, most recently in the United Kingdom’s widely discussed General Anti-Avoidance Rule¹²⁹. In the context of the OECD’s work on BEPS this traditional notion of economic substance shows up in some corners, most visibly in the proposal of a “principal purpose test” for the denial of treaty benefits for intermediate companies (Action 6), but also in its proposals to fend off “artificial avoidance of PE status” (Action 7) and – as part of the “transparency” initiative being part of the BEPS project - with regard to the obligation to disclose tax avoidance schemes (Action 12).

The notion of “economic substance” as part of any anti-avoidance doctrine is conceptually clearly related to tax-driven corporate behavior and less related to the allocation of taxing rights between countries. These taxing rights do not (and should not) depend on the intentions of the taxpayers or on the level of aggressiveness or artificiality of their respective contractual and corporate arrangements. This means in the first place that this narrow notion of economic activity under an anti-avoidance standard will not provide any guidance in the search for a new “model” of allocating tax jurisdiction on a global level. Rather, as *David Schizer* has pointed out in a major article, the much-cited requirement to add “economic substance” to corporate entities or contractual obligations boils down to a mere “friction”¹³⁰ which makes tax planning more expensive as some real investment and some real activities have to be shifted or performed in order to achieve full-scale recognition of the underlying arrangements by the tax authorities.

bb) Economic Reality and Source Rules

Other elements of the BEPS Action Plan point towards a broader understanding of the linkage between taxation and real activity. This trajectory rather looks like an attempt to enhance – both to strengthen and to readjust - source taxation in a new and general fashion¹³¹ to the detriment of residence countries, in particular to the detriment of tax havens hosting low-function subsidiaries of multinational companies. This policy has become clearly visible in the work on transfer pricing under

¹²⁶ OECD (2015) para 7.

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¹³¹ *Graetz* (2016) p.135; *Rosenbloom/Brothers* (2015) p.764.

Actions 8 – 10 of the BEPS Action Plan which explicitly aims at “aligning taxation with value creation” beyond individual hard cases of aggressive tax planning and abusive behavior. Under this model, the real allocation of assets and the actual performance of business functions and the control of risk by real people on the ground shall be the (future) benchmark for international tax allocation¹³².

While it is clear that this wider approach is better equipped to serve the need for a new “model” of international tax allocation, it suffers from an inborn inconsistency: What the OECD Action Plan tries to achieve under this heading is a move into a new direction of international tax policy while maintaining to a large extent the existing framework of the double taxation conventions based on the traditional division of taxing rights between residence countries and source countries. Moreover, it tries to give a new meaning to the arm’s length standard and its ramifications for corporate tax planning without changing the underlying law, simply relying on its power to “update” Transfer Pricing Guidelines and the issuance of new administrative regulations in the involved countries. It is telling that the European Commission takes sides with OECD pretending that this move is just about “re-establishing the link between taxation and where economic activity takes place”¹³³. While it is easily understandable that this incremental technique is helpful given the enormous political constraints of international tax policy and the never-ending search for an OECD-wide consensus, it fundamentally hampers the move towards a truly new paradigm for international taxation.

c) Retaining Recognition of Intra-Group Dealings under the Arm’s Length Standard

In order not to endanger the age-old consensus OECD in its Action Plan supports separate accounting and arm’s-length transfer pricing for intra-group dealings as they have evolved over nearly a century¹³⁴. This means that the binding character of contracts between affiliated entities – loan agreements, leasing contracts, sales and services, licensing and cost-sharing – is in principle recognized by tax authorities and forms an essential foundation for transfer pricing analysis. In its “Authorized OECD Approach” (AOA) for permanent establishments which was introduced a few years ago, OECD went so far to recognize “dealings” between head office and local branches which do not even exist under contract law¹³⁵. Moreover, under the OECD Model, allocation rules for business profits derived in an intra-group context (e.g. for royalties received from a subsidiary) do not deviate from allocation rules for business profits derived from interaction with third parties (e.g. for royalties received from an independent trading partner).¹³⁶

This can only lead to one conclusion: As long as under the current rules ownership and contracts play a role for the allocation of the tax burden between independent entities, the same holds true for the allocation of the tax burden between affiliated entities. From this starting point, OECD does currently not propose full disregard of intra-group contracting which would inevitably lead to some sort of formulaic apportionment. Therefore, it remains fundamentally unclear how the traditional concept of separate accounting and arm’s length contracting which grants to multinational groups the power to allocate assets, risk and income to group members can be reconciled with the rather vague concept of taxation based on “real activity” and “value creation”.

d) Reducing the Relevance of Ownership, Contracts, Funding, and Risk

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¹³³ European Commission (2015a) p.6.

¹³⁴ OECD (2013b) p.14.

¹³⁵

¹³⁶ Schön

Irrespective of the adherence to the traditional paradigm of separate accounting and arm's length pricing, the BEPS Action Plan put forward by OECD attempts to water down the relevance of concepts like "ownership", "contracts", "funding" and "risk" for intra-group profit allocation¹³⁷. Under current rules, ownership of assets can be shifted between affiliated entities at will, contracts can be used to fund assets and derive profits from activities performed elsewhere and contractual risk shifting is regarded to lead to profit shifting to a large extent in particular as it is hard to ensure full symmetry of upside and downside risk for the respective taxpayers¹³⁸. In this respect the BEPS initiative rests upon the theory that taxation should rather follow "real activity" and "value creation" in order to reduce allocation of taxable income to tax havens and other beneficial tax jurisdictions where no "economic substance" is to be found¹³⁹. This is perceived as infringing both upon standards of efficiency and standards of fairness.

A case in point concerns the assumption of risk by a subsidiary resident in a low-tax jurisdiction, e. g. by an IP Holding Co. which funds research and development activities performed by another group company in a high-tax jurisdiction on a cost-plus basis. According to recent OECD work, 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 failure¹⁴⁰. There seems to be an emerging if problematic tendency at OECD level that allocation of income has to be based on active performance of tasks, e. g. the presence of people obliged and able to "control" the risk in a meaningful manner¹⁴¹. Practically speaking, there has to be a sufficient number of "experts" present in the tax haven to justify the assumption of risk by the local subsidiary¹⁴². It is very clear that this kind of analysis will frequently clash with the intra-group allocation of asset ownership and financial risk to separate subsidiaries under property law and contract law; against this background, current OECD work pleads for an intensified policy to partially re-characterize or even completely disregard existing contracts and asset allocations between affiliated companies¹⁴³.

This incremental change of paradigm has met with a lot of support among the governments of OECD countries¹⁴⁴ and has recently been strongly endorsed by the European Commission¹⁴⁵ but it is itself subject to two major criticisms¹⁴⁶:

Firstly, one has to accept the fact that categories like ownership, funding, contract and risk are not in themselves abusive; on the contrary, the concept of taxable income as such, meaning the aggregate of economic means derived by one taxpayer within a given period of time, is built on the notion that this taxpayer is legally entitled to derive the income, that she owns the underlying assets and enjoys

¹³⁷ OECD (2015) Annex A, p.15.

