EDITORIAL

Is There a Light at the End of the Tunnel of the International Tax System?

1 The growing discomfort with the current international tax system

In the previous issue of this journal, taxation of the digital economy and the tax models that could be applicable were debated in depth. Those models included the abolition of corporate income tax grounded on taxation of net income and its replacement with a destination based tax; the evolution of transfer pricing to a profit splitting method; application of the permanent establishment concept to the digital economy, based on a significant digital presence concept; equalization levies; and withholding taxes.

The quest for new regimes, either applicable to all business sectors or only to digital taxation, has been an opportunity to relaunch the international debate on the allocation of taxing rights, and the future of corporate income tax. It has been noted from the beginning of the Base Erosion and Profit Shifting (BEPS) project that the project is meant to deal with aggressive tax planning without expressly reallocating taxing rights. It is true that *value created*, dealt with in Actions 8-10, introduces a connecting element for legitimate taxation.[1] 'It attributes income to where significant people who control risks are located, or where functions are performed, assets are used and risks related to intangibles are assumed.[2] The main view is that market states were left aside from the concept of 'value creation'[3]. At the same time, a 'subject to tax' clause for residence countries was introduced in some cases, and incentives not regarded as harmful in Action 5 can be offered by resident countries.

There were other signs of discomfort with the current rules regarding allocation of taxing rights in the BEPS project. The inadequacy of the current residence concept for corporations is acknowledged in the abolition of the place of effective management as a tiebreaker rule in the case of dual resident entities, and the requirement of mutual agreement;[4] The value chain analysis under Actions 8-10 renders the concept of residence useless for groups: formal residence is not relevant anymore for the cases of letter or cash boxes. And finally, Action 1 admitted a problem with the current international tax system by discussing other options to tax the increasingly digitalized economy.[5]

2 How to effect redistribution in a digitalized economy

There is a profound confusion on the purposes and design of the future international tax system. Whereas it is desirable to reach global consensus on the allocation of taxing rights, only a limited number of countries have implemented the various measures outlined in the 2015 BEPS Action 7 Final Report, which would allow them to tax non-resident companies, and, to a certain extent, business at distance (even if implying physical delivery of goods and services). This is the case of the revised dependent agent permanent establishment definition (Article 5(5) of the OECD Model Convention (OECD MODEL)) and of the revised provision defining specific-activity exemptions (Article 5(4) of the OECD Model)[6] (even if some tax treaties include withholding taxing

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1 For a discussion of the role played by 'value creation', *see* W. Schön, *Ten Questions About Why and How to Tax the Digitalized Economy*, Max Planck Institute for Tax Law and Public Finance Working Paper 2017-11, at 4–5.

2 OECD, *Aligning Transfer Pricing Outcomes with Value Creation – Actions 8–10 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 5 Oct. 2015). *See also* A. Martín Jímenez, *BEPS, the Digitalized Economy and the Taxation of Services and Royalties*, in this issue, s. 2.

3 *See*, however, differently, A. Martín Jiménez, BEPS, the Digital(ized) Economy and the Taxation of Services and Royalties, in this issue.

4 OECD, *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (OECD Nov. 2016) [*MLI*], Art. 4 (Dual Resident Entities).

5 OECD, *Addressing the Tax Challenges of the Digital Economy – Action 1: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 5 Oct. 2015).

6 OECD, *Tax Challenges Arising from Digitalisation: Interim Report 2018 – Inclusive Framework on BEPS*, OECD/G20 BEPS Project (OECD Publishing 16 Mar. 2018); OECD, *MLI, supra* n. 3, Article 13 – Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions.

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rights for royalties or services, or follow article 5 of the United Nations Model Convention (UNMC).

