

BEPS AND ALLOCATION OF TAXING RIGHTS: CURRENT GLOBAL SHIFT FROM RESIDENCE TO SOURCE TAXATION

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Five Main Issues

(1) BEPS documentation states that the BEPS Actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income. However, some BEPS Actions do in fact change standards on allocation of taxing rights.

(2) BEPS was not intended to cover all international tax issues affecting source countries. Several major tax issues affecting source countries are being worked on outside of BEPS by international organizations: IMF, World Bank, the United Nations and also by the OECD working separately or together.

(3) Change is constant. Changes in international tax take place in a step-by-step process — what I call the Dance Rule. We must look at the process of change over five year and ten year periods. There has been very substantial progress over the past ten years, and especially during the past five years. Therefore, we should expect substantial changes during the next five years and ten years.

- (a) Some change is Uncoordinated
 - (i) unilateralism
 - (ii) centrifugal forces
 - (iii) uncertainty
- (b) Some change is Coordinated
 - (i) multilateralism
 - (ii) centripetal forces
 - (iii) certainty
- (c) Certainty against:
 - (i) retroactive rulings
 - (ii) audit not based on the law and regulations- "random audit outcomes"
- (d) Certainty vs. unilateralism
 - (i) multilateral consensus
 - (ii) Centripetal forces

- (4) Substantial changes require long periods of time:
 - (a) Owens: The EU countries took 10 years to get their automatic exchange of information [AEOI] in place.
 - (b) The “Road” to OECD/G20 Multilateral Automatic Exchange of Information:

- (5) The OECD/G20 are still working on major issues affecting source countries:
 - (a) Taxation of the digital economy
 - (b) Attribution of profits to a Permanent Establishment
 - (c) Profit splits
 - (d) Impact on transfer pricing rules?

What Are The Major Trends

- (1) Dispersal of power, from the large, traditional industrialized countries, to large market countries, and the role of the G-20.
- (2) The "internationalization" of the OECD: the Global Forum on Transparency and Exchange of Information on Tax Matters, the Forum on Tax Administration, and the Inclusive Framework.
- (3) The new role of the European Union in tax matters: the EU State Aid cases, and Taxes on the Digital Economy.
- (4) Will the Heads of Revenue of the BRICS countries intensify their coordination on tax matters?
- (5) The increasing coordination of the work of international organizations: IMF, World Bank, and the United Nations, and the participation by the OECD in some of that coordinated work.
- (6) The voluntarily reduced role of the United States in the international scene:
 - (a) The need for the U.S. to reform its Internal Revenue Code and confront international tax issues.
 - (b) International Taxation of U.S. Tech Companies: The Inability of the U.S. To Face Tax Reality: for example, the Apple Case (U.S. Senate Permanent Subcommittee on Investigations, "Subcommittee to Examine Offshore Profit Shifting and Tax Avoidance by Apple Inc.," May 20, 2013).
 - (c) The failure of the United States to adhere to the Common Reporting Standard (CRS)

THE ALLOCATION OF TAXING RIGHTS: SPECIFIC ISSUES TO BE CONSIDERED

- (1) Definitional Problem: Changing Concepts: What Is The Source Country? What Is The Residence Country?
 - (a) Problems in defining these terms (IMF, "Spillovers in International Corporate Taxation," (May 9, 2014), pages 9-12).
 - (b) Need for revised definitions/terms?
 - (c) Place of organization versus place of effective management: changing definition of place of effective management (See the 2016 U.S. Model Treaty Article 22(7)(d)).

- (2) Source Countries Becoming Residence Countries
 - (a) How will countries which traditionally have been source countries react to increased source country taxation when those countries become residence countries for certain transactions: ((i) Importers becoming exporters; (ii) capital importers becoming capital exporters and (iii) recipients of services becoming providers of services)?

- (3) Taxation of Stateless Income: The Allocation of Taxing Rights over Stateless Income
 - (a) The "fight" to tax stateless income.
 - (b) Which country has the right to tax previously stateless income? The residence country or the source country?
 - (c) Allocation between two countries or between three countries?

