OXFAM

OECD public consultation on addressing the tax challenges of the digitalisation of the economy

RESPONSE TO THE OECD PUBLIC CONSULTATION ON ADRESSING THE TAX CHALLENGES OF THE DIGITALISATION OF THE ECONOMY

6th March 2019

Oxfam welcomes the renewed efforts to reach a long-term solution for challenges regarding the allocation of taxing rights and remaining BEPS-related issues. Digitalisation of the economy has increased the need to do so, in a way that is suited to new business models as well. In this response to the consultation document, we first provide general comments on overarching issues. After that, we provide answers to the consultation questions on each pillar. Oxfam's comments have been prepared by Francis Weyzig, Johan Langerock and Susana Ruíz Rodríguez, with input from Nguyen Hong Nga (Vietnam), Asim Jaffry (Pakistan), Joseph Olwenyi (Uganda), Henry Ushie (Nigeria), Rosa María Cañete (Domican Republic), Didier Jacobs and Daniel Mulé (US), Christian Hallum (Denmark), Quentin Parinello (France), Esmé Berkhout (Netherlands) and Oli Pearce (UK).

General comments

An ambitious approach is needed. We generally agree with the analysis of the problems presented in the consultation document. Limited reparations of the existing system cannot solve these problems anymore. Unfortunately, the international corporate tax system is fundamentally broken. The previous round of BEPS actions have provided much-needed temporary solutions for specific forms of tax avoidance. However, while some loopholes are being closed, new ones are being created and exploited. Even OECD countries themselves are now taking unilateral measures to supplement the agreed BEPS actions. The tax on base eroding payments introduced by the US and the conditional withholding tax on interest and royalties announced by The Netherlands illustrate the urgent need for broad further reforms. This is largely caused by two fundamental problems. First, trying to allocate profits to individual entities of a multinational as if they were separate enterprises, on the basis of transfer pricing, does no longer work. While this approach has always been problematic, the increased importance of various kinds of intangibles in the economy at large has made this approach simply untenable. Second, targeted measures aimed at specific forms of tax avoidance cannot put an end to the race to the bottom in corporate tax. Worse, they have accelerated it. These two problems are now being broadly recognized. Therefore we call on all countries to use this opportunity and support fundamental reforms of the international corporate tax system that make it fit for the 21st century.

Smaller developing countries must be better represented in the OECD Inclusive Framework. The previous BEPS Action plan was mainly about measures for countries to protect their own tax base. These measures had limited effects on other countries that did not facilitate aggressive tax practices. Moreover, the interests of large and small source countries were largely aligned. This will be different for the reallocation of taxing rights and minimum effective taxation measures. Such reforms have an impact on all countries. Moreover, the reallocation of taxing rights may have a different impact on large and small consumer markets, or on countries with a large dependence on mining or agricultural exports. Therefore a way should be found to increase the number of smaller developing countries that are represented in the OECD Inclusive Framework (IF), and to enable such countries to participate meaningfully in the development of new standards, providing technical support as needed.

Developing countries should be allowed to join the work on the current proposals without having to implement the existing BEPS minimum standards. The previous BEPS Action plan was intended to solve corporate tax problems of OECD and G20 countries, not those of smaller developing countries. Therefore non-OECD/non-G20 countries should only have to implement the existing BEPS minimum standards if they pose a substantial BEPS risk to other countries. Enabling the participation of smaller developing countries will help to reduce the risk of double taxation, uncertainty, and disputes. Moreover, depending on the outcome of the current proposals, some existing BEPS standards may be modified or even become obsolete.

The corporate tax system must become simpler. Current system difficult to administer, and not just for smaller developing countries. The arm's length principle has become very complex to apply, in part because of the increasing importance of intangibles that are inherently difficult to value. The previous BEPS Actions have further increased administrative burdens, notably through transfer pricing documentation, and complexity, for instance by adding complex rules against hybrid mismatches. To make things worse, countries have implemented the BEPS Actions unevenly and in different ways. For example, some countries have signed up to the Multilateral Convention (BEPS Action 15) without repairing permanent establishment rules (BEPS Action 7), and countries have used many different combinations of options to implement limitations on interest deductions (BEPS Action 4). The previous BEPS Actions may have been a necessary step towards a more fundamental long-term solution, but a simpler system will require simpler standards, not additional ones.