¹³⁸ Schön, Wittendorff (2016) p.332.

¹³⁹ Saint-Amans/Robert (2015) p.709.

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¹⁴¹ Kishore Bilaney (2016) p.576.

¹⁴² Verlinden/Ledure/Dessy (2016) p.111 rightly note that "control" in this sense is regularly scattered among different levels in the hierarchy of the firm.

¹⁴³ Hickman (2016) p.730 et seq.; for a critical view see: Schön (2014); Ernick (2016) p.1279; Verlinden/Ledure/Dessy (2016) p.113; Wittendorff (2015a) p.461.

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¹⁴⁵ European Commission (2015a) p.

¹⁴⁶ IMF (2014) para 59 Fn.79.

the consumption power generated by the inflow of financial means¹⁴⁷. Against this background, income taxation in general starts out from ownership and contracts and not from “activity”.

To give a simple example outside the context of multinational enterprises: Nobody will 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 income¹⁴⁸. This is due to the fact that the whole concept of capital income as opposed to labor income is in no way related to any “activity” as such and rather refers to and relies on ownership of the underlying capital assets and the resulting enjoyment of the resulting income at the level of the owner.

For business income, this leads towards a bifurcated analysis: Any business profit is derived from a combination of capital and labor. If the labor input is remunerated at arm’s length and taxed where labor is performed it is not self-evident (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 labor force. The same can be said for an allocation of the capital income on the basis of where “real” assets are used. Any assets employed by a business can be rented or leased from third parties, leaving nothing but a fixed remuneration of the third party to be taxable in the source country.

Taking a step back, one should start from the well-known fact that capital income in a business context consists of three elements: compensation for the time value of money, benefits from rents and the outcome of the assumption of risk. None of these elements logically relates to any physical activity performed by the taxpayer or his employees in a jurisdiction as such. They do therefore not give rise to a prior tax claim for the jurisdiction where any activity takes place.

This analysis is fully corroborated by the traditional tax divide between debt and equity¹⁴⁹: Under the current international tax system there is no doubt that any income generated by a local commercial activity will be taxed locally only if the profit goes to the business owner while it will go untaxed in the source country if and so far as it goes to a foreign creditor (via interest payments) as the OECD Model Tax Convention (and manifold unilateral legislation around the world) does not enforce a meaningful withholding tax on outflowing interest payments. It simply does not matter for the allocation of interest income where the underlying “activity” earns the profit including the return to debt capital. Again, this fundamental divide between debt and equity is not as such attacked by the BEPS Action Plan. Only insofar as multinational groups use hybrid financial instruments to avoid both residence tax and source tax (Action 2) and insofar as intra-group financing leads to “excessive” allocation of debt to some corporate entities within the group (Action 4) does the BEPS Action Plan try to address this fundamental trait of international taxation.

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 carry value also for the tax outcome of their activities and investments. Rather, it makes sense to doubt the value of these concepts for the tax treatment of intra-group relationships of multinational enterprises in particular. But this is not the result of the work done on BEPS.

¹⁴⁷ Schön

¹⁴⁸ *Boidman/Kandev* (2015) p.837.

¹⁴⁹ *Devereux/Vella* (2014) p.464 et seq.

e) Where does “value creation” happen?

One answer to this conundrum would be to leave all respect for corporate structures and contractual arrangements behind and to establish a model of international taxation which is built in full on the economic concept of “value creation”. This leads to the decisive question of whether the concept of “value creation” (irrespective of its current use in the BEPS Action Plan) can provide guidance as to the “true” location and fair taxation of business income¹⁵⁰. Again, this leads into several problems.

The first problem is how to decide whether value is created where goods and services are produced or where goods and services are consumed. Given the fact that any market transaction requires producers and consumers to meet in the market place and to exchange goods or services against consideration both the production country and the consumption country can claim the right to tax the underlying profit. The consumption country will point to the existence of the “customer base” on its territory as a decisive factor while the production country will point to the R&D activity, the manufacturing and the head office functions performed on its territory in order to supply the goods which are in demand in the market country¹⁵¹. Historically speaking, the “supply side” (i.e. the country where production takes place) had the upper hand, while the “demand side” (i.e. the country where consumption takes place) wielded not only less “market power” when negotiating double taxation conventions but also faced a substantial information problem with regard to the measurement of the profit derived from the sale of goods and the rendering of services within its jurisdiction¹⁵².

When we look at the “production side” of value creation the picture does not gain precision. In their BEPS Report of 2013, OECD referred to fixed assets, workforce, payroll, and sales as indicators for economic presence¹⁵³. While OECD does not offer any self-evident allocation key for the overall profit, one gets the strong message from the transfer pricing documents that the proposed reliance on “real activity” and “value creation” leads into a crypto-formulaic system overriding the existing division of taxing rights as agreed upon under the international tax regime, in particular the current network of double taxation conventions. In particular, the emphasis on “activity” seems to enhance the role of the labor factor (which performs those “activities”) for taxation of business profits lacking an explicit theoretical framework¹⁵⁴.

The outcome is: The concepts of “real activity” or “value creation” are meaningful to the extent that they keep passive subsidiaries in low-tax jurisdictions outside the allocation key but they do not provide any clear guidance with regard to the many other factors which can legitimately claim to contribute to the overall business profit generated by a multinational enterprise. This is not a promising starting point for a successful revamping of the international tax world.

f) The Challenges

It is interesting to learn whether the BEPS Action plan is both intended and capable to address the three major challenges of international tax policy laid out above. This is the case only to a very limited extent:

¹⁵⁰ *Devereux/Vella* (2014) p.464 et seq.

¹⁵¹ *Ernick* (2015) p.692.

¹⁵² *Kane* (2015) p.337 et seq.

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¹⁵⁴ *Boidman/Kandev* (2015) p.841 et seq.; *Robillard* (201x) p.

- Firstly, the ongoing debate between residence countries and source countries (or – to be more precise - between different groups of source countries) has deliberately not been addressed in the Action Plan in a systematic fashion¹⁵⁵. OECD countries tend to defend the *status quo* while emerging economies plead for strengthening source taxation. There is only one major issue regarding the allocation of taxing rights which has been explicitly discussed under the auspices of BEPS in OECD circles: the introduction of source taxation on the basis of “digital presence” irrespective of the PE threshold. Yet in the final outcome, any bold move to establish wide-reaching source taxation with regard to the exploitation of the digital networks established on a territory has been abandoned¹⁵⁶; the only remainder of this approach has been laid out under Action Item 7: “Artificial avoidance of PE Status” which addresses borderline situations like commissionaire arrangements, large-scale auxiliary activities and fragmented contracts¹⁵⁷. Some countries have gone a small step further in this direction, e.g. the United Kingdom with its “Diverted Profits Tax”¹⁵⁸ and Australia with its “Anti-Google Tax”¹⁵⁹.

