Kluwer International Tax Blog

Pillar II of the Digital Debate: Our View on the Approach Towards Blending and Substance Carve Outs to Determine Effective Tax Rates

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1. Introduction

The ability to stimulate economic activity and to attract foreign capital and investments through national tax policies has been known for many centuries. It was in the middle of the eighteenth century that the Russian Empress – Catherine the Great – granted to "[…] *Foreigners that have settled themselves in Russia to erect Fabricks or Works, and manufacture there such Merchandizes as have not yet been made in Russia* […]" the right to "*sell and export said Merchandizes out of our Empire for ten years, without paying any inland Tolls, Port Duties or Customs on the Borders* […]".[1]

Nowadays, the ongoing progress of globalization and growing freedom of cross-border capital flows persuade governments to an even greater extent to use tax tools aimed at the attraction of economic activity. This behaviour has led to an exacerbated competition between countries, which underlies the phenomena of international tax competition.

The problem of tax competition is constantly under discussion at the OECD. Namely, in its recent work on the taxation of the digital economy[2] the OECD addressed this issue and exhorted "*to stop a harmful race to the bottom, which otherwise risks shifting taxes to fund public goods onto less mobile bases including labour and consumption, effectively undermining the tax sovereignty of nations and their elected legislators*".[3] However, the OECD does not seek to eliminate tax competition entirely, but to "*establish a floor for tax competition*" which shall ensure that MNEs will bear the minimum tax burden (the current discussion seems to indicate the rate to be 12.5%).[4]

In order to determine the effective tax rate paid by the MNE, the leaked OECD Pillar II blueprint – the GloBE Report[5] ("Report"), shows a preference for the jurisdictional blending approach with no substance-based activity carve-outs. The only carve-out that is considered is a formulaic carve-out linked to payroll and tangible assets. As a final decision on these two parameters has not yet been adopted, the question

analysed in this blog is what should be the way forward?

Prior to answering this question, we would like to summarize the opinion of selected economists on the general effects of tax competition.

2. Perspective of selected economists' on the general effects of tax competition

2.1 Tiebout's (1956) and voting with one's feet rationale

Tiebout's study was dedicated to the impact of internationally uncoordinated tax policies[6]. He equated tax competition between states to competition between firms and concluded that it is welfare-enhancing, *per analogiam* to "*invisible hand*" of competition in private markets. Tiebout believes that "*voting with one's feet argument*" and the possibility of relocation to another jurisdiction, where the relation between public goods supply and the tax burden is the most appropriate for the taxpayer, lead to efficient tax policy. Therefore, the existence of tax competition results in "*an efficient outcome where different preferences of economic units regarding public expenditure are translated into different tax rates*".[7] His model, however, has its limitations, which are the assumptions that collected taxes, which are approximately equal the costs of supplying of public goods, are exclusively allocated to the supply of these goods and that all taxpayers are perfectly mobile across jurisdictions at no expense and such assumptions often do not reflect reality.[8]

2.2 Zodrow-Mieszkowski (1986) and under-provision of public goods

Their economic study, which follows the concept of benevolent government, presented a formalized standard tax competition model with a national system of competing local governments. The purpose of the model was to show how the use of a distorting property tax on mobile capital may reduce the level of residential public services. The main conclusion of the analysis is that the mobility of capital may lead to both non-optimal low capital taxation and under-provision of public goods.[9] This study was preceded by the findings of Oates who affirmed that "*The result of tax competition may well be a tendency toward less than the efficient level of output of local services. In an attempt to keep taxes low to attract business investment, local officials may hold spending below those levels for which marginal benefits equal marginal costs, particularly for those programs that do not offer a direct benefit to local business*".[10]

2.3 Leviathan model

Supporters of tax competition, who conceive it as a force for good, consider governments as self-interested revenue maximisers, whose voracity may be constrained by tax competition.[11] Behind this view lays the "Leviathan" model, proclaimed by Brennan and Buchanan[12], according to which government is not benevolent but aimed at the maximization of its own utility by increasing its power (maximizing the size of the state) or its own consumption and therefore, it is keener on over-taxation. Thus, tax competition is able to balance the government's tendency to excessive taxation. In addition, they argued that governments do not tax to provide essential public goods but because higher tax revenues enhance the power and

prestige of government officials.[13] This concept, however, has also its critics, who consider direct democracy[14] or political reforms[15] as a better tool than tax competition to restrain the Leviathan.