The proposed reforms should therefore replace existing anti-BEPS measures where possible. For example, allocation of total profits on the basis of objective factors, such as assets, employees and sales, would reduce the need for detailed transfer pricing guidelines and corresponding documentation requirements. Well-designed taxes on base eroding payments, in combination with strong income inclusion rules, could make several existing rules redundant. These include substantial economic activity requirements, complex rules against hybrid mismatches, and existing limitations on interest deductions. Strong income inclusion rules might also replace existing CFC rules instead of complementing them. However, replacing existing measures will only be possible if the new standards are strong enough.

Both pillars are necessary. Pillar 1 without pillar 2 is likely to reinforce the race to the bottom in general corporate tax rates and tax holidays. Unfortunately, the previous BEPS Action plan has accelerated tax competition. Also, the OECD Forum on Harmful Tax Practices (FHTP) requirements on substantial activities have caused some countries to replace preferential regimes with low-tax general regimes or lower corporate tax rates for larger companies. If reallocation of taxing rights causes the right amount of taxable profits to be attributed to each jurisdiction, but those profits would be taxed at a very low rate or not at all, the reform will have failed. Conversely, pillar 2 without pillar 1 will also not work. A minimum level of taxation in each relevant jurisdiction also requires the recognition of a taxable presence and sufficient taxing rights.

In addition, country-by-country (CBC) reporting must be enhanced and become public. This will facilitate the implementation of new standards. The reporting and exchange of CBC data have had some important positive effects. The data are very useful for tax authorities to conduct risk assessments, for example allowing easy identification of large low-taxed profits in specific jurisdictions or stateless income. However, the current system of CBC data exchange between tax authorities does has severe limitations. At present, only 77 countries participate in the multilateral exchange system, and receiving the data via the home country tax authority causes a substantial delays. Most developing countries do not receive the data at all. It would be much more effective, and much simpler, if home countries would agree on public CBC reporting. This would also create a more level playing field for large and small companies operating in one country, as the accounts of such firms provide even more detailed country-level data. Next to this, the turnover threshold for reporting should be set much lower, or additional host country thresholds should be added. This is because multinationals below the current threshold can still be among the largest investors in small developing countries. Finally, new data needs could be incorporated into the CBC template, such as the number of users of a digital platform per country. The final report for BEPS Action 13 provides for a reassessment of the CBC data standard no later than the end of 2020. This coincides with timeline for the current proposals. Therefore it makes sense to integrate the reassessment of the CBC data standard into the final part of this work.

Answers to questions on pillar 1 (Revised profit allocation and nexus rules)

1. General view

Under-allocation of income to particular countries needs to be addressed. At the center of the discussion around how to reform our international tax system and make it work in the 21st century lies the problem of allocating more income to certain countries that feel now disadvantaged. Although high on the political agenda, this problem is not new and has been waiting for at least two decades to be addressed. Many factors have pushed this debate to a higher pace, but things have been moving quicker now that some large developed economies are impacted as well.

The current system is detrimental to many developing countries. The existing international tax framework, with the arm's length principle, duality between source and residence in OECD the Model Tax Convention, separate entity approach and transfer pricing guidelines, is not working for many developing countries. It has been detrimental for government revenues, the fiscal health of countries, well-functioning markets, and the competitive position of SMEs. A system that encourages the attribution of a large share of profits to entities owning intellectual property, performaning certain functions or assuming certain risks is particularly detrimental to developing countries, where these are usually not located. It is for this reason that developing countries have been long requesting for an expansion of the permanent establishment definition. Because of the growing importance and mobility of intangibles in the global economy, which has been further increased by the digitalisation of the economy, the current system has also become highly problematic for developed countries. Oxfam welcomes the initiative to move beyond the arm's length principle, which has turned out to be the root cause of many tax avoidance structures. The proposed reforms should e designed in such a way that they deliver for developed as well as developing countries and for large as well as small economies.

