



International Fiscal Association

Relevance of “*substance*” in international tax policy

From BEPS 1.0 to BEPS 2.0 (or whatever it is...)

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Relevance of substance under BEPS 1.0

International tax system after BEPS 1.0

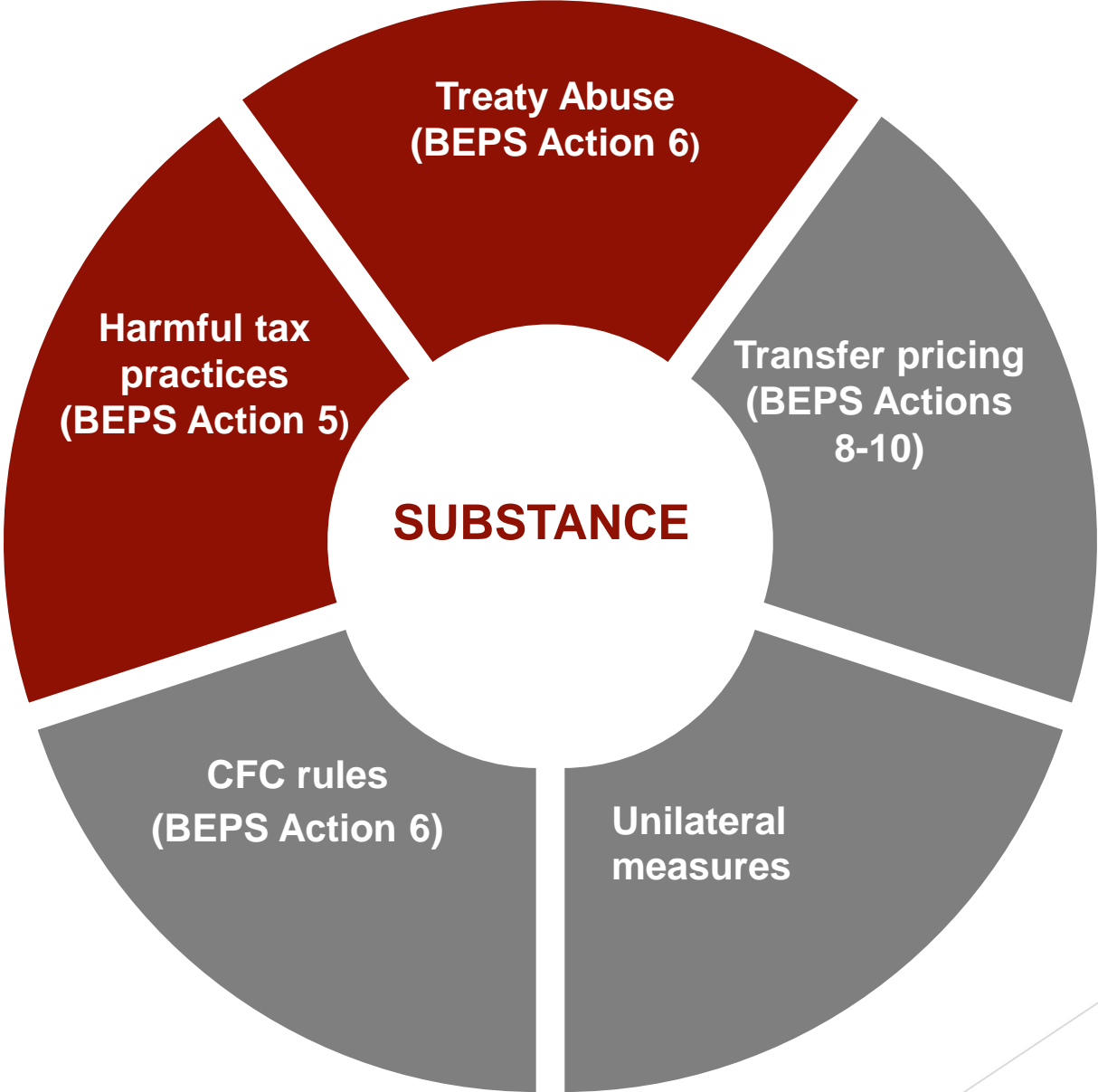
➤ After the OECD/G20 Base Erosion and Profit Shifting Initiative in 2015 (BEPS 1.0), the international tax system is still based on the following key principles:

- **Predominance of residence** over source with “**PE threshold**” remaining enshrined in tax treaty policy
- **Separate entity approach**
- Consensus around the “**arm’s length principle**” (ALP) :

