CHAPTER 16

The Evolution of Tax Law Design within an Increasingly Destabilized International Tax Law Framework

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INTRODUCTION

This chapter brings a legal perspective to the pressures in the international corporate tax system that have been discussed in other chapters largely from an economic point of view. In addition to the economic drawbacks of the current architecture, the current system is also marked by major legal weaknesses leading to continued uncertainty and providing opportunities for ongoing tax arbitrage and aggressive tax planning. The proliferation of anti-avoidance rules to combat these opportunities has made the international corporate tax system more complex. Failure to address the core structural weaknesses in the system has intensified the debate surrounding the fair allocation of taxing rights, particularly over lightly taxed residual profits—amplifying the need for fundamental reform.

This chapter is structured as follows: The following section summarizes the current state of the international tax law framework, and the gaps and mismatches in that framework that have been exploited. The third section identifies the weaknesses and deficiencies in the current international tax system that remain in the aftermath of the G20/OECD Base Erosion and Profit Shifting (BEPS) Project. The fourth section provides a legal assessment of future reform options and directions that the international tax system may take. It takes a broad perspective, drawing on fundamental proposals,[1] but is also of relevance to the assessment of the recent, more concrete, and narrower proposals under the two-pillar approach outlined in the program of work being carried out by the G-20/OECD Inclusive Framework on BEPS (hereafter referred to as "Inclusive Framework"). The fifth section emphasizes the need for greater tax cooperation in order to implement any agreed reforms. The sixth section specifically discusses the distinct problems faced by, and capacity limitations of, low-income countries, which require tailored responses. The final section offers concluding remarks.

[1] Especially those laid out in the IMF Board Paper "Corporate Taxation in the Global Economy" (2019).

CURRENT STATE OF THE INTERNATIONAL TAX LAW FRAMEWORK

Historically, international tax cooperation has focused primarily on the conclusion of double tax agreements with the principal aim of reducing double taxation. This cooperation has established a series of international concepts and norms underlying a current network of over 3,000 bilateral double tax agreements with which domestic tax systems have historically sought to comply in order to minimize inappropriate interaction issues that could lead to adverse consequences and distortions, particularly double taxation of cross border trade and investment (column 1 of Table 16.1).

More recently, international tax cooperation has focused on limiting the ability of multinational enterprises to exploit loopholes from existing gaps and mismatches between domestic tax systems and double tax agreements (column 2 of Table 16.1). This includes the 2015 BEPS package, which was intended to provide a comprehensive, coherent, and coordinated reform of the international tax rules. The BEPS package—which was subsequently endorsed by the G20 leaders—consists of 15 actions that produced a consensus on four minimum standards. The BEPS package was intended to provide governments with coordinated solutions for closing the gaps in existing international tax rules that allowed corporate tax bases to be eroded or artificially shifted to low- or no-tax jurisdictions, where typically little or no economic activity (substance) takes place. While the BEPS package represents the most comprehensive and internationally coordinated effort to date to strengthen the existing international concepts and norms, those underlying concepts and norms—being bolstered by a series of tax integrity and anti-avoidance rules (column 3 of Table 16.1)—have remained fundamentally unchanged.

The immediate aftermath of the BEPS Project saw a strong trend toward countries adopting anti-avoidance rules to address remaining weaknesses and deficiencies in the current international tax system (column 4 of Table 16.1). In response to the BEPS package, the European Union, for instance, adopted its own measures in the form of the Anti-Tax Avoidance Directive (ATAD) in July 2016 (Table 16.2). A number of the mandatory ATAD measures go further than the four minimum standards under BEPS. The ATAD measures were required to be transposed into law by EU member states by January 1, 2019, with the exception of the interest limitation rule (January 1, 2024, if existing rules are equally effective) and exit taxation (January 1, 2020).

SHORTCOMINGS IN THE CURRENT INTERNATIONAL TAX SYSTEM

While various tax integrity or anti-avoidance rules are important to effectively counter tax avoidance practices and protect the integrity of the tax system, the current trend to strengthen existing rules and develop more novel rules—as discussed hereafter—has also made the current international tax system relatively

TABLE 16.1.

