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International Tax Competition in light of Pillar II of the OECD project on Digitalization

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Purpose of the blog

The purpose of the blog, which is slightly futuristic, is to discuss whether countries will still compete with one another to attract activities in their jurisdiction post-Pillar II implementation.

State sovereignty and Tax Competition

A *sine qua non* condition for the existence of international tax competition is the opportunity to transfer capital from one tax jurisdiction to another with the purpose to reduce tax burdens imposed on taxpayers. To attract foreign capital and possibly prevent capital outflows, countries introduce appropriate tax reforms. The simplest method to achieve this goal is to reduce tax rates and/or introduce other tax advantages such as tax reliefs, exemptions or refunds. The phenomenon of international tax competition in very broad terms consists of such actions taken by countries within their fiscal policies which lead to preserving or increasing the attractiveness of the given area as a location to carry out business operations.

An instrument which enables the pursuit of such tax policies consists of relevant normative solutions introduced to the legal system by the local legislator. Making positive law is a manifestation of the country's sovereignty and independence that is not subject to any superior power and cannot be restricted against the country's will. A country acting within the realm of its jurisdiction is, in principle, free to shape its national tax legislation at its discretion and introduce appropriate competitive legal solutions with respect to taxes as a result of its sovereignty. The sovereignty of countries is not, however, absolute, as being a participant of international relations, countries frequently limit their sovereignty by way of concluding tax agreements (as well as, in some situations, non-tax agreements)/ joining an economic union or international organisation to which, in some cases, they may transfer some of their competencies, including in the field of law-making.

Nowadays, international tax competition is manifested as a competition among jurisdictions the purpose of which is to attract mobile production factors and to maximise state budget revenue owing to the influx of foreign capital, by way of creating favourable solutions for taxation. The main beneficiaries of domestic tax policy shaped that way are MNEs (also high net worth individuals), whose decisions on the business location are made based to a great extent on taxation

levels. Indeed, not only tax factors affect the selection of the appropriate jurisdiction, but also the entirety of institutions and the public goods offered by the given country. In turn, funds received from taxation of capital that came from abroad as a result of using preferential taxation principles enable certain jurisdictions to broaden the scope and enhance the quality of the public goods they provide.

In general, tax competition may be defined as deliberate, normative actions of a given country providing, directly or indirectly, MNEs and individuals with beneficial tax solutions by granting, for instance, low tax rates or tax reliefs, and aimed at the attraction of a mobile economic capital which leads to an extension of a tax base of that country at the expense of other countries.

Not arguing on whether the existence of tax competition, which is an unquestionable fact, in itself is a positive or negative phenomenon, it must be noted that severe, boundless and rampant tax competition may translate into a mere "*race to the average*" rather than "*race to the bottom*". From an idealistic standpoint, one of the best methods to prevent this "*race*" is to ban tax competition between countries by way of international agreements / international coordination and to persuade countries to undertake to maintain tax rates at some optimum levels. The countries' commitment to take such actions is in practice very difficult or simply impossible to achieve, as it is doubtful that they will be eager to unconditionally agree to transfer part of their sovereignty and tax setting competencies to another entity / international organisation.

International tax competition development factors

Development of tax competition is affected by numerous factors. One of them is the gradual elimination of traditional obstacles in cross-border transfers of public goods and services and propagation of the market economy across different areas in the world. Another factor, which augmented cross-border transfers, is scientific and technical progress which has accelerated, even more, the freedom of movement for production factors and exchange of information between different areas of the world. These days, international tax competition is undergoing a new and considerable transformation connected with the development of digitalization, which reduces costs of cross-border business operations.[1] It is difficult to ascertain which of the factors are of the greatest importance.

Notwithstanding the above, legal and institutional conditions must also be taken into account, since, regardless of the decrease in cross-border business costs and the possibility to manage it from various corners of the globe, the role of the location of production factors does not lose its meaning, which is reflected by the existence of differences in institutional legal and tax systems among jurisdictions.

At present, the importance of joint actions of the aforementioned factors is growing, which is related to globalisation of the world economy. From the perspective of the theory of tax competition, globalisation entails the elimination of the country's monopoly. Where a country used to offer its "goods" to taxpayers based on the monopoly principle, they could optimise their tax burdens only within the constraints of legislation of this particular country, while nowadays, legal tax systems of a number of countries can be taken advantage of for optimisation purposes. This has led to some "pressure" from MNEs on the legislator shaping the country's tax policy, as those entities have the opportunity of choosing between different tax jurisdictions and the choice of a new destination often means a decreased budget revenue of the former one.