Indeed, the OECD Interim Report of 16 March 2018, *Tax Challenges Arising from Digitalisation*, states as follows:

> The various measures outlined in the final 2015 BEPS Action 7 Report are currently being implemented in a number of existing tax treaties through the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (the MLI, Box 3.1), as well as in the course of bilateral tax treaty negotiations. Based on the provisional positions of the jurisdictions that have signed the MLI, however, it is estimated that the changes recommended under Action 7 will only be implemented in a fairly limited number of bilateral treaty relationships. The latest projections are as follows: For the revised dependent agent PE definition (Article 5(5) of the OECD Model): It is estimated that, based on the positions taken so far, this revised definition would apply to around 17% of the 1 246 tax agreements currently covered by the MLI (i.e., approximately 206 bilateral tax agreements). For the revised provision defining specific-activity exemptions (Article 5(4) of the OECD Model): It is estimated that, based on the positions taken so far, this revised provision would apply to around 22% (i.e., approximately 277 bilateral tax agreements).[7]

In contrast, the digital taxes that have been set up by some jurisdictions have a mix of compensatory purposes for aggressive tax planning practices and protectionist purposes.[8] This is also true for the EU proposal for a directive on an equalization levy.[9] The recently announced digital tax in Spain goes beyond this pattern, and is politically related to revenue purposes (payment of pensions).[10]

The new digital taxes acknowledge the inability to tax income of multinationals with a major share of sales in a certain market, but operating without a physical presence, or with scarce physical presence. It is perceived that an increasing portion of the business income from cross-border sales or services will not be taxed in the market jurisdiction. It has been argued that market jurisdictions are not entitled to tax income, due to the lack of economic allegiance (little or no creation of value in the market jurisdiction) – market states are entitled to indirect taxes and have no legitimacy to tax income from digital companies.[11] Less radically, it has also been argued that there are other competing jurisdictions claiming genuine links: market states are not more entitled to tax digital companies than others, because they compete with the residence country, the country where R&D is performed and the country where physical goods are produced.[12]

However, the high rate of growth in the digital economy and the afore-mentioned increasing absence of physical presence by companies is felt as a critical menace to the state, its companies and its constituents. This shift in the economic model threatens taxation based on economic connection and exchange of benefits.

In the political theory discourse, communitarians and statists would justify digital taxes as a relevant instrument to keep the existence of the state and the communitarian links.[13] The novelty is that communitarian links will be based on the immobile or less mobile factors (the traditional brick-and-mortar industry, property and less skilled citizens) and will not include the granting of public benefits to taxpayers operating in the market without a physical presence.

In other words, taking the example of digital taxes that are being set up, the lack of economic connection or exchange of benefits, can be interpreted as an instrument to assure the survival of states and their communities. This is so because redistribution is still a function performed by states based on state tax revenue. If sales and services are increasingly provided without physical presence, and the concept of value created is attached to the supply side of the economy, as it has been in the past, communities will be at risk. The afore-mentioned announcement of the Spanish digital tax, linked to a populist discourse (tax the digital economy (i.e. the future) to pay pensions (i.e. the past)), clearly expresses how states lack confidence in the future of the international tax system.

In this context, it does not seem rational that states are scarcely implementing the options under the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS Multilateral Instrument (MLI) on the permanent establishment concept. This may mean two contradictory things, namely that states are still striving to be

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7 OECD, *Tax Challenges Arising from Digitalisation: Interim Report 2018*, *supra* n. 5, para. 272.

8 *See* Schön, *supra* n. 1, s. IV.

9 European Commission, Proposal for a Council Directive on the Common System of a Digital Services Tax on Revenues Resulting from the Provision of Certain Digital Services, Brussels, 21 Mar. 2018, COM(2018) 148 final, 2018/0073 (CNS), https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_common_system_digital_services_tax_21032018_en.pdf (accessed 27 May 2018).

10 *Hacienda gravará un 5% los servicios digitales de empresas extranjeras y españolas*, Expansión (23 May 2018), https://economistas.es/wp-content/uploads/2018/05/zxc-p1digi.pdf.

11 E. C. C. M. Kemmeren, *Should the Taxation of the Digital Economy Really Be Different?*, 27(2) EC Tax Rev. 1–3 (2018).