2.4 Key arguments for and against tax competition

In light of the selected studies above, economists' opinions as to the impact of tax competition vary and, in general, they can be divided into those favouring tax competition and those who view it as a negative phenomenon.

The advocates of tax competition often raise the following arguments:

- lower taxes, especially on mobile investment capital, have a beneficial impact on savings rates which lead to greater wealth and positively affects markets;
- enhanced governments' efficiency and restrained risk of its arbitrariness in tax rate setting which may otherwise lead to excessive taxation;
- an opportunity for unattractive developing countries with meagre infrastructure and unskilled labour force to procure foreign investments and capital;
- reduced tax rates foster development of entrepreneurship and economic recovery through an increase in profits generated by companies.[16]

According to the opponents, whose number has been rising in recent decades, tax competition may lead to substantial negative consequences, such as:

- distortion in capital and investment flows;
- shift of taxes from mobile capital to immobile factors of production and hence a "*race to the bottom*" in the taxation of mobile factors;
- undermining of the fairness of the tax system;
- lower revenue resulting in under-provision of public goods;
- existence of "*free riders*" transferring capital to a tax-favourable country, which was generated in higher tax countries whose infrastructure and skilled workforce was exploited.

As presented above, economists views differ as to the general effects of tax competition. Keeping aside the debate as to whether tax competition is good or bad, it is quite obvious that those who consider tax competition as being "bad" will support the GloBE idea (or alternate proposals)[17], in particular, the adoption of a jurisdictional blending approach and no substance-based activity carve-outs. On the other hand, those who consider tax competition as being "good" will not support the GloBE idea (or other proposals) and even if the proposal goes through will most likely argue for global blending or / and substance-based activity carve-outs.

3. Base Erosion and Profit Shifting (BEPS) outcome: Acceptance of substance-based activities and tax rate related competition

It is evident that harmful tax competition and tax avoidance (sometimes tax evasion) are correlated and successful elimination of one of them may help to combat the other. Due to countries' autonomy in the design of their tax system, which stems from their sovereignty, there are no legal means to effectively enforce them to abolish tax practices which infringe other countries' rights to fairly execute their taxing powers.

However, it is possible to undertake relevant measures aimed at preventing tax avoidance and therefore, hindering harmful tax practices.

The mere fact that countries reduce their tax rates cannot be regarded as a harmful practice. In order to recognize tax competition as potentially harmful, the OECD had previously created a list of factors which allow identifying harmful tax regimes. The list includes the following main criteria:

- no or low effective tax rates,
- "ring-fencing" of regimes,
- lack of transparency,
- lack of effective exchange of information.[18]

Among the additional factors, the OECD mentioned the lack of substance-based activity.[19]

Based on these criteria, it is possible to conclude that tax competition is harmful when, along with artificial tax preferences offered by a country to attract mobile capital, there are no legal instruments enabling the effective exchange of information and no transparency as to the operation of the legislative, legal or administrative provisions. Conversely, if one country decides to reduce the tax burden, either by lowering tax rates or by granting certain genuine tax incentives and they are applied indiscriminately, providing at the same time with full transparency and cooperation with other tax authorities in tax information exchange, then it should not be attacked for applying harmful tax practices.

Indeed, BEPS Action 5 moved in this direction. As noted in the BEPS Project, the OECD's "*work on harmful tax practices is not intended to promote the harmonisation of income taxes or tax structures […], nor is it about dictating to any country what should be the appropriate level of tax rates. […] 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. This is essential in moving towards a "level playing field" and a continued expansion of global economic growth*."[20]

Thus, the main focus of Action 5 was to counter harmful tax competition rather than genuine / fair tax competition. Accordingly, countries can follow their own regulatory tax policy and offer tax incentives as long as they ensure that appropriate substance-based activities (linked to that incentive) are carried out in their jurisdiction.

