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A new tax code: based on robust pillars?

The tax pie will be redistributed – but this must be done fairly and in accordance with the law

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The end of history does not occur when historians or politicians declare it to be so. For the most part, history makes its own ending. This is true not only for the history of political systems, but also for the history of the global tax law system. It may well be, therefore, that the OECD's finance ministers and tax policymakers feel much the same way as Francis Fukuyama who, in 1989, heralded the end of history and of political system competition, which did not happen after all. But, it could very well be that international tax policy this year has at least reached a turning point from which – to continue with Fukuyama's metaphor – the tax policy wagons of many countries begin to head for the same town. Many are talking about the coming revolution in international tax law.

International tax law sets out, among other things, distribution decisions on which states of the world and their financial administrations agree. The image of a "tax pie" and the distribution of the pieces of the pie among the participating states is illustrative in this respect. The "first" international system was developed in the Finance Committee of the League of Nations in 1923 to 1926. States' taxation rights were defined in general terms internationally and then implemented in (mostly bilateral) double taxation treaties.

Generally speaking, the starting point for a state's right to tax in this system – i.e. both in the international framework or model conventions and in the specific double taxation treaties – was, and still is, the presence of a taxpayer, be it a natural person or a legal entity. This could be based on domicile, residence, a permanent establishment, or a subsidiary in a country. Many people are familiar with these points of reference, their volatility and the related issues from practical experience or public discussion (we need only refer to the discussions surrounding the Panama Papers, LuxLeaks and the like): are "letterboxes" sufficient to establish a presence? Is a home office a permanent establishment? Growing mobility, easier communication across borders and jurisdictions, and rapidly changing business models have multiplied these issues – there is often no longer a single tax "home" for life, either for individuals or for companies.

As difficult as this first question about presence is to answer in some cases, an even more difficult question must often be decided in a second step: what profit is actually attributable to that presence – the permanent establishment, the subsidiary, or a resident individual – for tax purposes in a particular state? And above all, how can such an allocation be made without the same tax base being "claimed" by several states at the same time and resulting in double taxation? For instance: a complex industrial plant is designed and manufactured in country A and sold via a local sales company in country B. How much profit from this sale should go to the producer and how much to the distributor?

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The OECD Pillar Project

This "presence-based system", which as a result of limited mobility was also associated with actual activity in a certain country, has been working for a long time. It was supported by a broad consensus of major industrialised countries, taxpayers had adapted to it, and the OECD made significant contributions to its development over time.

However, three developments have driven the realignment of international tax law via the OECD's BEPS project (which aims to prevent artificial shifting of the tax base) to the current Pillar project (known as Pillar 1 and Pillar 2): tax competition between states, globalisation and structuring options, and the increasing digitalisation of business models, all of which have made traditional taxation on the basis of presence more difficult.

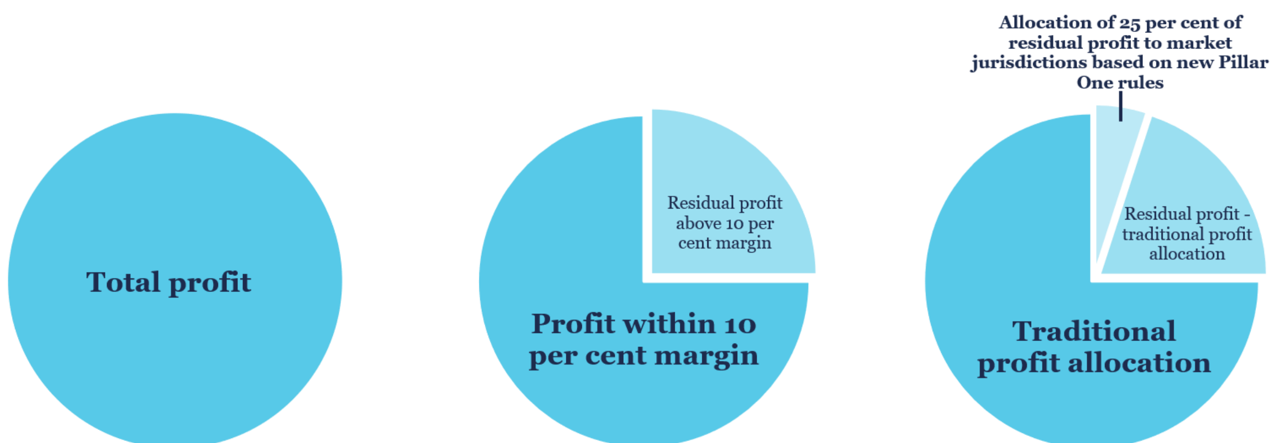
In many cases, new digital business models decouple economic success from "conventional presence" in a state. Profit can be made in a market by users participating in a digitised business model (for example, a platform provider) without the undertaking behind it, the taxpayer, being present and active in this state in a way that is relevant from a tax perspective.

The Pillar project, presented by the OECD and supported by almost 140 countries with much publicity, is now intended to take further steps towards a new "city map" in international tax law. The OECD's more concrete framework has been on the table since mid-October 2021. This project is a milestone in tax policy work.