While it seems legitimate to cure some of these issues, the BEPS project and its outcome do not render superfluous a fundamental debate on the future of international allocation of taxing rights between different source countries, in particular between production countries and market countries in general¹⁶⁰.

- Secondly, the proposals made under the BEPS Action Plan show a strong tendency to undermine the business model of tax havens and other low-tax jurisdictions (including high-tax jurisdictions offering special low-tax regimes for special assets, activities or items of income) which build upon notions of residence, ownership, contracts and funding¹⁶¹. At the same time the BEPS Action Plan does not do away with some of the basic features of the system which enable companies to benefit from tax havens and tax arbitrage in the first place: Parent and subsidiary companies (including subsidiaries in tax havens) are assessed as separate taxpayers, residence taxation of these taxpayers still prevails and contractual arrangements are still recognized¹⁶².

The main thrust of the BEPS Action Plan aims at a half-way reduction of options to exploit these features for tax minimization: Deductions for payments to related parties shall remain possible after the BEPS Action Plan will be implemented but can be denied under certain circumstances; deferral of a subsidiary's profits remains the basic rule but can be lifted under extended CFC provisions in the post-BEPS era; Pricing of intra-group sales and services and the outcome of contractual risk arrangements will still be the starting point for profit allocation but they will be subject to stronger adjustments and re-characterization measures than before if they do not reflect “economic reality”.

The most striking element of the BEPS action plan in this regard is the proposal to reduce the income attributable to a company providing financial funds for activities performed by other group members to a routine return for “lenders”, i.e. both the exploitation of rents and the outcome of risk will not be attributed to the funding entity without having sufficient “economic substance” in place¹⁶³.

¹⁵⁵ *Saint-Amans/Robert* (201x) p.20.

¹⁵⁶ OECD Action 1.

¹⁵⁷ OECD Action 7.

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¹⁵⁹ *Butler/Danby* (2015) p.349.

¹⁶⁰ *Lennard* (2016) p.740 et seq.

¹⁶¹ *Saint-Amans/Robert* (201x) p.22.

¹⁶² *Boidman/Kandev* (2015) p.837 et seq.; *Graetz* (2015) p.561; *Economist* p.62.

¹⁶³

- Thirdly, the more fundamental issues of the economics of intra-firm trade are not addressed by the BEPS Action Plan¹⁶⁴. While the Action Plan recognizes the need to increase transfer pricing discipline in order to reduce leeway for manipulation it does not reject the value of the arm's length standard as such. Moreover, it does not address the question of whether allocation of taxing rights for income from intra-group transactions should be subject to a different regime than income from third-party transactions. To give one example: As the economics of intra-group lending are completely different from the economics of third-party lending, given the hierarchical nature of firms under common control, one might be tempted to treat intra-group debt simply like equity¹⁶⁵. But the BEPS action plan does not go that far.

g) The Benchmarks

Irrespective of the above mentioned challenges, it is rather unclear to what extent the BEPS Action Plan will pass the tests of efficiency, fairness and administrability. This is particularly true for the efficiency test as this refers to "incentive compatibility" from the perspective of individual countries and their governments.

aa) Efficiency

The implementation of the goal to align profit allocation with real activity will challenge policy choices for nation states. By making recognition of contractual and corporate arrangements dependent on the existence of economic substance in low-tax jurisdictions, profit shifting becomes more costly for taxpayers. At the same time it provides an incentive to move real investment and workforce out of the high-tax jurisdiction instead of simply entering into contractual arrangements¹⁶⁶. The overall loss of welfare for the home country might be even larger when compared to simple offshoring of profits.

This outcome leads back to a fundamental assumption underlying the tax competition debate. In their 1998 report on "harmful tax competition", OECD assumed that movements of real economic activity would primarily be driven by non-tax considerations¹⁶⁷. If this is true, designing a tax system with the goal to "align taxation with value creation" is basically compatible with government incentives in the fiscal area. But this factual assumption is contested in the literature. According to findings by economists, there exists a tendency to move not only book profits but also real investment and real activities around globally simply for tax reasons. Some experts regard this to be the natural and beneficial outcome of "sound" tax competition as it urges governments to offer a balanced "package" of taxes and public goods to taxpayers, in particular foreign investors¹⁶⁸. Others regard this to constrain the freedom of the democratic process and the power of governments to define the size of the public sector and the level of redistribution in a country as they see fit¹⁶⁹.

Against this background it may well be that countries find it in their genuine interest to prevent this from happening and voluntarily decide not to beef up substance requirements with regard to tax planning. An example taken from real life are the more or less generous existing rules on inbound interest stripping which can be tailor-made to attract inbound investment without having to forgo

¹⁶⁴ *De Wilde* (2016) p.182.

¹⁶⁵ *Schön* (2012)

¹⁶⁶ *Devereux/Vella* (2014) p.468; *Graetz* (2015) p.566; *Sullivan* (2016a) p.

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public revenue from domestic corporate profits¹⁷⁰. If countries wanted to do away with tax competition for real activities and real investment for good they would have to agree on a minimum level of business taxation on a multilateral basis – an option going far beyond the current (ambitious) aims of multilateral cooperation under the BEPS project.

bb) Fairness

As far as the “fairness” aspect has to be taken into account, it is evident that the most pressing issue of “fairness” with regard to the allocation of revenue between traditional industrialized countries and developing/emerging economies is not really addressed by the BEPS Action Plan. While tax havens and preferential tax regimes will be widely closed down once the BEPS Action Plan has been implemented, the question will remain where the taxing rights should go: to the industrialized “residence” countries or to the developing world where cheap labor and a large customer base contribute to the profits of multinational companies.

Last but not least it remains to be seen to which extent a coordinated effort by states to stop ever-lower tax rates on business profits will narrow the gap between the tax burden on labor income and the tax burden on capital income in the long run. One thing that can be said is that coordinated efforts against tax competition shall lower or bring to a halt the ongoing reduction of the corporate income tax rate in different countries.

cc) Administrability and Compliance

As far as administration and compliance are concerned the necessity to take a stronger look at economic reality and the necessity to take into account tax treatment in other states will greatly burden the players. Under the current regime there is – 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 this country. Under the post-BEPS regime it seems necessary to establish a world-wide network of information and enforcement, starting with exchange of information between tax authorities and detailed country-by-country reporting by the multinationals.