BEPS Impact on International Concepts and Norms for International Tax Law Design

International Concept and Norm	Gap or Mismatch Being Exploited	BEPS Focus	Remaining Deficiencies and Weaknesses after BEPS
Residents are taxed on worldwide income (residence principle) and nonresidents are taxed on domestic source income (source principle).[1]	Ability to strip and shift profits out of high-tax (residence or source) countries (for example, through base-eroding payments such as interest deductions or profit shifting by minimizing assets or risks in those high-tax countries)	For example Actions 2, 4, 8–10, directed at limiting base erosion through interest and other deductions; neutralizing the (deduction) effects of hybrid mismatch arrangements; and seeking to align transfer pricing outcomes with value creation	Other base eroding payments (for example, cross-border service or management fees) are unaddressed, and intangible and risk-related returns are still capable of being shifting to low-tax jurisdictions using the arm's length principle (see below in this table)
The source country has the primary right to tax active income, subject to finding a sufficient economic presence (nexus), defined by reference to a permanent establishment in its jurisdiction.	Weakness of existing nexus requirement exacerbated by digitalization because a permanent establishment does not arise when businesses sell remotely from abroad, even though there is a significant internet and economic presence in a local market	For example, Action 7, directed only at preventing the artificial avoidance of a (physical) permanent establishment	No fundamental change to nexus test, which has focused attention on the fairness of existing allocation of taxing rights, particularly in the context of the digital economy
The residence country has the primary right to tax passive income (other than from immovable property in the source country), with the source country typically accepting rate limits on locally sourced passive income (for example, by entering into double tax agreements).	Engaging in treaty shopping or arbitrage of domestic tax rules to achieve low or no withholding tax on payments made from the source country	For example, Action 6, directed at preventing the granting of treaty benefits in inappropriate circumstances.	Reduced source country taxation under double tax agreement not otherwise dependent on passive income being subject to a minimum level of taxation in residence country
Residence country taxation of foreign income is deferred until repatriation, unless controlled foreign corporation rules apply to combat inappropriate deferral.	Ability to achieve inappropriate tax deferral by exploiting the absence of (effective) controlled foreign corporation rules	For example, Action 3, directed at designing effective controlled foreign corporation rules	Residual profit still capable of being shifted to low tax jurisdictions using arm's length principle, and often left untaxed by controlled foreign corporation rules

(continued)

[1]Some countries have pure territorial systems, that is, they impose tax only on a source basis.

TABLE 16.1. *(continued)*

BEPS Impact on International Concepts and Norms for International Tax Law Design			
The residence country provides relief from international double taxation, either through domestic law or double tax agreements, typically by way of a credit or exemption method.	Trend toward territorial system of taxation in residence countries enables residual profit shifted to low-tax jurisdictions to remain untaxed	Not specifically dealt with by BEPS, and often left untaxed by controlled foreign corporation rules.	Tax competition not fundamentally addressed (for example, no or nominal tax jurisdictions), with arm's length principle still enabling substance (assets or risks) to be shifted to justify the location of large residual profits in low-tax jurisdictions.
Income is allocated between jurisdictions based on the arm's length principle.	Ability to produce transfer pricing outcomes that do not align with value creation	For example, Actions 8–10 seeking to align transfer pricing outcomes with value creation	Intangible and risk-related returns still capable of being shifted to low- or nominal-tax jurisdictions under arm's length principle, exacerbated by unconstrained tax competition.

Source: Authors' compilation.

TABLE 16.2.

The EU's Anti-Tax Avoidance Directive (ATAD)

ATAD Measure	BEPS Action/ Minimum Standard?	Description
Interest limitation rule	Yes/No	ATAD prescribes an earning-stripping rule that denies interest deductions if the ratio of net interest payments to EBITDA exceeds 30 percent. Unused deductions can be carried forward.
Controlled foreign corporation rule	Yes/No	Under the ATAD, EU member states must implement legislation in their national laws incorporating certain legal design features.
Hybrid mismatches rule	Yes/No	This rule counters tax planning that exploits differences in countries' legal characterization of an entity or a financial instrument leading to double deductions or a deduction without an equivalent income inclusion. The rule was extended in March 2017 to also cover arrangements between EU and nonmember states (ATAD II).
GAAR	No/No	Under the GAAR (general anti-avoidance rule) in the ATAD, nongenuine arrangements that are put in place for the main purpose of obtaining a tax advantage that defeats the object or purpose of the applicable law should be ignored when determining a tax liability.
Exit taxation	No/No	EU member states must apply an exit tax to prevent companies from avoiding tax in the country of origin by moving their tax residence or closing a permanent establishment.