The “market” of international tax competition is characterised by the supply side being shaped by the country which still keeps a relative monopoly in tax system design. However, the demand side is created by large MNE’s (or high-net-worth-individuals). This said, it cannot be assumed that the globalisation creates a “market of tax systems” where perfect competition exists. In practice, state governments could strive to restrict competition freedom. The most primitive form of restricting tax competition is customs protectionism and restriction of the free movement of goods and services, whose role is gradually decreasing. More notable attempts of restricting tax competition are taken by the OECD which are aimed at combating harmful tax regimes. In the pre-BEPS era, taxpayers avoided taxes through territories applying harmful tax practices and transfer mispricing but this has changed in the past few years.

BEPS and Tax Competition

A key idea of the BEPS project was that profit should be taxed “where economic activities generating the profits are performed and where value is created”.[2] Thus, based on the foundations laid by the OECD’s report of 1998[3], the BEPS Project reignited a debate on harmful tax practises. One of its essential targets was to reduce the distortionary influence of taxation on the location of mobile activities, thereby encouraging an environment in which free and fair tax competition can take place.[4] The OECD work reinforced the application of the “substantial activity” factor.[5] Therefore, taxpayers should be given the access to the international tax framework (e.g., transfer pricing, tax treaty rules as well as selected EU Direct Directives) as long as they are able to pass the “substance” test and demonstrate economic rationale of structures/arrangements which engage entities from low-tax or non-tax countries. This development modifies the essential features of tax competition which is no longer solely a matter of tax rates, but also of the conditions necessary to create substantial activity/activities. Such transformation, however, does not prevent competition as MNEs can still engage in profit shifting activities by having the appropriate people functions in low tax jurisdictions. On the other hand, tax competition between states is intensifying in order to attract people functions.[6] In the light of the above, although the BEPS Project has achieved a high degree of international tax co-ordination/co-operation by ensuring that states adopt a common set of tax related rules, it has at the same time enhanced international tax competition.[7]

Tax competition in the light of the Pillar II OECD

The OECDs work on digitalization of the economy focusses on two areas: Pillar I and Pillar II. Pillar II, also referred to as the “Global Anti-Base Erosion” or “GloBE” proposal[8] seeks to comprehensively address the remaining BEPS challenges by ensuring that the profits of internationally operating businesses are subject to a minimum rate of tax.[9] A minimum tax rate on all income reduces the incentive for taxpayers to engage in profit shifting and establishes a floor for tax competition among jurisdictions. With respect to the latter, the GloBE proposal posits that global action is needed to stop a harmful race to the bottom on corporate taxes, which risks shifting the burden of taxes onto less mobile bases and may pose a particular risk for developing countries with small economies.

The GloBE proposal contains four components: an income inclusion rule, an undertaxed payment rule, a switch-over rule and a subject to tax rule.[10] While discussing all components is beyond the scope of this short contribution, nonetheless, , the main instrument for combating profit shifting / tax competition is to introduce a global minimum corporate effective tax rate which under an

income inclusion rule would discourage low tax jurisdictions to set effective tax rates below this minimum. The idea of an income inclusion rule is to ensure that the income of the MNE is subject to tax at a minimum rate thereby reducing the incentive to allocate returns for tax reasons to low taxed entities.[11]

Indeed, the question arises whether the income inclusion rule, restricts MNEs from shifting their profit in low-tax jurisdictions. According to the preliminary economic analysis on the impact of both Pillars on revenues and investments, the OECD states that the GloBE proposal is expected to result in a significant reduction in profit shifting by MNEs.[12] However, the answer to this question, which is not straightforward, would indeed depend on the design of the income inclusion rule.

The first design consideration relates to whether the rule would be based on a country-by-country basis on the one hand or a global blending basis on the other hand. Pure logic and common sense (without the need to resort to economic studies) tells us that if the former, tax competition (below certain tax rates) could be restricted to a certain extent. If the latter, tax competition may still thrive as tax rates of all countries (high tax and low tax) are blended with each other. This said, the global blending approach, at least from a conceptual standpoint, seems to be the simpler approach to implement. Also, this approach, intuitively, seems to entail low compliance costs for tax administrations and MNE Groups. Further, the approach seems to reduce the volatility in effective tax rates that are attributable to temporary differences. Moreover, issues concerning income allocation between branch and head offices as well as transparent entities become less onerous under this approach. Furthermore, issues concerning crediting taxes as well as treatment of intra group dividends become less problematic under this approach. All these parameters indicate that the worldwide blending approach would reduce administrative complexity and the compliance burden in comparison to the other approaches[13].

A second consideration relates to how a "substance-based" approach will be addressed in Pillar II. In particular, while discussing the use and effects of carve-outs in the GloBE Proposal, the OECD states that carve-outs for "regimes compliant with the standards of BEPS Action 5 on harmful tax practices, and other substance based carve-outs […] would undermine the policy intent and effectiveness of the proposal".[14] On the one hand, implementation of GloBE Proposal without substance-based carve-out would ensure its effectiveness, however, at the same time, it would run counter to one of the foundations of BEPS, which perhaps will have to be abandoned. On the other hand, including this carve-out would be in line with BEPS's output but will yield no effect on tax competition (especially, regimes approved by the Forum on Harmful Tax Competition).