The reforms should provide sufficient taxing rights to production countries as well. Distinction between source and residence taxing rights has become blurred. Some argue that the century old duality between source and residence is becoming obsolete. Oxfam believes that in the next reforms, the distinction between residence and source and current favouritism in taxing rights for countries of residence should be addressed. Now that the digital economy and rowing importance of intangibles is making the distinction less clear, some countries that have previously identified themselves as residence countries, have *de facto* become source countries as well. In such a context, Oxfam emphasizes that a it is important to separate two distinctive interests, starting by clearly separating two distinctive sources of income, that are both essential to generate profits: production (source as origin) and sales (source as destination). The reforms should take this distinction into account and not ignore the rights of countries with production, as the countries pushing for reforms are mostly the ones with large domestic markets. Source of origin countries include many middle income and low income countries where manufacturing, provision of services, or distribution take place. For apportionment formulas, Oxfam recommends to develop variations for (broadly defined) distinctive sectors, such as extractive industries, in protection of source of origin countries where economic activity takes place.

We support unitary taxation with multi-factor global formulary apportionment. We believe this is the opportunity to move towards a principles-based system of international taxation that is simple, efficient and equitable. Oxfam emphasises the need for alternatives to the current system grounded on the arm's length principle and the transfer pricing guidelines, and is calling for an open discussion. The proposals for unitary taxation with formulary apportionment as put forward by ICRICT or the BEPS Monitoring Group should form part of it. The discussion should also cover effective mechanisms for taxing extractive industries, which can ensure proper valuation of natural resources, and allocation of a significant part of the taxing rights to the country of extraction. It also includes strong emphasis on criteria that are of particular relevance for poorer countries.

Profit split or fixed margins could be intermediate solutions. If no timely agreement can be reached on unitary taxation principles with formulary apportionment, a second-best solution consists in agreeing on the broader use of OECD profit split methods in a standardized manner or methods using fixed margins. The profit split method is an acknowledged method under the transfer pricing guidelines and has the advantage that it can be applied to the consolidated profits of all entities of a multinational, as opposed to a method that considers each entity independently from the others.

Residual profit split is not a sustainable method. This is because a residual profit split method is an endorsement of the arm's length principle and the separate entity approach. Doing so, the current transfer pricing guidelines will remain at the heart of any calculation to distinguish routine from non-routine profits, which is needed to estimate the residual profit. This method is bound to fail as some tax-aggressive multinationals will seek to manipulate the amount of routine profits allocated to certain jurisdictions. It would therefore create a major weakness in the system as well as a key source of potential conflicts between jurisdictions. A profit split method should instead be applied to total profits, covering all contributions of the different entities of a multinational.

The user participation proposal is too narrow and complex. The proposal ring-fences the digital economy from other businesses and applies the residual profit allocation method in a very restricted manner. As it is currently drafted, the proposal illustrates the reasoning of that large consumer countries might benefit from a larger allocation of profits without changing the international tax structure. The proposal has the merit to propose an allocation of residual profits based on a factor and between all legal entities including permanent establishments. However, is another measure aimed at a specific problem, failing even to address other forms of aggressive tax avoidance by the same types of businesses. It is short-sighted as it will become more and more difficulties to clearly categorize business and it will significantly increase complexities in the transfer pricing system. Moreover, such a reallocation goes at the expense of poor countries and countries where production takes place.

The marketing intangibles proposal is innovative and broader in scope, but attributing profits to different types of intangibles is problematic. The scope of this proposal cover both users and consumers and it would apply to all business models. The proposal aims at valuing the market access and consumer relations built in a certain country, even if with limited physical presence or done remotely. The proposal argues that some value should be attributed to that relationship and market access in the country of consumption instead of the country from where this is managed. A strong and innovative feature of the proposal is that it limits certain BEPS risks regardless of the structure of a multinational's marketing and sales operations, for example it also covers profit attribution to distributing entities. On the other hand, the profit allocation rules require a distinction to be made between trade and marketing intangibles, which will add an extra layer in the already complex nature of valuing intangibles and as such increase BEPS risks. This is especially problematic for highly digitalised businesses, because these also own valuable trade intangibles, such as cloud computing technology, software code, and algorithms. Therefore this is a weak element of the proposal.