(4) BEPS and Allocation of Taxing Rights: BEPS Provisions which will Impact The Allocation of Taxing Rights

- (a) The Position in the Initial BEPS Project: OECD Action Plan on Base Erosion and Profit Shifting, July 19, 2013, page 11.
- (b) Action One: Addressing the Tax Challenges of the Digital Economy
- (c) Action Two: Neutralizing Effects of Hybrid Mismatch Arrangements
- (d) Action Four: Limiting Base Erosion Involving Interest Deductions Interest and Other Financial Payments
- (e) Action Five: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance
- (f) Action Six: Preventing the Granting of Treaty Benefits in inappropriate Circumstances
- (g) Action Seven: Preventing the Artificial Avoidance of Permanent Establishment Status
- (h) Action Eight, Nine and Ten: Transfer Pricing Issues
- (i) Action Thirteen: Transfer Pricing Documentation and Country-By-Country Reporting: How will this result in greater source country taxation?

- (5) International Organizations and their Work on Source Country Taxation (IMF, World Bank, UN, and OECD)
- (a) Indirect Transfers (the Vodafone situation) (IMF, OECD, UN, World Bank) "The Taxation of Offshore Indirect Transfers — A Toolkit" (2017)
 - (b) Extractive Industries (IMF and UN)
 - (i) The IMF ("Fiscal Regimes for Extractive Industries — The IMF's Work," June 5, 2014)
 - (ii) The World Bank ("Transfer Pricing in Mining with a Focus on Africa: A Reference Guide for Practitioners," World Bank Group, January 2017). (See also ATAF and the German Government, "Toolkit for Transfer Pricing risk Assessment in the African Mining Industry," September, 2017)
 - (iii) The United Nations Tax Committee Subcommittee on Extractives
 - (iv) Other: Michael Durst, "Improving Natural Resource Taxation in Developing Countries," Tax Analysts Worldwide Tax Daily, October 4, 2017 (2017 WTD 191-15)
 - (c) Transfer Pricing (UN, IMF, World Bank, OECD): (The Platform for the Collaboration on Tax) "A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analysis " (2017)
 - (d) Tax Incentives (UN, OECD, IMF) "Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment" (October 2015)
 - (e) Capacity Building (UN, IMF, World Bank, OECD) "Enhancing the Effectiveness of External Support in Building Tax Capacity in Developing Countries " (July 2016)
 - (f) Tax Treaties (IMF, OECD and UN)
 - (g) Services (UN) New Article on Technical Services in UN Model Income Tax Treaty, and United Nations Practical Portfolio, "Protecting the Tax Base of Developing Countries against Base Erosion: Income from Services" (2017)
 - (h) BEPS Issues (IMF) "IMF Working Paper: Base Erosion, Profit Shifting and Developing Countries" (May 2015)
 - (i) Various Tax Issues Affecting Developing Countries (IMF) "Spillovers in International Corporate Taxation" May 9, 2014)
 - (j) Capital Flight and Illicit Funds Flows
 - (i) Automatic exchange of tax information: The OECD: Common Reporting Standard (CRS)
 - (ii) The IMF: "Revenue Administration: Implementing a High-Wealth Individual Compliance Program" (April 2017).

(6) Treaty Developments and the Allocation of Taxing Rights: Permanent Establishments

- (a) The OECD Model Tax Treaty and Permanent Establishments
 - (i) OECD Guidance on the Attribution of Profits to Permanent Establishments (2010)
 - (ii) OECD Additional Guidance on the Attribution of Profits to Permanent Establishments (2016)
- (b) The UN Model Tax Treaty and Taxation of Permanent Establishments
- (c) The 2016 U.S. Model Tax Treaty and the Taxation of Permanent Establishments
- (d) The OECD Multilateral Instrument

(7) The Fragmentation Problem

- (a) Changes in (i) the OECD Model Tax Treaty and (ii) the UN Model Tax Treaty, to confront the fragmentation problem.
- (b) The suggestion in the China country report in Chapter Ten of the U.N. Tax Committee Transfer Pricing Manual about "local unitary taxation" applied by the source country at the national level.

(8) Limitation on Benefits Clauses and Increased Source Country Taxation

- (a) BEPS Action Six
- (b) The 2016 U.S. Model Tax Treaty.
- (c) The OECD Multilateral Instrument