What do the Pillars look like? Pillar 1 creates a taxation right for market jurisdictions in relation to the (residual) profits of large multinational enterprises ("MNEs") that have a total worldwide turnover of more than 20 billion euros (decreasing in the future to 10 billion euros) and a profitability of more than 10 per cent. Regulated financial services providers and extractives are excluded, as they are considered less likely to shift their tax base due to their business models and existing regulations. The new taxing right of the market jurisdiction applies without the need for a presence, in the conventional tax sense, in that market jurisdiction. The market jurisdiction, and thus the starting point for the new taxation right, is defined by the place where the turnover is generated. This is ultimately intended to overcome the aforementioned weakness of traditional international tax law *vis-à-vis* new digital business models. But what is important is that this new "no presence" taxation right can affect any undertaking that makes profits without a presence – for example, a car manufacturer if it generates the corresponding margins. Pillar 1 brings a second significant change to international tax law. In addition to taxing rights without presence in the conventional sense, it introduces a formula-based distribution of the tax base.

Pillar 2 includes the introduction of a global minimum tax. This Pillar is not intended to put an end to international tax competition but rather imposes multilaterally recognised restrictions on it. International companies with a worldwide turnover of at least 750 million euros are to pay 15 per cent tax on their worldwide income. Previously, the discussion was around a rate of "at least 15 per cent", which would have made an increase possible at any time. However, this was dropped as a political concession to Irish participation.

The objective of minimum taxation is to be achieved through the interaction of several complex rules. The interaction of all these rules is intended to ensure that an MNE does not in effect pay less than 15 per cent tax in any country in which it operates – by imposing additional tax liabilities without changing the underlying tax base (which remains in the low-tax countries). In addition to sectoral exemptions, the proposals include a formula-based substance carve-out and exemptions for distributed, highly taxed profits. Pillar 2 combines existing regulations with new concepts and thus tries to achieve a more comprehensive application of the rules.



A foundation based on the rule of law

Good architecture can be very expensive, especially when the architects – in this case the tax administrations – work without a given budget, perhaps only complying with the requirement to build a new, beautiful city. The guiding principles for this tax system change, such as fairness or the "more equitable" redistribution of a tax pie are vague and imprecise. The concept of "international revenue neutrality", i.e. continuity of the tax share in a "profit pie", is not one of them. Therefore, it could be that "more" is distributed in the new system than in the old system, and many countries want it that way. But taxes are interferences, restrictions on freedom. Therefore, what is needed – both nationally and internationally – is a legally sound basis for the new taxation rights and fast and robust dispute avoidance and resolution rules in the – very likely – event that taxpayers face double taxation.

The following rule-of-law foundation should be considered when building the Pillars: according to the OECD's proposals, Pillar 1 and, in part, Pillar 2 will be implemented by means of new multilateral agreements. These agreements must then be ratified by the states concerned in order to be applicable. This is complex, and not just for lawyers, as similar multilateral processes already under way have shown. And for many countries, tax interventions require not only international consensus, but also the implementation of new rules under national law with clear limits to taxation in a manner that is consistent with the rule of law – and this appears difficult, to say the least, in the regulatory thicket envisaged by the OECD.

It is essential that a neutral binding dispute avoidance and resolution mechanism is available from the outset. This is not a new issue. Ideally, this needs to work more efficiently and robustly than similar processes already in place and provided for in the OECD model convention, which often take a long time and do not include any obligation to reach agreement.

The Pillar project will be further fleshed out in the coming months. For Pillar 1, a draft of the multilateral agreement should be available at the beginning of 2022, with further detailed regulations at the end of 2022. Realistically, however, it may take five to ten years before there is comprehensive standardised implementation. At the same time, the political pressure for implementation has never been as high as it is now.

Within the EU, Pillar 2 is reportedly to be implemented by means of a directive, and a draft is due to published before the end of 2021. It remains to be seen whether the provisions of Pillar 2 can be brought into line with the anti-abuse doctrine of the European Court of Justice and whether compatibility with fundamental freedoms can be achieved. Things are starting to move as regards unilateral digital taxes as well. Thus, the UK, France, Spain, Italy and Austria have reached a compromise with the US, under which unilateral digital taxes of those countries will be suspended and replaced by Pillar 1. Taxpayers should welcome this statement of intent, as national, uncoordinated measures do not make compliance work any easier for taxpayers. However, it should be noted that many other countries also impose digital taxes or are planning to do so, including the EU (i.e. the EU digital levy). And apart from this, in German tax law it is worth remembering the highly controversial – extraterritorial – taxation of royalty income in third countries if the underlying intangible right is registered in a German register.

For the Greeks, the Pillars of Heracles at the outlet of the Mediterranean Sea in Gibraltar constituted the end of the known world: *non plus ultra* – that's as far as they should go. The OECD's Pillars, in contrast, are an approximate directional indication of where the journey should go. The international tax code must first reach these Pillars - that is as far as we can go at present. But in the end, with all the risks involved, this journey is necessary to achieve a system with reasonably clear rules again. And international tax law ultimately needs as clear rules as possible, for taxpayers and states alike.

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