4. Worldwide Corporate (Minimum) Tax

a) Current International Tax Practice

Worldwide taxation of current corporate income on a residence basis is a well-established standard of international tax policy. Given the ubiquitous practice of world-wide taxation in the context of the individual income tax it has traditionally been accepted to extend this approach into the world of the corporate income tax¹⁷¹. This corresponds to the systematic view of the corporate income tax as a “backstop” or “proxy” for individual income tax on non-distributed corporate profits.

Only few countries – like France – adhere under their domestic tax law to a territorial system in the narrow sense which subjects to the corporate income tax only profits derived from sources inside the geographic confines of their jurisdiction¹⁷². Most countries – in particular European countries – apply the concept of worldwide taxation on a current basis to those foreign sources of income which are owned and controlled by the domestic corporate taxpayer itself. This means that income arising from

¹⁷⁰ Graetz (2015) p.554; Sullivan (2016b) p.259.

¹⁷¹ Fleming/Peroni/Shay (2015) p.678 et seq.

¹⁷²

foreign permanent establishments and income from inbound interest, royalty and dividend payments is taxable while income arising in foreign-based corporate entities (in particular controlled subsidiaries) is not taxable at the parent company level on a current basis. These profits become only taxable upon repatriation as “dividends”.

Moving even closer to the narrow French concept of territoriality, many countries have decided – unilaterally or under double taxation conventions - not to tax inflowing intercompany dividends at all, in particular dividends derived from substantial shareholdings in foreign entities (the OECD Model Convention requires a minimum participation of 10 %). This move corresponds to a widespread traditional practice in continental Europe and Latin America to fully exempt income from foreign permanent establishments from domestic taxation under double taxation treaties. As a result, territorial taxation has become the rule for active business income in those countries (exempting foreign permanent establishments and corporate subsidiaries) while worldwide taxation is largely applicable to passive income (interest, royalties and portfolio dividends)¹⁷³.

Most countries – in particular in Europe – regard the resulting non-taxation of profits arising in a foreign subsidiary to be a natural element of the corporate income tax (given the “shielding” effect of the separate legal status of the foreign subsidiary under corporate law). But U.S. tax policy and U.S. tax academics have long shared the view that any “deferral” of taxation for foreign-source income presents an irregularity which has been accepted in the past somewhat grudgingly in order to support the “competitiveness” of foreign subsidiaries in foreign markets and to lower the administrative burden when it comes to the measurement of foreign income and to the enforcement of the resulting tax claim. Against this background, in 1962 the Kennedy Administration introduced “CFC legislation” for passive income thereby abolishing deferral for subsidiaries in low-tax jurisdictions insofar as these entities receive interest, royalty and portfolio dividend income¹⁷⁴. In the decades which followed, CFC legislation has spread all over the world and has also been recommended as an anti-avoidance device both in the context of the BEPS Action Plan (Action 3) and by the European Commission¹⁷⁵, although its compatibility with double taxation treaties is in doubt¹⁷⁶ and its scope under European Union Law appears rather limited¹⁷⁷. In the United States, Senator *Camp*’s proposal of a “Tax Reform Act of 2014” involved an extension of the existing CFC Regime (“subpart F”) to “foreign intangible income” and “related-party sales income” (Sec. 4103 of the Draft) whenever the foreign tax burden went below 15 %.

b) Ending “Deferral”?

From the perspective of the residence country of a multinational’s parent company the self-standing taxability of foreign subsidiaries seems to be the most prominent source of strategic tax planning and tax avoidance. This perception is linked to the fact that “deferral” leads to the prevalence of the host countries’ level of taxation, in particular before repatriation of profits. Following this line some U.S. writers regard worldwide taxation at the level of the parent company without any “deferral” for undistributed profits reinvested at the level of foreign subsidiaries to be a “first-best” choice from the perspective of the home country¹⁷⁸. Combined with a “foreign tax credit” this extended tax liability

¹⁷³ IMF (2014) para 10.

¹⁷⁴ *Graetz* (2016) chapter 2.

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¹⁷⁸ *Fleming/Peroni/Shay* (2015) p.673; *dies.*, (1999).

would result in a uniform tax burden on domestic and foreign group profits following the (higher) tax rate set by the home country of the first-level corporation. Under such a system, multinational enterprises would lose interest in tax-driven allocation of assets, functions and risks as they would not benefit from tax differentials any more (only issues of intra-entity loss compensation would still play a role).

Against the background of this straightforward “first-best” model, the current U.S. debate largely circles around hybrid models which try to extend worldwide taxation and to limit “deferral” without overly hurting the “competitiveness” of U.S. multinationals with regard to their foreign-based operations:

- A far-reaching proposal has been put forward by *Shaviro* who recommends ending deferral for both active and passive foreign source income. The “competitiveness” of foreign activities of U.S.-based multinationals shall be secured by setting a low tax rate on foreign profits. In order not to incentivize the host state to “level-up” source taxation the foreign tax credit shall be replaced by simple deductibility of the foreign source tax.
- In a similar vein, *Fleming/Peroni/Shay* propose an “interim minimum tax” of 15 % on active CFC income subject to a low tax rate in the host country¹⁷⁹. For active income, the difference between the minimum tax and the full-level U.S. tax shall be paid at realization. For passive income, full current inclusion and taxation shall remain the rule.
- The reform proposal put forward by the Obama Administration in its 2016 budget (building on the 2012 “President’s Framework for Business Tax Reform” and on scholarly work by *Altshuler* and *Grubert*¹⁸⁰) takes yet another twist. The main characteristic of this proposal is the introduction of a “minimum tax” of 19 % on current profits derived by all foreign establishments and subsidiaries. This “minimum tax” would go substantially beyond existing CFC legislation as it would lift deferral on all items of current income irrespective of its source. The tax base will be the profit generated in a foreign jurisdiction minus an allowance for corporate equity. Thus, only excess profits (in particular rents from the exploitation of intangibles and financial assets) shall be subject to this minimum tax; moreover, a foreign tax credit will be granted on a country-by-country basis but limited to 85 % of the foreign tax in order to avoid an incentive for the foreign jurisdiction to introduce “soak-up” taxation up to the very limit of the U.S. minimum tax.

Fleming/Peroni/Shay have criticized this latter proposal – on the one hand they don’t like the incentive effect of a low “final” taxation on a current basis as this leaves no room for a further tax on repatriation which they regard to be necessary to provide for equal treatment of domestic and foreign income. On the other hand they consider the granting of an allowance for corporate equity in the case of foreign source income to contradict the requirement that income measurement should follow the same rules for domestic and foreign profits¹⁸¹. Last but not least they plead for U.S. portfolio shareholder taxation of dividends from foreign companies which should be increased by the corporate tax difference in order to do away with any foreign tax effects¹⁸².

¹⁷⁹ *Fleming/Peroni/Shay* (2015) p.705 et seq.

