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Detecting clouds before the Post-BEPS storm becomes uncontrolled

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A critical appraisal of the EU Switch Over Rule and the Indian Equalization Levy

At present, it is unavoidable to recognize that the international tax scenario is in transition to a much more inter-nation equitable system, where the national tax base will be better protected against erosion and profit-shifting corporate manipulations than it was in pre-BEPS times.

The international tax system, however, is not yet stable, and simultaneous OECD-G20, EU, and unilateral state's efforts under the BEPS label, aimed at correcting and closing double non-taxation originating loopholes, as well as improving TP rules, transparency and associated aggregate and national information, may at times collide among them and/or with more fundamental international tax principles.

For that very reason, this is a transitional period where the risk of ending up in situations of multiple or cascade taxation in the international field may not be fully discarded. In fact, back in 2014, leading heads of the OECD/G20 project recognized that tax overlapping is a risk for the years to come, at least until countries harmoniously consent to the allocation of the new (greater) global tax basis.(1)

Multiple taxation fears are then not irrational and concrete in actual risks as soon as one looks at the national government sometimes aggressive desire to grasp income from an extended post-BEPS global basis on income generated by borderless businesses, such as income from the digital economy, private commercial use of satellites and other artifacts in outer space, and the like; to the extent unilateral, uncoordinated and misaligned endeavors become widespread in this area of taxation, the national initiatives would lead to inter-country tax imbalances as well as to cascade taxation on global businesses.

Aware of these potential setbacks, OECD is willing to cooperate with national governments during the BEPS implementation stage,(2) though the initiative appears not to be sufficient to properly channel highly innovative and aggressive jurisdictions wishing to go forward by their own.

Of all open possibilities, the taxation of income from the digital economy appears to be the most attractive field to actuate individual states' innovation. And this is so, in part, due to the fact that when Chapter 7 of the Final Report on Action 1 dealt with the direct tax challenges raised by the digital economy, not a single response but three options were presented to address said challenges, including: (i) a new nexus based on the concept of significant economic presence; (ii) a withholding tax on digital transactions; and (iii) an equalization levy.

These options were presented by the Final Report without expressing any preferences and thus, without a clear guide on their concrete application by individual countries; moreover, their main features are meagerly described, so that application at the national level may show great variances, as the already started domestication process shows.(3)

To the standalone U.K. gross-basis final withholding tax on digital transactions, i.e., payments to nonresident providers of goods and services ordered online (digital sales transactions), under certain specific conditions, designed under UK tax law,(4) and the Australia's multinational anti-avoidance law that originates treaty override issues,(5) the recently proposed equalization tax in India must now be added and discussed by its own merits (demerits?).

The 2016 Indian finance bill introduces a 6% "equalization levy" which is conceived as a levy separate from the income tax applicable on every consideration received by non-residents from Indian tax residents for the provision of online advertisement, digital advertising space, or other similar online advertisement services.(6) The levy is to be withheld by Indian residents from the consideration paid to the nonresident service provider.(7)

Aside from the fact that the equalization levy, by its own nature, will not allow the crediting against income tax at the nonresident´s home country, a much more fundamental jurisdictional issue somehow taints the proposed levy. From this perspective India's digital equalization tax is as innovative as controversial; it is a well settled principle that international income tax jurisdiction may not be based on a legal fiction:(8) And that is precisely how the levy functions when advertising expenses incurred by Indian residents are deemed a succedaneums of actual activity in India by the nonresident recipient of the payments. In this context, the query is whether just by changing the nomen iuris of the tax the proposed levy is able to overcome an ultra vires taint under general and conventional (treaty) international tax law.(9) From a different perspective, and assuming that the equalization levy is kept afloat after passing an income-type jurisdictional scrutiny, one may easily imagine the aggregate over-taxation that would result from a simultaneous application of similar levies by market jurisdictions (not to mention the overlap with the VAT on the importation of services). At this point, and as an additional comment, looking at all the difficulties inherent to the application of traditional jurisdictional principles to the taxation of income from the digital economy, one may well wonder whether it might have not been better to migrate to a destination based corporate tax model, a still untested but highly attactive alternative to tax income from the digital economy.(10)

Another tax innovation (the switch over rule) comes from the new proposed rules to tackle multinationals' tax avoidance, made by the European Commission in January 2016.(11)

In essence the switch over rule is aimed at soaking up foreign tax jurisdiction on foreign non-taxed or low taxed income –thus creating an unwarranted level of taxation under the umbrella of an exemption system– if and when the foreign country (in full exercise of its sovereignty) decides not to tax or not to tax at a level similar to that applicable in the respective EU country. In this respect, it is worth noting that all sort of full or partial tax holidays that a non-EU country might grant to attract FDI would be affected (including those addressed to certain zones or economic sectors in developing countries as well as low rates in developed countries). Moreover, the proposed rule would affect longstanding participation exemption regimes in the EU even when the EU parent derives dividends or capital gains made of low-taxed foreign operating income.(12)