The significant economic presence proposal provides a broad and simple approach to profit allocation, but needs to be further developed. The proposal would expand the existing permanent establishment rule, something that has been asked for by many developing countries. Oxfam supports the idea to strengthen the taxing rights of source countries, both production and consumption, regardless of which entities of a multinational own intangibles or bear risks. A point of attention for the current proposal is that the profit allocation rules need some further design. Also, the scope of application remains limited to non-resident legal entities, as such not covering allocation of profits to a domestic distribution subsidiary or another resident legal entity. This is a key limitation of the current proposal. Multinationals can easily avoid paying large sums of tax through the use of limited risk structures (e.g. limited risk distributors/manufacturers), excessive debt and deductions for the right to use intangibles, so that the balance of profits is attributed to mobile intellectual property, funding and strategic functions/risks (e.g. global procurement, management, intellectual property related activities), which may be located in low tax jurisdictions. Therefore the proposal provides a good starting point, but the allocation rules would need to be further developed and the scope of application should be broadened.

A holistic approach is needed to find a comprehensive solution for taxable presence and allocation of profits. Oxfam notes that the 3 proposals put forward approaches to taxable presence (nexus) and profit allocation rules in a different manner. Oxfam believes that in the current form, none of the current proposed alternatives, user participation, marketing intangibles or significant economic presence are sufficient on their own to tackle the broad challenges of our outdated tax system. The common objectives and synergies between these 3 proposals need to be identified and used to find a simple, efficient and effective solution. Still, in our assessment of the three individual proposals, the significant economic presence proposal provides the best starting point for such a holistic, broad and fair approach.

A unified approach would be the best way to take forward the three proposals. Several technical and political problems surrounding the three proposals put into question the prospects of a single proposal gaining sufficient support and delivering on the required fundamental reforms. A general approach is preferable. In points 62 and 63 of the consultation document the OECD calls for consensus-building to address all the issues that have been identified for each of the proposals put forward. Oxfam agrees with this approach, combining strong elements from each of the three proposals. As noted, before, the proposed reforms should be designed for the long term, broad (i.e. applicable to both traditional and digital businesses), fair, effective and simple.

2. Recognition of taxable presence

Oxfam supports broad solutions encompassing all businesses leading to a level playing field and horizontal equity. The digital economy is exacerbating existing problems. The international tax framework is outdated for both traditional business, which also rely increasingly on intangibles in their value chain and businesses in the digital economy.

Oxfam rejects the idea of business line segmentation. This will be unworkable for developing countries and in developed countries this will lead to more disputes due to information asymmetry. The digitalization of the economy has created a need to reconsider nexus rules and to consider users as a factor of production for the allocation of profits. However, this is not confined to specific business lines. A robust and simple solution calls for such principles to be applied to all businesses, even though they may initially have a larger impact on certain highly digitalised business models. With many established digital companies having multiple business lines, it becomes challenging to clearly categorize companies, identify the value chains and find comparables. At the same time, traditional businesses have started to digitize their processes and services as well. This economic reality should be kept in mind when designing the tax system of the future. For reasons of public trust, and business certainty we should avoid entering in 3-5 years' time in a new round of global reforms.

3. Design considerations

The significant economic presence proposal provides a good foundation for a redefinition of taxable presence. All three proposals agree that the lack of physical presence is a key struggle in the digital economy. New nexus rules are therefore needed for those non-resident companies active in a country remotely. The user participation and marketing intangible proposals do not outline an approach to determine when sufficient nexus is reached to attribute profits to a certain country. For example, t is unclear how it will be determined whether interaction with users or consumers is large enough to trigger a taxable nexus. This could be solved with a clear, broad and simple definition of significant economic presence, taking users, consumers and other factors into account in a way that creates a fair balance between the tax revenue interests of all types of countries. While deciding on a definition for significant economic presence, consideration should be given to the proposed rules on digital trade (e-commerce) at the World Trade Organization (WTO).