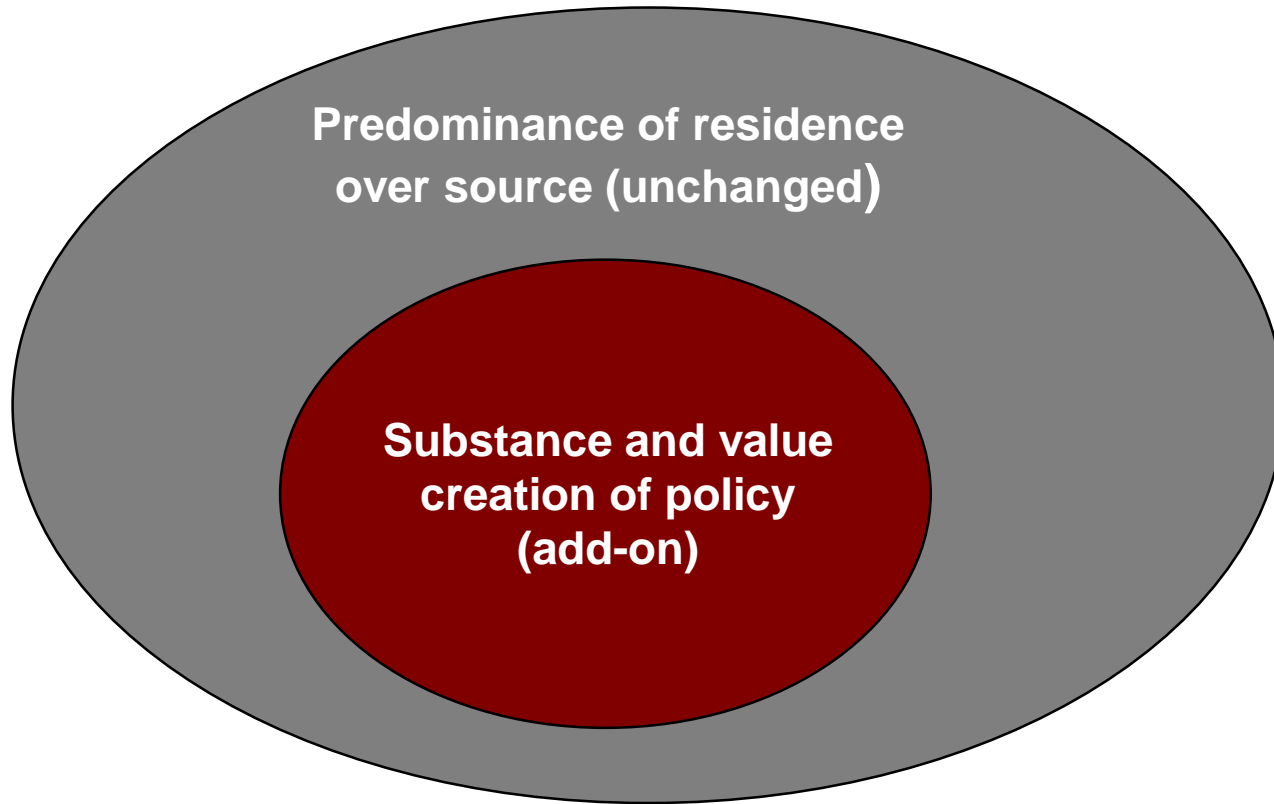
*«OECD member countries reiterate their support for the consensus on the use of the arm's length principle that has emerged over the years among member and non-member countries and **agree that the theoretical alternative to the arm's length principle represented by global formulary apportionment should be rejected**»*

However reinforcement of the “**arm’s length principle**” (DEMPE functions, etc.) pursuant to Actions 8-10 essentially to deal **with artificial structures**

Relevance of substance under BEPS 1.0



Relevance of substance under BEPS 1.0



International tax system becomes "hybrid" due to coexistence of value creation policy with traditional predominance of residence over source (in the same vein Devereux M. P. /Vella J., Implications of digitalization for international corporate tax reform, in : WP 17/07)

“coherence” of substance under BEPS 1.0

➤ A few examples

- Relation between “substance” under **BEPS Action 5** (harmful tax practices) and **BEPS Action 6** (treaty abuse) ?
- Relation between “substance” under **BEPS Action 5** and **BEPS Action 3** (CFC rules) ?
- Relation between “substance” under **BEPS Actions 8-10** (transfer pricing) and **BEPS Action 6 and BEPS Action 5** ?