A recent CFE Opinion Statement on the European Commission´s proposal for an Anti-Tax Avoidance Directive, is highly critical on the switch over rule making reference not only to the issues referred to in the preceding paragraph but also to other issues like the lack of clarification on the interrelation with the CFC rules, a potential "race-to-the-bottom" effect with regards to EU statutory rates, and the possible crediting of the resulting additional tax.(13)

If the switch over proposal is finally approved as currently drafted could even originate some sort of tax retaliation from affected non-EU countries that find the decision as an undue interference with their sovereignty. Tax retaliation might take, among others, the form of a statutory exclusion of EU-owned companies from FDI incentives in developing countries.

In times of significant changes like the current post-BEPS era, the tax community should keep mostly concerned not only with the widely shared policy goals pursued, but also with the international public law and tax principles involved in their implementation so as to prevent a domestic deviation that, even though inadvertently, may have chaotic effects on the inter-nation jurisdictional balance, and trade and investment flows.

(1) On occasion of the Brisbane G20 Meeting, Pascal Saint-Amans recognized in a Fairfax interview that in the short term may be a "…intensification of tax audits and tax controversy because governments are frustrated and may be more aggressive…" "As countries are more aggressive you have more controversy and more double taxation, but that's not due to a change in international rules … That´s about countries trying to protect themselves." See *Brisbane G20 2014: Tax deal aims for even playing field*, The Sydney Morning Herald, November 14, 2014.

(2) First, the G20 Antalya Summit Communique calls for a "widespread and consistent implementation" monitored by OECD on the basis of a framework which includes even non-G20 countries committed to implement the BEPS project; *Communique* November 16, 2015. See also, more recently, OECD, *All interested countries and jurisdictions to be invited to join global efforts led by the OECD and G20 to close international tax loopholes*, February 23, 2016.

(3) As I alerted in these same pages back in October 2015, meaningful revisions of the alternative options should not be expected before 2020; a period long enough to observe the appearance of diverging (even conflicting) experiments at the national level; see Teijeiro, *The BEPS Project Lacks Comprehensive Definition on the Taxation of Digital Economy in Market Jurisdictions, An open door for emerging economies or the beginning of the end in international tax co-ordination*, Kluwer International Tax Blog, October 24, 2015.

(4) UK Diverted Profit Tax (DPT), conceived as a separate levy from the income tax and designed as a full proof tool against challenges based on EU law and trade obligations. See, *inter alia*, Baker, *Diverted profits Tax: A partial response*, British Tax Review, 2015-2, p. 167-171; Neidle, *The diverted profits tax: flawed by design*, British Tax Review, 2015-2, 147-166; Self, *The UK's New Diverted Profits Tax: Compliance with EU Law*, Intertax, 43, 4, p. 333-336 (2015). A common issue to withholding and equalization taxes designed as separate levies would be the crediting against the corporate income tax payable at home.

(5) Elliffe, *The Lesser of Two Evils: Double Tax Treaty Override or Treaty Abuse?*, British Tax Review, No 1, 2016, pages 62-88.

(6) The levy is similar to that passed by the Italian parliament in 2013 (see: here).

(7) Paresh Parekh and Sagar Wagh, *International tax proposals in Budget 2016 – India's 'Digital Tax' googly!*, The Tax Booster.

(8) This principle was clearly stated by the Indian Supreme Court *in re Vodafone*, January 20, 2012.

(9) The *Report of the Committee on Taxation of E-Commerce* (dated on February 2016, and prepared by the Committee on Taxation of E-Commerce formed by the Central Board of Direct Taxes, Department of Revenue, Ministry of Finance, Government of India), found no possible challenges on this basis.

(10) See on point, Devereaux and de la Feria, *Designing and Implementing a destination-based corporate Tax*, Oxford University Centre for business Taxation, WP 14/07, May, 2014; reproduced in Tax Notes International, May, 2015.

(11) Article 6. A switch over rule was not contemplated under the OECD-G20 BEPS Project.

(12) See Fabo landa and Vinuesa Magnet, *La switch-over clause propuesta por la Comisión Europea o cómo retroceder veinte años en materia de fiscalidad internacional*, Gomez-Acebo y Pombo, Spanish Tax Alert, March 7, 2016.

(13) *CFE Opinion Statement FC 3/2016 on the proposal for an EU Anti-Tax Avoidance Directive*, opinion submitted to the European Commission and the OECD on 25 March 2016.

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