Source: Authors' compilation.

more complex and uncertain. Tax certainty is increasingly recognized as important for economic agents (see IMF and OECD 2017; 2018; and 2019), but countering tax avoidance (especially through general anti-avoidance rules) necessarily creates uncertainty for taxpayers, implying a trade-off.

At the same time, tax competition issues remain fundamentally unaddressed, in particular through the continued existence of no or nominal tax jurisdictions, which, in combination with the existing arm's length principle, effectively enable substance (assets or risks) to be shifted to low-tax jurisdictions, leaving large residual profits subject to no or low levels of taxation (see Table 16.1). The increasingly digitalized economy—exacerbating the limitations of the current nexus requirement of a permanent establishment—further intensifies the debate surrounding the fair allocation of taxing rights and the need for fundamental reform. These factors also continue to inform the design of more novel unilateral international tax law reform measures that countries are adopting in the absence of longer-term multilateral solutions.

Countries' newly designed or proposed unilateral tax law reform measures generally seek to effectively tax a greater portion of offshore residual profits that otherwise remain lightly taxed post BEPS. In this regard, many countries have already gone further than BEPS and have unilaterally implemented their own tax law measures under the ambit of anti-avoidance.

Examples of such unilateral and uncoordinated measures include the United Kingdom's diverted profits tax and Australia's Multinational Anti-Avoidance Law, which are designed to counter the erosion of the tax base by multinational enterprises using artificial or contrived arrangements to avoid establishing a permanent establishment in, and attributing related business profits to, those jurisdictions.

Furthermore, the 2017 US tax reform similarly includes measures that go beyond those set out in the BEPS package, such as the GILTI (global intangible low-taxed income, which is a residence-based minimum tax on outbound investment from the United States) and the BEAT (base erosion antiabuse tax, which is a residence-based minimum tax on inbound investment into the United States). While generally aimed at combatting broader BEPS issues that were otherwise left unaddressed (for instance, because of the application of the existing arm's length principle), those measures are also uncoordinated in their design and operation, thereby giving rise to double taxation concerns, particularly in relation to the BEAT (which does not take into account the effective rate of tax paid by the recipient of the base-eroding payments in regard to which the BEAT is seeking to reverse the benefit). The US tax reform also contains other novel features that lessen the tax motivation to adopt international base-eroding and profit-shifting structures, including a specific measure that seeks to regularize previously untaxed foreign earnings of US multinational enterprises through a deemed repatriation tax.[2] This measure was deliberately designed to address the historic

[2] At 15.5 percent for foreign earnings held in cash or cash equivalents (or 8 percent otherwise).

US tax deferral on foreign earnings of US multinational enterprises that gave some of the impetus to the BEPS Project in the first place.

In the meantime, others (for instance, the European Union, France, Spain, the United Kingdom, Mexico, India, Chile, and Kenya) are exploring or adopting short-term (interim) measures such as a digital services tax—also with a view to maintaining pressure toward reaching international consensus on a more modern allocation of taxing rights. Many of these short-term (interim) measures diverge with respect to underlying principles and tax law design (for example, the EU measure takes a volume-based approach, whereas the UK measure takes a value-based approach with respect to user participation in certain highly digitalized business models).

While generally legally designed to be compatible with existing domestic laws and double tax agreement obligations, these unilateral tax measures may still create distortions and spillovers because of their uncoordinated nature. Furthermore, anti-avoidance instruments—typically designed to counter tax avoidance practices—are not particularly well suited to operate as a backstop to address what are considered by those adopting countries to be structural deficiencies in the existing international tax law framework. Similarly, bespoke turnover taxes like a digital services tax generally impose a levy on gross income from specified transactions, which raise all the efficiency concerns generally associated with these types of taxes. While countries may feel pressure to take immediate action, uncoordinated interim measures may also create significant spillovers and distortions, including from retaliatory measures other countries might take in response to the real or perceived targeted nature of such measures.