New profit allocation rules could be designed on the basis of global formulary apportionment. Formulary apportionment, with possibly an intermediate step applying profit split rules, would still be the best option to balance between simplicity, effectiveness and fairness, taking into account all proposed profit allocation keys like marketing intangibles, sales and users. Formulary apportionment is a framework that allows discussion on how allocations keys should be applied and weighted, this could even differ among business sectors and specific guidelines could be produced. The apportionment approach could build on the significant economic presence proposal, applying the approach to all entities and permanent establishments of a multinational. As noted earlier, the profit allocation rules from the user participation and marketing intangibles proposal are too complex,. They would not change some fundamental errors in the current system and lead to new BEPS risks. For example, valuing the contribution of users is problematic. Unless users are taken int account in thresholds and a formulas based on key factors that can be objectively observed, determining their contribution to profit generation would give rise to the same complexities and subjective assessments that have made the current transfer pricing method unworkable.

4. Reducing complexity, ensuring certainty and avoiding disputes

New standards should be designed in such a way that they prevent further transfer pricing disputes. The current design of the user contribution and marketing intangibles rules, being very complex, will create inherent information asymmetries. Tax administrations will therefore be at a normally insurmountable disadvantage and frustrations will likely increase. This imbalance can result in transfer pricing adjustments that taxpayers find unreasonable and arbitrary. Since the adoption of the transfer pricing guidelines, there has been a continuing increase in disputes, and in the time taken to resolve them.

Answers to questions on pillar 2 (Global anti-base erosion proposal)

1. General view

Pillar 2 must apply to all types of businesses. Pillar 2 is essential to address remaining possibilities for profit shifting to low-tax entities and the race to the bottom in corporate tax rates. These two problems are relevant for all business sectors. Although the risk of profit shifting to entities with real economic activities is often large for highly digitalized business models, it is present for other businesses as well. For example, for firms with valuable trade intangibles or brand names, and for firms with high investments in tangible assets that can be financed via aggressive intra-group structures.

Both parts of pillar 2 are necessary. A tax on base eroding payments is required to protect the tax base of countries where business activities take place. If pillar 2 would only consist of an income inclusion rule, some tax-aggressive multinationals would still shift profits out of high-tax countries, to take advantage of the difference between these countries tax rate and the minimum rate under the inclusion rule. Moreover, some source countries may want to tax capital gains on transfer of assets, and protection against tax avoidance via offshore indirect transfer of assets is only possible via a tax on base eroding payments. The income inclusion rule is complementary. Potentially base-eroding payments may be embedded in the prices of intra-group trade in goods. This can only be addressed by an income inclusion rule, not by a tax on base eroding payments.

The tax on base eroding payments should take priority over the income inclusion rule. This is necessary to provide sufficient protection to countries where business activities take place, including developing countries that are net recipients of foreign investment. The income inclusion rule may then function as backstop and provide a credit for taxes on base eroding payments. It is important that the income inclusion rule covers all directly and indirectly owned entities and branches to make sure that it is a comprehensive backstop. Such a design could allow for simplification of the subject to tax rule. Additional “conduit” or “ imported” arrangement rules, beyond the type of anti-abuse rules that have been included in tax treaties, could be left out or become optional. This would make the subject to tax rule easier to implement for smaller developing countries that have a strong need for it. The more complex income inclusion rule covering multi-layer structures would generally be implemented by home countries of multinationals that have more capacity to do so. It will also be easier for parent countries to demand information from entities with which there are no direct transactions, because it indirectly controls those entities.

2a. Design considerations for a tax on base eroding payments

All countries should apply either the undertaxed payments rule or the subject to tax rule. As some countries have withholding taxes on certain payments and others do not, countries should have a choice between both rules. Some countries might also apply withholding taxes to some types of base eroding payments and disallow deductions for other types. It is important that all countries implement such measures, even if they do not see a need to protect their own tax base, because a tax on base eroding payments helps to protect the tax base of other countries too. For example, conditional withholding taxes on interest and royalty payments also work against conduit structures. Similarly, making the deduction of acquisition costs for intangible assets conditional on minimum effective taxation of the corresponding seller’s income would help to prevent aggressive structures affecting third countries.