It seems that a compromise will have to be struck between these two key design considerations. One compromise could be to adopt a global blending approach without any carve outs. Another compromise could be to adopt a country by country approach with carve outs. Designing the Globe proposal on the basis of a global blending approach with carve outs or a country by country approach without carve outs seems unlikely (at least, pre COVID 19).

Keeping aside these two considerations, we would like to state that the GloBE proposal cannot eliminate the tax factor from international economic rivalry. It may curb "*race to the bottom*" or "*average*", but there will still be "room" for tax competition above the GloBE's minimum rate.

Alternates to the Globe – Fundamental reforms: Are they sensible?

In order to curtail tax competition to a great extent, some commentators have argued for the introduction of fundamental reforms such as destination based cash flow taxes (DBCFT). At the core, the supporters of these proposals contend that 'production', 'origin', 'supply', or 'value creation' factors (such as employees in combination with intangibles) are mobile. Accordingly, MNEs can move these factors from high tax to low tax jurisdictions and engage in profit shifting. Also, countries may compete with each other in order to attract such factors within their territory by offering tax incentives in the form of reducing corporate tax rates. Therefore, the current framework encourages profit shifting and tax competition. On the other hand, the proponents of the DBCFT argue that their proposals do not lead to profit shifting/tax competition as they are linked to consumers in a market. As customers are relatively immobile, an MNE does not have an incentive to move, for instance, its 'production' factors to a low tax country. At the same time, countries will not engage in tax competition to attract 'production' factors.

While these proposals may have their merits from efficiency aspects, a general question arises as to why the Market Country should obtain substantial taxing rights over income that is substantially 'sourced' in another country. Does this proposal not directly conflict with the direct 'benefits' principle? In our opinion, this should definitely be the case, especially for the DBCFT. Also, if the proponents of these proposals argue for a full/part destination framework for corporate income tax then why should VAT not be based on the residence or origin principle to maintain an equilibrium for State finances?

To end on a controversial note, this proposal could trigger the opposite effect of tax competition, that is, *tax annihilation* for businesses, in the sense that large consumer markets (eg. BRICS and USA) in which an MNE sells (and on which it is dependent) could unilaterally increase their corporate tax rates. Then international policy making organizations, academics as well as other stakeholders will be busy working on ways to restrict ***"race to the top" tax annihilation***.

All views expressed are personal. The authors would like to thank Alessandro Turina (IBFD) for reviewing the draft version of this blog.

[1] Tax Competition and E-Commerce, Avi-Yonah, Reuven S., Tax Notes Int'l 23, no. 12 (2001): 1395-400.

[2] Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project, OECD 2015, p.4.

[3] Harmful Tax Competition: An Emerging Global Issue 1998 Report, OECD, 1998.

[4] Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5, 2015 Final Report, OECD, p. 11.

[5] *Ibidem*, p. 23.

[6] The Relevant Economic Activity Test and its Impact on the International Corporate Tax

Policy Framework Chand Vikram, Malek Benjamin, British Tax Review Issue 3, 2019, p. 424.

[7] Ibidem p. 423.

[8] Global Anti-Base Erosion Proposal (“GloBE”) – Pillar II, Public consultation document, 8 November 2019 – 2 December 2019, OECD 2019.

[9] Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy, 28 May 2019, p. 25.

[10] *Ibidem*, p. 6.

[11] Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy, 28 May 2019, p. 27.

[12] See https://www.oecd.org/tax/beps/oecd-presents-analysis-showing-significant-impact-of-proposed-international-tax-reforms.htm

[13] See comments by De Broe, Danon and Chand on the OECDs consultation document on Pillar II available here https://serval.unil.ch/resource/serval:BIB_D8C1987EFA9C.P001/REF

[14] Global Anti-Base Erosion Proposal (“GloBE”) – Pillar II, Public consultation document , 8 November 2019 – 2 December 2019, OECD 2019, p. 32.

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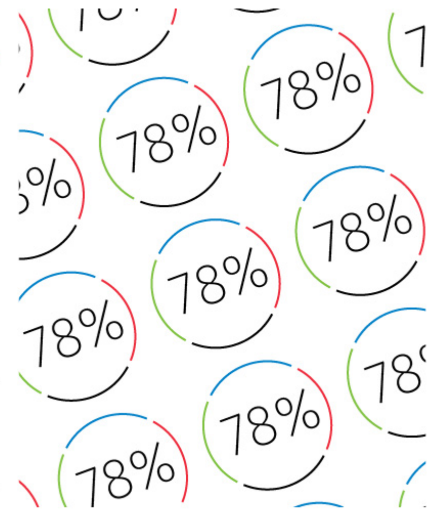

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