LEGAL ASSESSMENT OF FUTURE REFORM OPTIONS AND DIRECTIONS

Previous chapters have explored a number of alternative directions that the international tax system could take. This chapter assesses their feasibility from a legal perspective, focusing on the following policy options: (1) a strengthened nexus requirement to include a significant economic presence without the need for a physical presence or permanent establishment (as currently defined); (2) a residence-based minimum tax on outbound investment (like the GILTI), combined with a residence-based minimum tax on inbound investment (modified BEAT); (3) unitary taxation with formulary apportionment (combined formula); (4) residual profit split, with sales factor; and (5) a destination-based cash-flow tax (DBCFT), with an exclusion for location-specific rents. The features of policy option (4) reflect those being explored under Pillar 1 of the Inclusive Framework, with the features of policy option (2) reflecting those being explored under Pillar 2 of that Framework.

The degree of implementation feasibility of each option or direction needs also to reflect the current legal and other constraints (Box 16.1), beyond those international concepts and norms embodied in double tax agreements as

Box 16.1. Existing International Institutions and Frameworks Imposing Tax Reform Constraints

World Trade Organization: The multilateral trading system is governed by World Trade Organization (WTO) agreements, which have been negotiated and signed by the bulk of the world's trading nations. These documents provide the legal rules for international commerce. They are essentially contracts, binding governments to keep their trade policies within agreed limits, complemented by a dedicated dispute settlement mechanism. The WTO agreements recognize that countries' tax laws can undermine the proper functioning of international trade rules in two main ways: First, taxes can serve as tariff barriers if they are imposed on imports but not on domestic sales of similar commodities. Second, remission of taxes on exports can amount to prohibited export subsidies.[1]

European Union: The European Union imposes constraints on member states' policies and protects certain freedoms to foster intra-EU trade. For example, the EU single market seeks to guarantee the freedom of movement of goods, capital, services, and labor—the "four freedoms"—within the European Union. The legal framework seeks to remove or reduce barriers to intra-EU trade and prevent the creation of new ones, so enterprises can trade freely in the EU and beyond—indeed, the free movement of capital also applies to capital movements between EU and non-EU countries. The functioning of the single market is monitored by a central authority—the European Commission—including through infringement proceedings brought against EU countries that do not comply with governing EU law and principles. Domestic tax policy is also constrained by other obligations and commitments in the European Union, notably the Code of Conduct for business taxation and the state aid rules. The Code of Conduct for business taxation is a political commitment by member states to refrain from engaging in "harmful tax competition," which covers many preferential tax regimes. EU Treaty–based state aid rules also prohibit member states from offering government support, including through the tax system, that gives a company an advantage over its competitors in the European Union. Cases can be simultaneously within the ambit of the Code of Conduct and state aid rules.

Other regional blocs/agreements: Many of these were inspired by the process of European integration and have adopted common and institutional legal frameworks to achieve economic integration, which also shapes and constrains national policy reform, although often with relatively weaker monitoring and enforcement mechanisms compared to the European Union. This includes the Andean Pact, now the Andean Community, which aims to liberalize intraregional integration between members (Bolivia, Colombia, Ecuador, Peru). Similarly, other regional economic communities have been established such as those throughout Africa including the West African Economic and Monetary Union, the Economic and Monetary Community of Central Africa, and the Southern African Development Community, all with various legal obligations binding on members. The use of soft law rules is also a feature of a number of these regional economic communities, which can still be highly persuasive and enjoy considerable political legitimacy, while preserving required flexibility.

Source: Authors' compilation.

[1] In particular with respect to the trade in goods there are also legally binding instruments imposed on members of the World Customs Organization that sign them that are not covered here.

strengthened by BEPS. However, double tax agreements are still expected over the short to medium term to remain a means for settling—on a coordinated basis—common problems that arise in international taxation, including with respect to settling disputes, with the present multilateral instrument or a similar new multilateral instrument providing an efficient implementation mechanism.

A residence-based minimum tax could be designed and implemented through unilateral domestic tax law measures, and in a manner that is consistent with existing norms and double tax agreements (for example, because of the savings clause in double tax agreements, which does not prevent a jurisdiction from adopting a residence-based measure to tax its own residents, provided the measure is nondiscriminatory).