Combined, the undertaxed payments and subject to tax rules need to cover a wide range of payments, transactions, and other rules for profit determination. They should at least cover interest payments, royalty payments, payments for the acquisition of intangible assets, fees for services, and insurance premiums. To the extent that these concepts remain relevant under revised profit allocation rules, these rules should cover attribution of profits to PEs and adjustment of transfer prices as well. Note that for countries that choose to levy withholding taxes on technical services, the subject to tax rule could apply to service fees (thus related tax benefits under Article 12A of the UN Model Tax convention or Article 21 of the OECD Model Tax Convention should also be made conditional on the subject to tax rule).

For the subject to tax rule, any downward adjustment of transfer prices should be conditional on a corresponding upward adjustment subject to minimum effective taxation in the other state. It does not matter whether the primary state is a low-tax jurisdiction making an upward adjustment or a high-tax jurisdiction making downward adjustment. In practice, both situations occur.

With an ambitious revision of profit allocation and nexus rules, the scope of the undertaxed payments rule could be more limited. For taxable profits that are allocated between countries on the basis of objective factors instead of individual transactions between related entities, there would be no need for protection against base-eroding payments. Thus, with an ambitious outcome for pillar 1, a tax on base eroding payments could be limited to capital gains, for source countries that want to tax these, and to any other parts of the tax base that still depend on intra-group transactions and structures. The income inclusion rule will remain necessary to end the race to the bottom in tax rates.

Countries should have the possibility to apply the subject to tax rule to capital gains, while exempting regular intra-group dividends. Some source countries may want to tax capital gains from the (direct or indirect) transfer of assets. This is in line with the purpose of the subject to tax proposal. Therefore a new standard should also allow this. Dividends can remain exempt to the extent that they are paid out of after-tax profits, preventing double taxation. For super-dividends that exceed after-tax profits, the subject to tax rule could still be applied. This way, avoidance of capital gains taxes through dividend payments (up to the value of the capital gains) could be prevented.

The subject to tax rule can be limited to related parties in case of interest, capital gains and super-dividends. This eliminates the need to consider exemptions for special taxpayers, such as pension funds or charitable organizations, because these are usually not related parties. For royalties and payments for the acquisition of intangible assets, a broader scope may be appropriate, for example to cover franchise business models.

For the undertaxed payments rule, covering "conduit" or "imported" arrangements may be too complex. The reason is that payments may be changed from one type into another, or mixed with payments from different source countries. Depending on the design of the undertaxed payments rule, it could therefore be extremely complex to effectively counter all types of conduit or imported arrangements. Countering such structures will be easier through the subject to tax rule, by making use of the type of anti-abuse clauses that have already been developed under BEPS Action 6. Additional rules, especially against "imported" arrangements, would be complex for the subject to tax rule as well and could be left out or become optional. This would make the subject to tax rule easier to implement for smaller developing countries that have a strong need for it.

Instead of modifying tax treaty articles in a complex way, some articles could simply leave out the limitation of taxing rights. To implement new standards that follow from the current proposals, countries will need to adjust their domestic legislation anyway. They can use this opportunity to redesign withholding taxes and/or rules for deduction of international payments in such a way that benefits depend on effective minimum taxation instead of bilateral tax treaties. Countries could include domestic rules against conduit structures similar to the anti-abuse rules currently included in tax treaties that were agreed under BEPS Action 6. To allow application of new domestic legislation, treaty articles 7 and 9-13 might be replaced by a relatively simple standard text specifying that taxing rights will not be limited by the treaty. This could greatly reduce complexity of the international tax system. Information exchange regarding conduit structures can be provided for through a multilateral implementation agreement. This would be much simpler than through bilateral treaties and earlier BEPS Actions have proven that multilateral implementation agreements can work well.

Alternatively, tax treaties could be changed through a new Multilateral Convention. However, this would again involve a demanding process, to modify thousands of existing bilateral treaties on the basis of a complex set of options to accommodate many different possible combinations of treaty partner preferences. Considering that many developing countries have not (yet) joined the current one, it should then be possible for such countries to join only the new Multilateral Convention. This will help to generate support for a new agreement and facilitate implementation.