¹⁸⁰ *Altshuler/Grubert*

¹⁸¹ *Fleming/Peroni/Shay* (2015) p.711 et seq.

¹⁸² *Fleming/Peroni/Shay* (2015) p.719 et seq.

The rest of the world has not followed the U.S. in this direction. Most tax systems keep the basic standard of “territoriality” in place. Nevertheless, the BEPS Action Plan includes a couple of recommendations which involve an extension of world-wide taxation. One example is the “defensive” rule on hybrids under Action 2, which requires the country of residence to tax cross-border capital income which is treated as deductible expenditure in the country of source. Another example is Action 3, which urges States to introduce or expand CFC taxation in order to ensure the “single-tax-principle”. But unlike the approach embraced by U.S. writers, the BEPS Action Plan sees worldwide taxation only in a “supporting role” and grants the respective source country to take the first bite.

c) The Challenges

With regard to the challenges laid out above, the proposals which have been floated in the U.S. debate on international tax reform only refer to some of them:

aa) Residence versus Source

It is clearly not intended by any of these proposals to reshape the basic divide between residence countries and source countries. The politically sensitive delineation of taxing rights between traditional industrialized countries and the developing world is not addressed in a fundamental fashion. Rather, the intention is to leave source taxation as it is and to incrementally extend U.S. residence taxation on top of the foreign source tax with respect to profits derived by foreign subsidiaries of U.S. corporations. Insofar, the principle of worldwide income taxation is simply reconfirmed. But by unilaterally extending residence taxation to active income derived in foreign source countries without reducing the scope of source taxation simultaneously, the risk of double taxation of that foreign-source income will be greatly increased. Therefore, the interaction of residence tax and source tax on foreign-source income is at the heart of existing U.S. proposals. These proposals seem to share the common view that residence countries (in particular the U.S.) should restrict the leeway of source countries in taxing local income.

In this respect, two scenarios have to be addressed:

- In the first scenario source countries try to attract investment by lowering source taxation. This policy option will be sharply reduced by the introduction of a U.S. “minimum tax” on active business income arising in foreign jurisdictions as proposed by *Altshuler/Grubert* and *Fleming/Peroni/Shay*. Under these proposals, foreign-source profits will lose the protection awarded by “exemption” or “deferral” under the existing system. Developing countries might view this as an encroachment upon their legitimate political claim to embark on “sound” tax competition for real investment and activities.

- In the second scenario source countries try to raise revenue without efficiency losses by leveling up their tax rate to the residence country’s tax rate so that corporate taxpayers are sheltered from the impact of source taxation by the foreign tax credit in the residence country. The main difference between *Altshuler/Grubert* and *Fleming/Peroni/Shay* on the one hand and *Shaviro* on the other hand lies in the fact that the latter two keep the foreign tax credit largely in place which allows host countries to “level-up” their tax to a certain extent. *Shaviro*’s proposal pleads for moving from the full creditability of the foreign tax to the mere deductibility of the source tax as a business expense. In this world, the source country will not benefit from a soak-up option but will have some leeway to substantially influence the overall tax burden of the local investment.

Thus, it cannot be said that the U.S. proposals change the delineation between source and residence, they only increase the pressure exercised by the country of residence vis-à-vis the underlying source taxation.

bb) “Ownership” and “Contracts” versus “Economic Activity”

Abolishing “deferral” for foreign source income in low tax countries is clearly helpful in reducing the attractiveness of tax havens. Under all existing U.S. proposals, the tax burden on income reported in a low- or no-tax jurisdiction will be lifted to the U.S. (minimum) tax, thus heavily reducing the incentive for moving financial or intangible assets to the tax haven. Tax competition will remain but the U.S. tax will work as a “floor” to the policies employed by other countries than the United States.

But there remains one major problem: The treatment introduced by these proposals relies fundamentally on the taxable residence of the parent company in question. There will be no U.S. minimum tax for parent companies whose tax residence is located outside the territory of the United States. This will generate enormous pressure on U.S. companies to “invert” or to “emigrate” in order to leave behind the constraints of the new U.S. minimum tax. While it is possible that other countries will start to emulate the U.S. system it is also possible that fierce tax competition for the location of corporate headquarters will break out, involving countries who apply strictly territorial systems and try to cater to multinationals by offering lenient CFC legislation in order to “underprice” the United States.

It is clear that countries are able to introduce different “tests” for residence which differ with respect to their malleability. If residence is simply built on incorporation, residence is easier to move than if residence is built on the real seat of management and control. And it is also true that corporate residence is hardest to change if it is built on the personal residence of the shareholders. But for publicly held companies, there are options as well. In Germany, the average percentage of foreign shareholders among the top DAX 30 corporates amounts to 56 % and has shown a high degree of volatility between companies and between years. Making the tax status dependent on those numbers will not only give rise to ongoing uncertainty but also to tax-driven strategies for corporate boards where to raise capital - at home or abroad.

cc) Theory of the Firm versus Separate Accounting/Arm’s Length Standard

The rules on taxing firms in general, in particular the principle of separate accounting and the arm’s length standard will not be touched upon by these reform proposals. “Dealings” between separate business units within a single firm will still be recognized as a matter of principle. But the practical relevance of these contractual arrangements will be reduced once it becomes clear that shifting of profits to foreign subsidiaries will not result in an exclusion from U.S. corporate taxation.

Nevertheless, the legislative technique of allocating profits to domestic business units and to foreign business units according to the corporate and contractual structure will live on along two dimensions: Only domestic profits will be subject to (high) mainstream U.S. corporate tax (as opposed to the newly introduced (low) U.S. minimum tax). Insofar as the foreign tax credit remains in place, only foreign profits will generate a foreign tax credit. Both dimensions require line-drawing between domestic and foreign profits built on traditional separate accounting.

d) The Benchmarks

aa) Efficiency

Existing literature on the U.S. minimum tax has largely focused on efficiency and revenue gains for the United States. It is therefore accepted that the U.S. minimum tax will lead to a shift of revenue from foreign source states to the United States (assuming this is the residence state of the corporate parent). It has been argued that this will contribute to “national welfare” on the side of the United States. It is also in line with the time-honored self-perception of the United States as a net exporter of capital which does not have to fear symmetric treatment by other jurisdictions.

It is interesting to learn that the different U.S. proposals try to comply with different standards of neutrality. The proposal made by *Fleming/Peroni/Shay* to extend current taxation of foreign source income to profits made and withheld by foreign subsidiaries clearly matches capital export neutrality (if the foreign tax credit stays in place). The proposal made by *Shaviro* to scrap both deferral and the foreign tax credit in order to reduce the tax on foreign income and to make the foreign tax deductible as a business expense, is largely in line with the concept of “national neutrality” – under the assumption that the combined foreign and domestic tax burden on foreign income will align with the domestic tax burden on domestic income.