Greater legal implementation complexities arise whenever there is a need to establish new norms, such as ones that need to be embodied in double tax agreements (for example, altered allocation of existing taxing rights under a new nexus concept, or the reallocation of taxing rights based on a new formula or factor, and so on). This would require the new norms to be adopted in all existing and new double tax agreements, which could be facilitated by a new multilateral instrument. Optionality with respect to core features relating to the reallocation and attribution would need to be minimized—underpinned by a robust dispute resolution mechanism—in order to avoid double taxation and reduce the risk of other adverse spillovers occurring, which could lead to increased cross-border tax disputes that would jeopardize the collection of any reallocated revenues.

Where the scheme retains significant aspects of current norms and practice (for example, the arm's length principle for routine returns), then the legal implementation will be relatively less difficult (for example, a residual profit split will be relatively easier to implement legally when compared to full unitary taxation with formulary apportionment). The key legal challenges will center around ensuring the consistent calculation of residual profits (total profits less routine returns) in order to, in turn, enable the determination of the reallocated residual profits based on a globally agreed formula or allocation factors—again, to be implemented through new double tax agreement norms. Greater implementation complexity will arise where residual profits are determined with regard to multilayered segmentation, such as by business lines, product lines, and geographic regions, and so on. In all cases where some global consolidation of profits is required—whether in respect of residual returns or of all profits under full unitary taxation—there would also be a need for significant harmonization of the calculation of the apportionable profits across jurisdictions, noting that harmonized tax base rules over residual profits will be more likely to be agreed to as compared to full unitary taxation at a global level. All deviations from current norms and practices (for example, taxing in the absence of a physical presence) would also need to be implemented through domestic law, with their reallocation supported by double tax agreements. The design, drafting, and implementation of these new rules and norms will again be critical to avoid double taxation and manage the risk of other adverse spillovers occurring across jurisdictions. The imperative to maximize the ease of legal implementation and administration—of particular relevance to low-income countries[3]—would tend toward the adoption of more formulaic approaches over apportionable (for example, residual) profits and losses, rather than seeking to replicate the complexity inherent in the current system which apportions profits and losses on an individual entity and transaction basis, commonly involving complex segmentation.

While implementation of the DBCFT can draw on experience with the VAT, it represents a more fundamental shift giving rise to significant legal questions relating to consistency with World Trade Organization (WTO) rules and double tax agreements (although these double tax agreement issues also arise under any alternative that departs from the current norm by seeking to create a taxing right in the absence of a physical presence). These questions warrant further discussion, but when combined with the WTO sensitivities make this option the most difficult legally to implement. A DBCFT that is designed in a way that (1) denies deductions for imports or imposes a withholding tax on imported goods or services to achieve the border adjustments; and (2) implements the wage subsidy via a deduction within the tax system itself (rather than by way of separate direct relief or credit), gives rise to significant WTO and tax treaty consistency issues.

The consistency issue arises under WTO rules because border adjustability resulting in imports and exports being taxed differentially is not currently permitted for direct taxes, including corporate income taxes. The DBCFT raises key national treatment concerns on the import side because the purchase cost of imports would not be deductible, whereas the purchase costs of domestic inputs would be deductible. Further, wage deductions would be available to domestic businesses, whereas the tax would likely be imposed on importers without a similar wage deduction. The wage deduction could also amount to a prohibited export subsidy. It is possible that a DBCFT could be designed in alternative ways to better defend against a WTO challenge (for example, by treating import and exports consistently or by reducing labor costs through mechanisms other than embedded tax deductions). A more direct way would be to change WTO rules, which would be possible in the (admittedly unlikely) case of an agreed global adoption of such tax.

Similarly, consistency issues arise in relation to the DBCFT with respect to double tax agreements. The threshold question with respect to the DBCFT and double tax agreements revolves around whether the DBCFT is an income tax or "substantially similar" tax and therefore within the scope of double tax agreements. This ultimately depends on how a country chooses to design and draft the implementing legislation. While consistency between characterization of the nature of the tax for WTO and double tax agreement purposes might be

[3] See the fourth section, "Legal Assessment of Future Reform Options."

desirable, this is not guaranteed. If characterized as a tax within the scope of double tax agreements (which would be considered the more favored characterization based on the design features outlined above), the key legal issue would seem to be that existing double tax agreements would need to be renegotiated or terminated because of the following reasons:

- Taxing importers (for example, remoter sellers) without a permanent establishment would violate existing double tax agreements.
- There would be a potential violation of the nondiscrimination provisions (for example, where providing benefits to local exporters as compared to others).
- The impact on existing withholding taxes would also be uncertain. In theory, withholding taxes should not be imposed by the DBCFT country in relation to imports by taxable entities, as tax is "collected" via disallowances of deductions, with payments for exports giving rise to exempt income. However, at the opposite end, there will be little incentive for non-DBCFT countries (or DBCFT treaty partners) to reduce their withholding taxes (given that export income is likely to be untaxed in the DBCFT country). This also highlights the foreign tax credit–related issue. As the DBCFT more closely reflects a territorial system, there may be little need for the DBCFT country to give foreign tax credits (see also the following discussion, from the perspective of the non–DBCFT country, which may still seek to deny a foreign tax credit for the DBCFT paid abroad). On the other hand, if the DBCFT country were to collect the DBCFT in relation to imports by nontaxable entities by way of withholding, that could be problematic in a double tax agreement context.
- A number of other tax treaty modifications would also be required to achieve full implementation of the DBCFT —for example, in order to subject cross-border royalties and derivative payments to import treatment (which seems essential to preserve the intention and proposed benefits of the tax, particularly compared with current profit shifting and transfer pricing practices).

However, if characterized as something other than an income tax, then the DBCFT would be outside the scope of existing double tax agreements (which would simplify the implementation somewhat), but this could mean that:

- Parties have no access to tax treaty based bilateral dispute mechanisms regarding the operation of the DBCFT.
- A non-DBCFT country would not be obliged to give any credit for tax levied by the DBCFT country under an existing double tax agreement (although double tax relief is now commonly conferred through domestic law rather than relying on double tax agreements). In any case, given the unique nature of the DBCFT, particularly the bespoke expensing mechanism on imports, treaty partners may argue that any DBCFT is not creditable (this is a common issue for withholding taxes levied on gross payments of services income, for instance).

TABLE 16.3.

Assessment of Legal Implementation Feasibility of Reform Options

Global Reform	Implementation Feasibility
New nexus definition (expanded permanent establishment concept to capture digital permanent establishment/significant economic presence)	Medium
Residence-based minimum tax on outbound investment combined with a residence-based minimum tax on inbound investment	High-Medium
Unitary taxation with formulary apportionment (combined formula)	Medium-Low
Residual profit split, with sales factor	Medium
DBCFT, with exclusion for location-specific rents	Low

Source: Authors' compilation.

Table 16.3 summarizes the assessment of legal implementation feasibility in simple overall ratings ranging from low to medium-high in respect of the various reform options.

NEED FOR GREATER TAX COOPERATION TO IMPLEMENT GLOBAL REFORM

Irrespective of the chosen longer-term reform, greater tax cooperation is likely to be required. To avoid undesirable spillovers from double (non) taxation, tax competition, proliferation of unilateral measures and trade distortions, the international tax system should continue to be based on mutually accepted concepts and norms, but appropriately adapted to the modern economy. A multilateral approach to international tax reform producing consensus-based solutions should also be preferred because of its capacity to take into account the interests of all parties involved. For example, the recent EU listing of noncooperative tax jurisdictions exposed the shortcomings of not adopting a more inclusive multilateral approach. The EU listing process seeks to impose EU and OECD standards on non-EU and non-OECD countries (with the exception of also applying to OECD countries outside the European Union), which were not involved in setting those standards. For instance, the EU Code of Conduct, which was initially developed to apply to EU member states, does not translate easily to low-income countries, which often face capacity constraints. Low-income countries can—and many do—join the Inclusive Framework on BEPS, within which they are expected to adhere to BEPS standards that have already been set. While the BEPS (or EU Code of Conduct) principles should generally be supported, these are not necessarily reform priorities for low-income countries, which often require more structural and critical reforms to their domestic tax systems before turning to the implementation of those standards.