The effective tax rate test should be kept simple. One option might be to implement the subject to tax rule through creditable and rebuttable withholding taxes. Many companies will be able to fully use the credits in the partner country, because the withholding taxes are charged on types of income of a foreign recipient that are taxable abroad. In cases where the multinational cannot obtain a full credit for the withholding taxes, it can provide proof that the payment is subject to an effective tax rate above the minimum in the foreign country. Another option to keep the test manageable is to use different country lists: one of countries without tax rules that provide for an effective tax rate below the minimum, one of countries with general low-tax regimes, and one of countries with preferential regimes or special rules that result in an effective tax rate below the minimum in some cases. Only for the last category, a case-by-case assessment may be needed. To facilitate such assessments, the role of the FHTP could evolve towards identifying regimes that may provide for a low effective tax rate according to generally agreed tax base criteria. With strong rules under pillar 2, in the future there may be no need any more for the FHTP to assess whether such regimes are actually harmful, or to monitor the implementation of substantial economic activity requirements. Instead, tax administrations could then use FHTP guidance to assess the application of specific partner country rules on relevant payments, transactions, or recipient entities. The scope of the FHTP's identification of regimes should then be broadened towards non-preferential regimes, such as notional interest deductions, that might result in low effective taxation. Similarly, the FHTP should assess territorial tax systems to determine whether these facilitate double non-taxation, as the FHTP is currently contemplating.

2b. Design considerations for an income inclusion rule

An income inclusion rule should be designed in such a way that it works against tax rate competition. Thus, the rule should not provide an incentive for home countries to lower their domestic tax rate in order to attract corporate headquarters. This may require agreement about an absolute minimum effective tax rate. Moreover, it should be designed in such a way that the minimum functions as a backstop, and does not become the standard. Perhaps this could be achieved by agreeing on a range of rates that home countries could apply for the income inclusion rule.

An income inclusion rule should apply to all income, regardless of whether it is distributed in the form of intra-group dividends. This is key to make the rule robust and prevent new loopholes. In addition, it would allow simplifying the current system, in which many home countries apply some combination of controlled foreign corporation and switchover rules.

It is essential that the income inclusion rule is applied to each jurisdiction individually. To end the race to the bottom, a minimum effective tax rate must be imposed on profits in each foreign jurisdiction. Otherwise, some jurisdictions might still be tempted to levy no or (close to) zero corporate tax. Such jurisdictions might then attract highly profitable entities of multinationals that have activities in high-tax jurisdictions too and aim to reduce their global average rate towards the home country minimum rate, shifting profits out of the high-tax jurisdictions. This, in turn, would create pressure on other countries, perpetuating the rate to the bottom. In line with the floor imposed through an income inclusion rule, countries should also commit to have domestic effective tax rates above this minimum.

There should be no exemptions for real economic activities. The OECD IF now requires countries that have preferential tax regimes, no corporate tax, or a zero or close to zero corporate tax rate, to apply real economic activity tests. This is works against profit shifting to empty shells, through completely artificial structures. Moreover, the modified nexus approach for R&D has limited the possibilities to attribute income from intellectual property to a low-tax entity that did not generate the intellectual property. However, as a consequence of these rules, tax competition for real activities has further intensified. Various countries have replace preferential regimes with general low-tax regimes or lower corporate tax rates for larger companies. In addition, under the current transfer pricing system, it remains inherently difficult to determine what part of a multinational’s profits can be attributed to intangibles. This applies to marketing intangibles as well as trade intangibles. For highly digitalised business models, the latter are important too, as these involve search engine code and other software, content selection algorithms, cloud computing technology, etc. Thus, while it has become more difficult to attribute income from intangibles to a jurisdiction where no such income belongs, the current rules hardly prevent manipulating the amount of income from intangibles attributed to a low-tax entity that has real substance. Therefore the race to the bottom can only be stopped if the tax on base eroding payments does allow exemptions for real economic activities.