As regards different flavors of neutrality, the most ambitious project seems to be the U.S. minimum tax. *Altshuler/Grubert* regard their proposal to combine benign features of CIN and CEN:

- As the U.S. minimum tax would grant an allowance for corporate equity, routine returns in the source states will not be covered by U.S. taxation before repatriation. This is meant to contribute to capital import neutrality as no U.S. tax burden will prevent U.S. investors to receive a level playing field treatment in the source state as local routine income will simply be subject to local corporate income taxation). This might also strengthen the “competitiveness” of U.S. firms as far as they invest in foreign countries¹⁸³.
- For “excess returns” it is argued that the U.S. minimum tax ensures capital export neutrality as the tax reduces the incentive to relocate the underlying assets (in particular financial and intangible assets) abroad.

While this may be true, the larger issue of corporate emigration remains. The whole concept of the U.S. minimum tax consists under all models in the unilateral creation of a “floor” or a “level playing field” for U.S. multinationals when compared to other U.S. multinationals and to local U.S. business. But this will drive a wedge between U.S. multinationals and multinationals resident elsewhere, creating not only huge downward pressure on the minimum tax (if foreign competitors can exploit existing tax havens better than U.S. firms, thus reducing their cost of capital) but also a huge pressure on U.S. corporations to invert or to fully emigrate¹⁸⁴. One might say that under the current U.S. proposals tax competition is lifted up from the level of subsidiaries to the level of corporate headquarters. It remains to be seen to what extent this is offset by benefits from being a U.S. corporation.

¹⁸³ *Fleming/Peroni/Shay* (2015) p.681 et seq.

¹⁸⁴ IMF (2014) para 65; *Graetz* (2016) chapter 3, p.137 et seq. and chapter 4, p.212.

bb) Fairness

The current proposals address some dimensions of fairness but not all of them. They are meant to create a substantial tax burden on U.S. multinationals, thus contributing to the taxation of capital income and to reducing competitive disadvantages for small and medium-sized business entities within the United States. In the end, they show a tendency to extend the tax burden on U.S. shareholders of U.S. companies which can be seen as “fair” from the point of view of taxpayers receiving labor income in the United States.

The issue of international equity is basically not addressed by these proposals. They contain a unilateral move to gain revenue from foreign activities of U.S. multinationals. The interest of the source countries is only addressed to a limited extent. Under the *Shaviro* proposal deductibility of the foreign tax will replace the foreign tax credit. Under *Altshuler/Grubert's* plan, the routine return on foreign investment will not be subject to the minimum tax and thus only burdened by foreign source tax. But it remains unclear why and to what extent “excess returns” shall be taxable predominantly in the United States. Some of these excess returns might be attributable to location-specific rents (local workforce, local commodities, local customer base) which source countries might see to reflect benefits not provided by the U.S. government. By and large, the U.S. proposals mentioned in this chapter do not pretend to take the claims of the source countries seriously, they rather want to make sure that residence taxation is not eroded by separate accounting and transfer pricing.

cc) Administrability and Compliance

With regard to administrability and compliance, the introduction of the U.S. minimum tax will involve two major effects: there will be the necessity to run two kinds of taxes in parallel: the current corporate income tax (high tax, deferral of taxation until repatriation) and the minimum corporate tax (low tax, current inclusion of income). This will lead to a substantial amount of costs both on the side of the tax authorities and on the side of the taxpayer. This burden might be slightly compensated for as the necessity to allocate income sharply to foreign and domestic entities loses some of its relevance; nevertheless, as long as there exists a tax wedge between the full corporate tax on domestic profits and a low minimum tax on foreign profits, the requirement to exercise transfer pricing control, foreign tax credit calculations etc. will not go away.

5. Formulary Apportionment: The Common Consolidated Corporate Tax Base

a) The Model

Formulary Apportionment has been on the agenda of international tax reform for many decades. It is currently in place at the level of state taxation in the United States as the inter-state allocation of the corporate tax base is performed on a formulaic basis treating corporate groups as one unitary enterprise¹⁸⁵. While the rules on profit measurement are largely derived from the set of rules governing the Federal Income Tax, each state is entitled to apply its own formula for allocation. These formulas traditionally used to refer to the location of assets, workforce and sales. The leeway granted to states on what formula to apply has consistently led both to double taxation and to tax competition and is hardly constrained by the U.S. Constitution¹⁸⁶. Over the years, there has been an ever stronger ten-

¹⁸⁵ *Hellerstein*

¹⁸⁶ But see U.S. Supreme Court in *Wynn and Knoll/Mason*.

dency to move the formula towards the “sales factor” as this policy provides for tax relief benefitting local production and puts a tax burden on foreign imports.

Some U.S. commentators – in particular *Reuven Avi-Yonah*¹⁸⁷ - have pleaded for an extension of formulaic apportionment to the international arena. So far, no international organization has shown much sympathy for this approach. OECD in particular has consistently rejected the concept in order not to endanger its precarious “consensus” but also because OECD doesn’t regard traditional transfer pricing control to be in such a deplorable state as critics assume¹⁸⁸. Neither the UN nor the IMF have subscribed to this method either. Rather OECD has embraced a limited influence of formulary elements on the evolution of the arm’s length standard. In its most recent draft guidance on the “profit split” a formulaic approach has been integrated into the world of separate accounting and arm’s length pricing¹⁸⁹: Whenever there is a highly integrated value chain involving hard-to-measure unique contributions (e.g. intangibles) by separate entities within the group, a transactional profit split seems to be advisable. According to OECD, such profit split may resort to “profit splitting factors”¹⁹⁰ which are largely identical with the factors applied under formulary apportionment. Still, there remains a difference between an all-embracing concept of formulary apportionment covering the whole corporate group and its activities at large and a transactional approach which limits the impact of factor attribution to individual transactions (e.g. product lines) which cannot be dissolved in the traditional fashion.

The only major reform proposal going for grand-style formulary apportionment has been put forward by the European Commission: the “Common Consolidated Corporate Tax Base” (CCCTB). Starting in 2001¹⁹¹, the European Commission had worked on this project for a decade and came out with a fully-fledged draft directive in 2011. Since then, two major developments impacted their work: Firstly, it became clear that not all Member States of the European Union were willing to support this proposal which was by then referred to the “enhanced cooperation” procedure under which a limited number of European Member States is entitled to enact a European Directive having effect only for this group of countries. Secondly, the nature of the CCCTB was shifted from a voluntary instrument (which multinational firms would be entitled to employ in order to reduce compliance costs and deadweight losses) to a mandatory instrument (which is meant to reduce the leeway for companies to allocate corporate profits at will within the European Union)¹⁹².