In the light of the above, a competitive measure is admissible and fair as long as it does not result in separating the taxable income from the activity that generates it. In consequence, countries should be allowed to pursue tax competition on "*substance-based activities*" and "*tax rates*". In fact, the Inclusive Framework by signing up to BEPS Action 5 accepted such competition for FHTP compliant regimes.

4. The ongoing work on Pillar II

As a result, many have argued for carve-outs for Action 5 blessed regimes. However, we would like to point out that if the true objective of the Globe proposal is to counter

competition vis-à-vis tax rates then a partly balanced approach i.e. an approach which carves out BEPS Action 5 activity situations whereas BEPS Actions 8-10 activity situations are not carved out, is incoherent and is clearly non neutral.

The leaked report moves in this direction and indicates a preference for no substance-based activity carve-outs as such[21]. However, the leaked report discusses the possibility for a formulaic substance-based carve-out based on payroll and depreciation of tangible assets (probably a carve-out which is similar to the one contained in the US GILTI rules) [22].

According to the leaked Report, the tax base of the minimal tax will be reduced by the carve-out amount, but only for purposes of the computation of the top-up tax for each MNE's entity. The carve-out amount is equal to the sum of the payroll component and the tangible asset component and it is computed on a jurisdictional basis.

The tangible asset carve-out base includes the annual cost of using depreciable property, plant and equipment, land, natural resources, and a lessee's right-of-use assets that are used in the production of income. According to the Report, such a broad range of tangible assets in the carve-out base is justified by their indicative character in terms of substantive activities. Moreover, "*it helps to level the playing field across industries that use varying types of tangible assets in their business*".[23]

One of the main challenges of such carve-out is determining the proper method to measure tangible assets. Two options are being considered (i) carrying value and (ii) depreciation with the last most supported, which, when combined with payroll, would generally align with a cost-plus transfer pricing method.[24]

As regards the payroll component, it will be determined on the basis of the eligible payroll costs of eligible employees, which include not only all full and part-time employees of the MNE, but also independent contractors participating in the ordinary operating activities. The payment component will be linked to the jurisdiction where the actual activity is performed. If, however, the residence jurisdiction of the entity paying the employee's salary differs from the jurisdiction where the employee's activities or services are performed, the residence of the employee should be used.

While such a carve-out would be neutral as it applies across the board, in our opinion, such a carve-out adds complexity to the already complex proposal. In fact, as argued previously, the determination of effective tax rates (ETRs) under a jurisdictional blending approach to is far more complicated than the global blending approach[25].

Undoubtedly, an approach which is based on a jurisdictional blending approach coupled with a formulaic substance-based carve-out will trigger high compliance costs both for MNEs and tax administrations.

5. Personal view and conclusion

In light of the above discussion, we believe that a balance would need to be struck between the aim of combating tax competition (for tax rates) and achieving an administrable system for both taxpayers and tax administrations.

Indeed, if we are liberal on blending then we can be stricter on substance based activity carve outs. Thus, we prefer the adoption of a global blending approach without any carve-outs as it represents a simpler system wherein compliance costs would be lower for all. On the other hand, if we are stricter on blending (jurisdictional blending) then we need to be liberal on carve outs. But this latter approach seems more complex.

We do acknowledge that tax competition may still thrive under a global blending approach. However, this approach could probably also be advantageous to developing countries and investment hubs as opposed to a jurisdictional blending approach with formulaic carve-outs. Indeed, developing countries or small investment hubs (or mid sized investment hubs) should not be deprived of the possibility to use tax incentives to attract real economic activity. It could well be possible that tax incentives may be the only way for them to develop infrastructure, create new working places and, in general, improve welfare.

Accordingly, instead of having a direct carve-out only for BEPS Action 5 compliant regimes (which could raise neutrality issues), a global blending approach which blends taxes paid / profit before taxes of all countries (high tax and low tax) could be a suitable and less complicated way forward.

Nonetheless, in the light of a variety of arguments for and against tax rate type competition, it is a fact that an unambiguous answer on how to approach it is difficult to be found. But what is certain is that tax factor cannot be entirely eliminated from the economic reality and it has always been a part of international relations.

All views are personal and do not necessarily reflect the views of the organisations to which the authors are affiliated.

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