In the ideal situation, the income inclusion rule would be applied to all relevant multinationals by the home country of their top holding. It would then be unnecessary to apply the income inclusion rule at the level of intermediate holdings, which would greatly simplify its implementation and eliminate a potential source of disputes. Depending on design elements such as control thresholds, a coordination rule may be needed for joint ventures or other entities that could fall under the income inclusion rules of several ultimate parent or beneficial owner jurisdictions.

However, a solution is needed for home countries that do not implement an income inclusion rule. To implement an income inclusion rule, countries that are home to the top holdings of multinationals need to have a corporate tax system. For home countries with a zero corporate tax rate or a domestic rate below the required effective minimum rate, it might be difficult to implement an effective income inclusion rule. Host countries would need to alternative backstop rules to protect their taxing rights on activities of any multinationals that are not subject to an effective income inclusion rule. Such backstop rules might for example involve an alternative minimum tax base consisting of a portion of a multinational’s global profits determined using objective factors, for example. In the absence of such alternative backstop rules, strong anti-inversion rules or exit tax rules would needed, to prevent relocation of top holdings of large multinationals to jurisdictions without an effective income inclusion rule. That would be an undesirable situation, because such rules are typically more complex and less robust. To stop the race to the bottom for investments not covered by an income inclusion rule, countries should also commit to uphold minimum effective tax rates domestically, which could be subject to peer review.

A limited turnover of profit threshold per jurisdiction would be appropriate. This would allow for a level playing field for investors that serve local markets in very small island jurisdictions that choose not to levy corporate income tax. It would also limit administrative burdens for small firms with international operations.

Countries would still have the possibility to provide accelerated depreciation schemes, limited tax rate reductions and other benefits to investors. Such benefits tend to have less negative by-effects, because they are less prone to manipulation by investors involving in aggressive intra-group tax structuring, provided that safeguards such as ring-fencing of extractive industry projects are in place. An effective tax rate test should therefore allow that the tax base is calculated using accelerated depreciation (or deduction) of investments in tangible assets. This will mainly be relevant for the income inclusion rule. Obviously, it remains important that countries conduct a proper assessment before granting such benefits, govern them in an accountable manner, and are transparent about their costs and benefits.

There may be a need for transitional arrangements for source countries that have granted corporate tax exemptions that they cannot revoke. This applies especially to developing countries that have signed investment agreements including a stabilization clause with individual foreign investors. However, there should then be a cutoff date no later than 6 March 2019, otherwise foreign investors may put pressure on host countries to quickly make agreements locking in tax holidays. Perhaps the OECD could issue guidance explaining to what extent international investment treaties might complicate the introduction of a tax on base eroding payments, to discourage certain aggressive investors from threatening with arbitration cases that would actually not be admissible.

3. Scope limitations

Pillar 2 must apply to all types of businesses. See question 1 above.

There should be no exemptions for real economic activities. See question 2b above.

The subject to tax rule can be limited to related parties in case of interest, capital gains and super-dividends. See question 2a above.

4. Co-ordination

The tax on base eroding payments should take priority over the income inclusion rule. See question 1 above.

A coordination rule may be needed to enable application of the income inclusion rule to a whole multinational by one ultimate home country. See also question 2b above.

5. Reducing complexity, ensuring certainty and avoiding disputes

New standards should enhance certainty through simplification, reducing the need for dispute settlement. Thus, new standards should be easier to apply than existing ones, and limit the scope for discretion. As argued above, a strong tax on base eroding payments and income inclusion rule, without exemptions, will help to achieve this. Substantial economic activity tests, which require subjective judgements to be effective, would then become redundant.

The proposed reforms should therefore replace existing anti-BEPS measures where possible. See first section with general comments.

Instead of modifying tax treaty articles in a complex way, some articles could simply leave out the limitation of taxing rights. See question 2a above.

The effective tax rate test should be kept simple. See question 2a above for a discussion how this might be achieved.

The income inclusion rule could be applied to all relevant multinationals by their ultimate home country, with an alternative host country backstop rule in case the home country has no income inclusion rule. This would greatly simplify implementation and eliminate a potential source of disputes. Moreover, a simple alternative backstop rule implemented by host countries would make complex anti-inversion or exit tax rules unnecessary. See question 2b above.