12 Schön, *supra* n. 1, at 3.

13 T. Dagan, *International Tax Policy, Between Cooperation and Competition* Chs 1 & 6 (Cambridge 2018); T. Nagel, *The Problem of Global Justice*, 33(2) Phil. & Pub. Aff. 113–128 (2005); M. Sandel, *What Money Can't Buy: The Moral Limits of Markets*, 21 Tanner Lectures on Human Values 89, 119–120 (G. B. Peterson ed., 2000).

competitive, and that they do not trust transfer pricing rules, even if improved by the 'value creation' concept.

No doubt, the essence of the current discussion within the Inclusive Framework, the European Union and within states, is related to the allocation of taxing rights, and to intense mistrust among all players. Even if some voices still plead in favour of the traditional allocation of taxing rights between residence and source states, and the supply side and demand side, it is difficult to ignore that the compromise achieved between residence and source states since the League of Nations is no longer recognized as valid. A new model based on cooperation will have to be developed, on either an evolutionary or revolutionary basis.[14] Because it will be a challenge to achieve worldwide consensus, also among OECD countries, unilateral or regional compensatory and protectionist measures will be inevitable, even if provoking inefficiencies and distortions.

3 Article 12A of the UN Model and the quest for withholding taxes

There is good news brought to developing countries by the UN MC. The new Article 12A of the UN MC brings the possibility to apply withholding taxes to all types of technical services, without the need for any substantial physical presence in a state, thus including digital services. Although the Commentary 2 on Article 12A makes reference to BEPS Action 1, the issue is whether the proliferation of withholding taxing rights would be per se adequate to combat aggressive tax planning, and therefore in line with the spirit of the BEPS project. If that were the case, this would be a simple path, from the perspective of inter-nation equity.

Several authors are proposing that solution be applied worldwide. The history of income tax treaties, however, shows that withholding taxes on capital income and services have been progressively eliminated. Indeed, tax treaties concluded before World War I between the Austrian-Hungarian Empire and states of the German Empire, as well as after World War I, and the treaty on common principles signed in Rome on 13 June 1921, between Austria, Hungary, Italy, Poland, the Kingdom of Serbians, Croatians, Slovenians and Romania, agreed on the primary right to tax of the production state.[15] Rules were established on the basis of objective income taxes and personal income taxes. Property and capital income taxes were allocated to the source state.[16] Taxes which, in the residence state, were handled as personal income taxes implied taxation of foreign income, including capital income. Subsequently, the benefit principle as introduced in the League of Nations Model and later in the OECD Model Convention reduced the role of the source state.

Especially within the OECD, tax competition among states aimed at attracting foreign indirect investment has led to the abolition, in practice, of withholding taxes or to the drastic reduction thereof. EU directives on direct taxation have also abolished taxing rights of source jurisdictions based on withholding taxes. Even if the position of capital exporting and capital importing countries in OECD countries is not static, corporations are not interested in withholding taxes, unless they could be credited somewhere. The move towards territoriality in OECD countries eliminates the possibility for crediting in residence countries, assuming that a withholding tax on services would be allowed, in line with Article 12A of the UN MC. It is therefore more than questionable whether withholding taxes would be able to achieve consensus in the OECD and unanimity in the EU.

Whereas aggressive tax planning measures not directly implying rules on the allocation of taxing rights can be discussed in the Inclusive Framework, it will not be possible to reach worldwide consensus on the allocation of taxing rights. Article 12A of the UN Model is therefore welcome for developing countries, although it will hardly become a rule applicable to all jurisdictions on a worldwide scale.

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[14] Martín Jímenez, *supra* n. 2.

[15] *Rapport et Résolutions Présentés par les Experts Techniques au Comité Financier de la Société des Nations* 12 (1925). *See also* O. Buehler, *Les Accords Internationaux concernant la Double Imposition et l'Évasion Fiscale*, 60 Recueil des Cours 437, 461 (1936).

[16] *Rapport et Résolutions Présentés par les Experts Techniques au Comité Financier de la Société des Nations* 12–13 (1925).