- (9) BEPS Action One: Addressing the Tax Challenges of the Digital Economy: The Impact on Source Countries, and Recent Developments
- (a) How will greater source country taxation be achieved and implemented?
 - (b) Unilateral Actions to Increase Source Based Taxation.
 - (c) The U.K. Diverted Profits Tax (DPT)
 - (d) The Australian Multinational Anti-Avoidance Law (AMAL)
 - (e) The Indian Equalization Levy and other similar taxes: Unilateral actions by other countries: the EU Proposals (at Tallin) and after (within BEPS Action One "options")
- (10) The EU State Aid Cases and Source Country Taxation: The Impact of those EU Decisions (The Apple Case and Other Cases)
- (a) What is the source of such income?
 - (b) Which country has the right to tax such income?
 - (c) State Aid cases: which country is the appropriate residence country? Is the residence country receiving appropriate amount of taxable income?
 - (d) The "combination" of (i) the State Aid cases and (ii) the taxation of the digital economy: Increasing claims by source countries (EU countries) leading to international tax friction/tax war?
 - (e) Mindy Herzfeld: "News Analysis: A Looming Global Tax War?" Tax Analysts Worldwide Tax Daily, October 3, 2016, 2016 WTD 191-1

- (11) Location Savings and Source Country Taxation: Recent Developments
- (a) The status of the arguments for "Location Savings" and "market premium," and other arguments in favor of allocating income to the "market country" (market intangibles).
 - (b) The UN Tax Committee Transfer Pricing Manual and Source Country Taxation (Chapter Ten, Country Reports, especially India and China).
 - (c) The proposal by China in Chapter Ten of the UN Transfer Pricing Manual about "local unitary taxation" in order to confront the fragmentation problem.
 - (d) BEPS Actions 8, 9 and 10: value creation and the market.
- (12) Proposals for Destination Based Corporate Income Tax: The Impact on Developing Countries
- (a) Will this be beneficial to developing countries? Will a destination based corporate income tax have to be supplemented by another type of tax to protect developing countries which are export oriented?
 - (b) WTO Issues: Will a destination based corporate income tax create WTO problems?
 - (c) The "end" of the proposal in the United States for a destination based corporate income tax.
- (13) The Impact of the OECD International VAT/GST Guidelines (April 12, 2017)
- (a) on cross-border "digital taxes"
 - (b) on source (market) country taxation in general
 - (c) "Mechanisms for the Effective Collection of VAT/GST where the Supplier Is Not Located in the Jurisdiction of Taxation" (OECD, October 2017)
- (14) Profit Splits
- (a) The BEPS Proposal
 - (b) The Platform for Collaboration on Tax:
"A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses"

(15) The Taxation of Services: Expanding Source Country Taxation and the New Article on Technical Services in the UN Model Income Tax Treaty

- (a) Will countries adopt this new article on the taxation of technical services?
- (b) Do traditional source countries provide technical services subject to this new article?
- (c) How will traditional source countries react to this new article on technical services when those traditional source countries become resident countries in this regard (that is, their providing, rather than receiving, those technical service)?

(16) BRICS and the Allocation of Taxing Rights

- (a) The Positions of the BRICS Countries
- (b) Will the BRICS Countries cooperate and pressure to change the allocation of taxing rights? Will BRICS Countries pressure to increase source country taxation?
- (c) Will the BRICS Countries work more cooperatively with other less developed, and less powerful, developing countries?

(17) The Group of 77 and China, Representing about 134 Countries

Will the Group of 77 and China present specific proposals for international tax reform, in addition to calling generally for an upgrade of the Tax Committee into an intergovernmental committee (organization)?

(18) Other Efforts to Increase Source Country Taxation: 2016 U.S. Model Tax Treaty

- (a) Subsequent Changes in Law
- (b) Special Tax Regimes
- (c) Minimum Foreign Income Taxes
 - (i) Permanent establishment in a third jurisdiction (Article 1(8))
 - (ii) Definition of Special Tax Regime (Article 3(L))
 - (iii) Subsequent Changes of Law (Article 28)
- (d) Treaty benefits based on taxation requiring remittance
- (e) Definition of "resident" not including a person subject to Fixed Fee based taxation
- (f) "Residence" and "Source"
 - (i) How is "source" determined for different items of income? What types of income; present problems in the determination of source?
 - (ii) How is "residence" determined in different situations: (A) Domestic law determinations and (B) Treaty law definitions

(19) Proposals for Formulary Apportionment and Unitary Taxation: The Impact on Developing Countries and Source Countries

- (a) Will this be beneficial to developing countries? "Formulary apportionment which has been widely canvassed, involves significant risk of distortion, and may not benefit developing countries. "See the IMF Report, "Spillovers in International Corporate Taxation" (May 9, 2014), page 1).
- (b) Unitary Taxation or Consolidated Taxation: The Impact on Developing Countries
- (c) What will be the impact of Profit Splits on Developing Countries?

Income Tax Treaties: Allocation of Taxing Rights—Four Fact Situations

Assume in these Four Fact Situations that Country A and Country B have an income tax treaty in force between them.