Substance and *“tax competition”* under BEPS 1.0

The final report on BEPS Action 5 (N3):

*“The work on harmful tax practices **is not intended to promote the harmonisation of income taxes or tax structures generally within or outside the OECD, nor is it about dictating to any country what should be the appropriate level of tax rates.***

Rather, the work is about reducing the distortionary influence of taxation on the location of mobile financial and service activities, thereby encouraging an environment in which free and fair tax competition can take place”

Policy assessment under BEPS 1.0

Relevance of substance under BEPS 2.0

Relevance of substance under BEPS 2.0

- BEPS 1.0 has not addressed more fundamental challenges raised by the digitalization of the economy: ability to operate in **a market without a physical nexus**. Limits of the **separate entity approach and of the arm's length principle** ? Relevance of **equality and neutrality** ? Balance between **unilateralism and multilateralism** ?
- BEPS – in particular transfer of functions – **to low tax jurisdictions** allegedly remains possible despite BEPS changes **introduced pursuant to value creation pillar** (BEPS Actions 8 to 10 i.e. control over risk, DEMPE functions). Conceptually, what is then the definition of BEPS ? From substance to low taxed income ? Single tax principle ? Need for additional rules from the perspective of **source and residence** states: emergence inter alia of the **Minimum Tax concept**.
- **Ongoing work on Pillar 2**

Pillar 2 in “context”

Impact of Digitalization

- Non residents, in particular, Highly Digitalized Businesses can operate in market countries with low-to-no physical presence
- This is mainly attributable to the increase in use of intangibles assets
- Question: How market countries can/should tax as a result of digitalization?

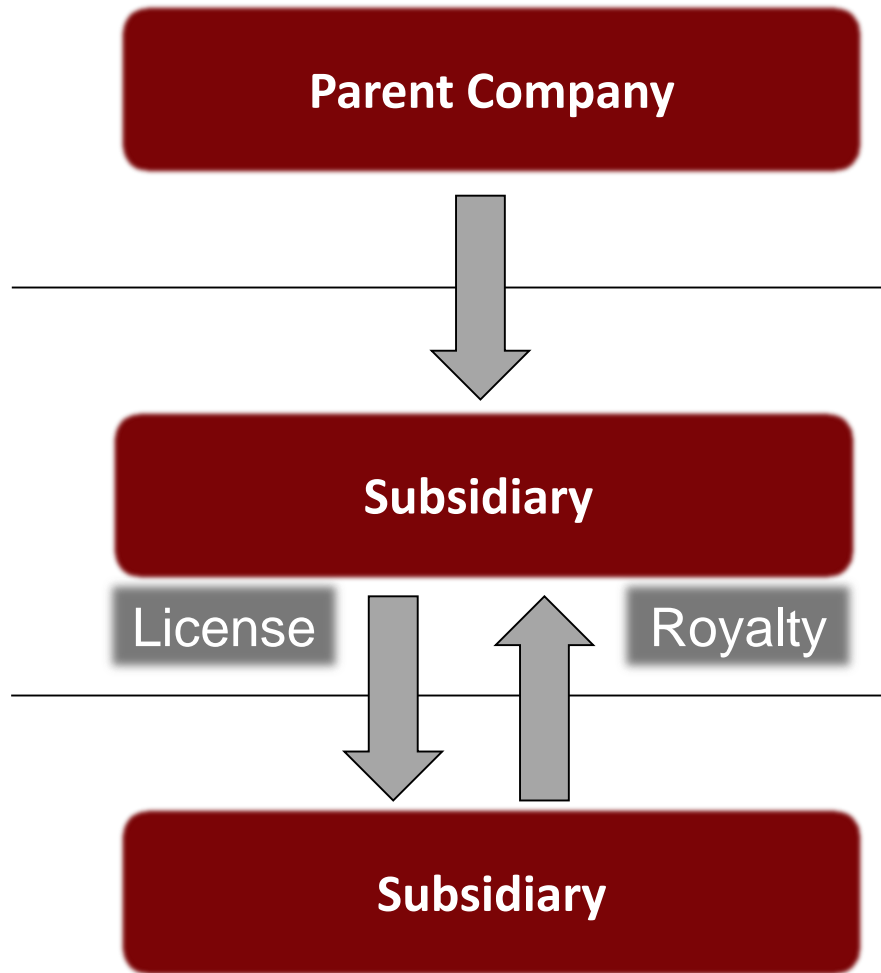
Pillar One

- Objective is to allocate more taxing rights to market countries
- Develops a unified approach (multilateralism versus unilateralism)
- Goes beyond the ALP due to its inherent complexity

Pillar Two

- Objective is to tackle remaining BEPS challenges. Impact on tax competition ?
- Income inclusion rules
- Base eroding payments rules

Pillar II – The GLOBE proposal



Income Inclusion
or
Switch Over Rules

Low Effective Tax Rates

Denial of Deductions
& Tax Treaty benefits

Pillar II – The GLOBE proposal

- **Relation with substance based carve outs:** *“the Programme of Work calls for the exploration of carve-outs, including for: Regimes compliant with the standards of BEPS Action 5 on harmful tax practices, and other substance-based carve-outs, noting however such carve-outs would undermine the policy intent and effectiveness of the proposal»*
- Relation with European law

General policy assessment and conclusion