This is the baseline for the most recent proposal which was published by the Commission in mid-2016. This proposal aims at a two-step procedure: In a first step, the rules on profit measurement shall be harmonized for all entities being part of a corporate group above a threshold of 750 million € turnover. This first step might be useful to reduce compliance costs and to prepare the field for further integration. But it does not affect fundamentally the allocation of profits between business units and taxing rights between countries. In a second step, there would be full consolidation of profits and losses within the group. This would at one stroke do away with problems of cross-border loss compensation, cross-border transfer pricing and cross-border financing or asset allocation. But it requires agreement on a method to allocate the overall corporate profit to the involved countries.

¹⁸⁷ *Avi-Yonah/Clausing/Durst*

¹⁸⁸ TP Guidelines

¹⁸⁹ OECD (2016).

¹⁹⁰ OECD (2016) para 46 et seq.

¹⁹¹ European Commission (2001).

¹⁹² European Commission (2015).

Following the proposal of the European Commission, the overall profit shall be allocated to the involved jurisdictions under a formula composed of fixed assets, payroll/workforce and sales.

b) The Continuum of Economic Organization

The introduction of formulary apportionment presupposes that there is a clear-cut division between independent taxpayers on the one hand and integrated groups on the other hand. This assumption is far from evident. There are many mixed situations, e.g. when individual subsidiaries have to comply with the interests of minority shareholders or when two separate multinationals engage in joint venture companies. Against this background, the legislator has to decide which affiliated entities qualify as a "group" to be consolidated under the new tax system. It seems also fair to say that the business models of multinationals can be very different from an economic perspective – some are highly integrated and rely on internal synergies and hierarchies while others work as conglomerates, giving large discretion to local managers doing business in completely separate markets. In some cases the corporate headquarters even goes so far to create real-life internal markets within the firm in order to get rid of slack, i.e. to reduce options for local management to use their resources in a non-efficient manner. But the opposite structure also exists: In recent times, more and more successful enterprises have set up highly integrated business models including routine manufacturers which operate outside the common control of the corporate group. In these cases, the firm itself reduces its own functions to head office, research and development, branding and distribution ("factoryless goods producing firms"¹⁹³).

Against this background it is highly disputed how to delineate the corporate group which shall be subject to consolidation: which size of majority shareholding shall be decisive for entering the group and which level of economic integration shall be required to apply formulary apportionment. The introduction of fully-fledged formulary apportionment requires a bright line between two completely different worlds: the world inside and the world outside the multinational firm. Against this background, the European Commission has proposed to apply a two-prong test (50 % of voting rights, 75 % ownership rights) to corporate groups but does not look closer into the level of actual economic integration.

It is evident that this "black and white" view does not reflect legal and economic reality which shows a whole spectrum of commercial arrangements between full integration and independent action. The creation of two completely different worlds – separate accounting vis-à-vis independent trading partners and formulary apportionment within the firm – crudely drives a wedge into the make-or-buy decision of a company. Given this continuum of business models there exist good reasons to follow the OECD approach which proposes to take incremental measures and to deal with economic integration by applying limited profit splits embedded in a traditional transfer pricing framework.

c) The Challenges

When we revisit the current line of conflicts in international taxation the impact of formulary apportionment on those is the following:

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aa) Residence versus Source

The conflict between residence and source and the conflict between different countries of source will survive under formulary apportionment, albeit in a different form¹⁹⁴: it will come up in the context of choice of formula: strengthening the sales factor will lead to increased participation of market countries; strengthening the asset or payroll factor will lead to increased participation of production countries. It is very clear that countries will have quite different political views on this. To give one particular example: the impact of labor can be measured either by payroll or headcount – a difference inevitably giving rise to a conflict between low-wage countries and high-wage countries. The European Commission has come up with a compromise in this respect for the CCCTB: half of the labor factor shall be determined by reference to the payroll expenditure, half of it by reference to the number of employees¹⁹⁵.

With regard to intangibles being a major value driver for corporate profit it will be hard to nail their impact down under a certain formula: allocation of intangible value to a specific jurisdiction seems to be virtually impossible – not only because it is hard to measure but also because it might give rise to strategic shifting of intangible assets. From an economic point of view this is not overly convincing: The jurisdiction where high-value intangibles are created but not shown in the books and in the formula will lose out to jurisdictions where highly-staffed production units perform routine functions with high capital investment and limited returns on capital or where sales are performed at low margins vis-à-vis consumers in competitive markets. For such an R&D unit, only the payroll factor might reflect to a certain degree the intellectual power of human researchers and other creative employees.

bb) “Ownership” and “Contracts” versus “Economic Reality”

On the other hand, the relevance of “ownership”, “contracts”, “risk” and “funding” will be greatly diminished under formulary apportionment. This is one of the reasons why many academic writers regard formulary apportionment to offer a convincing alternative to the current world of separate accounting and arm’s length transfer pricing. Formulary apportionment requires a consolidation of the individual accounts of all entities belonging to a corporate group, thus doing away with all effects resulting from allocation of ownership and risk within the group and all contractual dealings which might otherwise be employed to shift profits between different taxpayers within the group. This is in particular true for the debt/equity divide widely blamed for creating a “debt bias” within the group.

The consolidated profit will then be allocated to jurisdictions not according to the residence of the involved entities or according to the location of particular sources but rather according to a general formula which is only to a very small extent pre-conditioned on legal characteristics of the corporate and contractual structure of the multinational enterprise.

In order to solve the above-described conflict between “real activity” and “ownership” it will be particularly relevant to leave financial assets and intangible assets outside the formula. Any factor formula which largely relies on payroll, real assets and/or sales virtually therefore excludes tax havens from participating in the global tax base. Intra-group games relating to the allocation of debt or the

¹⁹⁴ IMF (2014) para 69.

¹⁹⁵

choice of specific transfer prices which make profit shifting and base erosion possible under current rules will largely go away¹⁹⁶.

Insofar, formulary apportionment seems to be far better equipped to solve the “tax haven” problem than to solve the “source versus residence” or “source versus source” problem. But this beneficial impact of formulary apportionment on the international tax world will strongly depend on a substantial number of countries willing to apply a uniform tax base and a uniform factor formula between themselves. This is the model presented by the CCCTB initiative of the European Commission. But it is clear that – even under optimistic assumptions - only a limited number of countries will agree on such a binding set of rules in the mid-term future.

This will lead to a separation of the international tax world into two different spaces: the world inside the formulaic system and the world outside the formulaic system (which will most probably live on under the traditional separate accounting/arm’s length model). As corporate groups will be free to set up subsidiaries in both worlds, multinationals will then enjoy the freedom to perform strategic tax planning on the borderline between the world of formulary apportionment and the world of separate accounting and arm’s length pricing. In the end, options for multinationals to allocate assets, functions and risks at will between jurisdictions will rather increase than decrease as they can exploit the benefits of two different tax frameworks simultaneously.

d) The Benchmarks

aa) Efficiency

Introducing formulary apportionment is logically linked to the concept of territorial taxation. Once the overall profit of a firm is allocated under a formula between the involved countries, none of these countries is going to apply world-wide income taxation on a residence basis to those profit slices which have been allocated to the other participating countries. This has a strong effect on the efficiency features of this reform option.