(1) Fact Situation One

An enterprise resident in Country A ("Enterprise A") derives dividends, interest, royalties, or other income, which for purposes of the tax treaty and domestic law in Country B, has its source in Country B.

Country B has the discretion of negotiating with Country A the applicable taxation (withholding taxes) in Country B under the treaty, and the allocation of taxing rights between Country A and Country B with regard to the taxation of such income in the source country and the residence country.

Withholding Tax Rates in Source Country Suggested Withholding Tax Rates

	<u>Dividends</u>	<u>Interest</u>	<u>Royalties</u>
(1) OECD Model Income Tax Treaty	Not to exceed 5 percent if the shareholder owns directly at least 25 percent of the payor. Otherwise, at a rate not to exceed 15 percent	Not to exceed 10 percent	0 percent
(2) UN Model Income Tax Treaty	Not to exceed a rate which is not specified but to be agreed by the parties if the shareholder owns directly at least 10 percent of the payor. Otherwise, not to exceed a rate which is not specified but to be agreed by the parties.	Not to exceed a rate which is not specified, but to be agreed by the parties.	Not to exceed a rate which is not specified, but to be agreed by the parties.

(2) Fact Situation Two

Enterprise A has business activities (including but not limited to the digital economy) with regard to in Country B. According to the definition of Permanent Establishment in the tax treaty, such business activities of Enterprise A do not constitute a Permanent Establishment in Country B.

Country B, the source country, can do the following, in order to try to allocate more taxing rights to Country B:

(a) adopt the changes to the definition of Permanent Establishment proposed in BEPS Action Seven and the Multilateral Instrument, and consider other changes which would expand the definition of Permanent Establishment, including confronting the problem of Fragmentation. For example, and consider the reference in the Country Report on China in the U.N. Transfer Pricing Manual, in favor of "unitary taxation" at the national level, that is, all companies in China owned by a foreign enterprise might be treated by the Chinese tax authorities as one entity.

(b) participate in the BEPS discussions about BEPS Action One, Addressing the Tax Challenges of the Digital Economy.

(c) participate in the discussions and implementation of those other BEPS Actions which will impact the allocation of taxing rights and the capacity of governments to effectively and efficiently tax appropriate amounts of income: Actions Two, Four, Five, Six, Eight, Nine, Ten and Thirteen.

(d) consider other types of income earned by Enterprise A, or another resident of Country A, which could be taxed by Country B, such as services, as confronted by the U.N. Tax Committee in its new article on Services in the UN Model Income Tax Treaty.

CHINA COUNTRY PRACTICE ON TRANSFER PRICING

Paragraph 10.3.5.2 (page 381) of the United Nations Practical Manual on Transfer Pricing (2013 version)

10.3.5.2. A holistic view of functions and risks may need to be taken. Many MNEs have set up multiple companies in China with each company performing only a single function, such as manufacturing, distribution, R&D, and services, and with the claim that each of these entities is entitled to a limited return. Others have some or all of manufacturing, distributing, R&D, and services functions in one entity, and still claim that each of these functions is entitled to only a routine return. The Chinese tax administration takes the view that when a group has multiple single function entities, they may have to be taken into consideration as a whole in order to properly determine the return the group companies should earn in China. Similarly, an entity with multiple functions may have to be reviewed its entirety in order to properly determine its returns.

(The 2017 version of the Manual has basically similar language).

See "News Analysis: Should Separate Entities Be Respected? " Mindy Herzfeld, Tax Analysts Worldwide Tax Daily, October 19, 2016

Revised OECD Model Income Tax Treaty: Article 5(4) and The Anti-Fragmentation Rule

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

- (a) the use of facilities solely for the purpose of storage, display or delivery* of goods or merchandise belonging to the enterprise;
- (b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;*
- (c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- (d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
- (e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity;
- (f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.

4.1 Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and

a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, OR

(b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprise at the two places, is not of a preparatory or auxiliary character,

provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation. [Emphasis added]. **

.....

8. For the purposes of this Article, a person or enterprise is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person or enterprise shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person or enterprise possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise or in the two enterprises.

* The revised UN Model Income Tax Treaty between Developed and Developing Countries deletes the references to "delivery" in Article 5(4)(a) and (b).

** The revised UN Model Income Tax Treaty between Developed and Developing Countries includes the same anti-fragmentation rule as in the revised OECD Model Income Tax Treaty.

See also the rule against Contract — splitting in Article 5(3), which refers to "connected activities are carried out by one or more closely related enterprises"