First of all, formulary apportionment is clearly neither intended to implement capital export neutrality nor shall it further national neutrality in the same way as the U.S. proposals on a “minimum tax” do. Moreover the strong territorial concept means that the choice where to locate the parent company of a firm is not substantially important for the overall tax burden of the firm. All countries which have taxing rights under the formula are “source countries” in the narrow sense. Against this background, the CCCTB as proposed by the European Commission implies an “exemption system” under which the residence of the parent company only plays a procedural role, as the seat of the parent company is the starting point for the administrative handling of profit measurement and profit allocation within the group.

Given its territorial nature, formulary apportionment effectively implements the concept of capital import neutrality as local investment by a foreign corporate taxpayer in a jurisdiction participating in the CCCTB will be subject to exactly the same corporate tax treatment as domestic taxpayers doing business solely in that state. This is particularly true if the formula draws heavily on the asset factor and on the payroll factor both of which relate to local investment in the traditional sense. But if participating states choose to strengthen the sales factor or even go for a sales-only formula, the location of investment will not play a role anymore and capital import neutrality will no longer apply.

¹⁹⁶ IMF (2014) para 67.

Rather, the concept of “market neutrality” will prevail as the resulting profit allocation to the consumer countries will equalize the tax burden on profits depending on the location of the customer base. This leads to the conclusion that the CCCTB and similar models of formulary apportionment will clearly implement some sort of neutrality but the choice of formula factors will strongly impact the specific neutrality features of the overall tax system.

Depending on the choice of formula, the introduction of the CCCTB or a similar reform option will not abolish strategic tax planning within the taxable group, in particular with regard to the asset factor and the sales factor. Similar to the BEPS proposals to “align taxation with real activity”, formulary apportionment will induce companies to move corporate functions which relate to the decisive factors to low-tax countries. But this outcome might well be regarded as part of “sound” tax competition which forces countries to offer attractive “packages” to investing multinational firms, thereby increasing efficient allocation of resources.

Moving beyond this self-evident source of strategic tax planning for real activities, firms will consider gaming the factor formula by deliberately investing into factors located in those jurisdictions where the tax rate is lower than in other involved jurisdictions for pure tax reasons¹⁹⁷. This holds particularly true for the asset factor and the payroll factor as the location of the underlying assets and employees can easily be influenced by the group management. Such a move might drive down the tax burden on profits which are effectively “generated” in a high tax country. A highly profitable R&D company resident in a high-tax country might be induced to acquire shares in a routine manufacturing firm in a low-tax country in order to allocate as much profit as possible to the low-tax jurisdiction. On the other hand, strengthening the sales factor for the formula would reduce leeway for tax planning opportunities as the location of the customer base is harder to manipulate. But this will also lead to less revenue allocation to the production countries – an effect which these countries will have to evaluate when they compare the efficiency effects and the revenue effects of tax reform.

Against this background one might also consider giving up on a single formula and leaving it to the individual states whether and how to introduce formulary apportionment or not on a unilateral basis. This is the model of corporate taxation as applied within the United States. There is some limited harmonization for the tax base, but both the tax rate and the factor formula are set by the respective country. It might be argued that countries around the world should be encouraged to take this path, choosing the formula they are most happy with (regarding the trade-off between promoting efficiency and raising revenue) and let tax competition decide where investments and activities by multinationals will finally end up. But this trajectory comes at a cost – at least for a long transitional period. It would give up on the long-standing international policy to reduce or even abolish double taxation as far as possible (a clear benefit of the existing consensus-based approach for international trade) and it would hugely increase compliance costs for cross-border firms who would be required to file tax returns and income statements with regard to their worldwide profits and their worldwide factors with each individual state and its tax authorities.

The many advantages of the CCCTB project like a harmonized tax base or a one-stop-shop for filing and assessment would be missed under an uncoordinated approach where every single state would have to administer its own world-wide formula. It goes without saying that most countries will then start to “reinvent” their bilateral treaty network over a very long period in order to find individual solutions for their respective economies.

¹⁹⁷ IMF (2014) para 69.

bb) Fairness

With regard to the different aspects of “fairness” laid out above, it can be said that the CCCTB meets some of them. Given the fact that profit allocation under a factor formula undermines corporate taxpayers’ ability to stash away financial and intangible assets and the respective income in tax havens, it contributes to an implementation of the “single-tax” principle. The overall income will be taxed once but not more than once (given the clear allocation of profit slices to specific jurisdictions). This might be important to achieve more or less equal treatment of rich and poor taxpayers, labor and capital and a level playing field for domestic and multinational business enterprises.

But the final outcome will depend on the worldwide development of the corporate tax rate. The corporate tax rate is important both with regard to the comparison between “rich” individuals (owning shares in corporations) and “poor” individuals (relying on labor income and transfer payments), but also with regard to the comparison between domestic and cross-border business. The CCCTB (and similar reform models for formulary apportionment) harmonizes the tax base and the allocation formula, but it does not harmonize the tax rate and does not even set a minimum “floor” in this respect. Against this background, under the CCCTB tax competition in Europe (and probably beyond) will to a large extent focus on the tax rate. One should expect multinational companies to exert pressure on jurisdictions to lower the tax rate favoring foreign investment. This will in turn reduce the role of the corporate tax as a “backstop” or “proxy” for the individual income tax. Some writers have argued that under formulary apportionment (as under the current international tax regime) a reduction of the tax rate to “zero” will be a possible outcome. For many observers, this would fundamentally undermine the fairness of the overall system and will – in another turn – put pressure on individual income tax and net wealth tax or inheritance tax to compensate for this effect.

cc) Administrability and Compliance

From an administrative point of view, the introduction of the CCCTB can have a beneficial effect: The tax base will be harmonized across borders which shall reduce both compliance costs, tax arbitrage and administrative efforts. On the other hand, any centralization of procedural tasks – like a “one-stop-shop” regime at the level of the parent company is likely to bring along new conflicts, e.g. about the application of the factor formula.

Moreover, as multinational companies and their respective business units will probably be present both inside and outside the CCCTB area, corporate tax experts and tax authorities will constantly have to cope with the overlap and arbitrage options between the old regime (separate accounting and transfer pricing) and the new regime (consolidation and factor formula). Multinational groups will have large leeway to structure their intra-group activities and entities in order to live in the “best of both worlds”. It is hard to say in advance whether the afore-mentioned reductions will be outweighed by the latter effect on tax planning, compliance and auditing.