However, the Inclusive Framework on BEPS still serves as a practical and useful model for bringing about a consensus-based solution under a multilateral approach. This was reconfirmed at the virtual G20 meeting of finance ministers and central bank governors in October 2020, where further progress on addressing the tax challenges arising from digitalization was encouraged, and the blueprints for Pillars 1 and 2 were welcomed as a solid basis for negotiations and possible political consensus.[4] The Inclusive Framework generally embodies very efficient features enabling the production of soft law standards, supported by review and monitoring mechanisms to ensure more effective implementation outcomes. A framework of this kind also avoids the legal and institutional complexities associated with seeking to develop a forum or body based on "hard" law or legally binding obligations (for instance based on one-country-one-vote or quota-based systems). The "soft" law approach also more naturally lends itself to a consensus-based mechanism and arguably better reflects the current geopolitical reality, balancing the need for multilateral solutions with the desire to maintain tax sovereignty. Any consensus-based framework should also be underpinned by a functioning dispute settlement mechanism, with supporting mechanisms to put pressure on countries to abandon harmful tax policies that are inconsistent with the agreed soft law principles.

IMPACT FOR LOW-INCOME COUNTRIES

The distinct problems faced by, and capacity limitations of, low-income countries require tailored responses. The main forms of profit shifting affecting them are typically less sophisticated than those affecting more advanced economies, while tax incentives often give rise to an especially prevalent form of tax competition. While external support can help to develop capacity, attention is needed to the design of legal rules and norms themselves. Capacity limitations put a premium on the use of simpler methods to protect developing countries' tax bases. Not least, their interests—since they host no major multinational enterprises—can be quite different from those of advanced economies. For example, as capital importing countries, inbound measures are typically even more important for low-income countries.

Pending more fundamental reform of the international tax system, low-income countries' primary focus should be on further strengthening their domestic legal framework (beyond BEPS) to counter base erosion and increase domestic revenue mobilization. Any such additional measures should be rules based to achieve greater tax certainty and designed to mitigate against distortions and the risk of double taxation. In this regard, the current trend is toward domestic tax law measures (to complement existing traditional measures) in the form of minimum taxes, particularly in respect of inbound investment, to counter the continued erosion of the corporate income tax base, especially of low-income countries. As noted above, an inbound minimum tax measure is more relevant and crucial for low-income countries. In contrast, an outbound minimum tax measure will

[4] Communique, G20 Finance Ministers and Central Bank Governors Meeting, virtual, October 14, 2020, https://www.mof.go.jp/english/international_policy/convention/g20/g20_201014.pdf.

typically be of limited relevance since low-income countries typically host no major multinational enterprises. Low-income countries have a sovereign right to implement a well-designed inbound minimum tax measure and should be cautious about agreeing—whether bilaterally or multilaterally—to constrain their ability to enforce that right, including by agreeing to allow another country's outbound measure to apply in priority to their own inbound measure. Such inbound measures are also capable of being designed to ensure consistency with double tax agreements. Further, care needs to be taken when designing these minimum taxes so that they achieve their policy objective without jeopardizing trade and foreign investment. Therefore, the current trend toward minimum taxes on inbound investment into low-income countries should conform to the following general legal design principles:

1. They should be residence based so as to maintain consistency with existing double tax agreements, which do not typically affect a contracting state's right to tax their own residents, such that:
   a. the measure operates to tax a resident entity or local permanent establishment;
   b. by denying tax benefits (for instance, deductions or treaty benefits), and/or as a separate minimum tax assessment to essentially reverse those tax benefits,[5] and
   c. in each case, with the denial of tax benefits or separate minimum tax assessment being calculated with regard to base-eroding amounts/payments, including high risk profit shifting payments giving rise to deductions in the low-income country, which could cover payments for both goods[6] and services.[7]

[5] This leaves open the possibility of adopting an assessment mechanism of a similar kind to the BEAT. While much of the current debate revolves around the denial or scaling back of base-eroding deductions under the regular tax, a key difference with the BEAT mechanism is that it produces a minimum by applying a different rate (currently, 10 percent) to a narrowed base and imposing a separate minimum tax (BEAT) liability. It has been suggested by various commentators that this difference in the BEAT mechanism (while somewhat more complex) could be legally significant (for example, could arguably overcome the nondiscrimination article depending on terms of individual double tax agreements because the BEAT does not actually formally limit deductions, which still apply under the regular system at the corporate tax rate of 21 percent), but instead operates to impose a separate BEAT liability with the effect of eroding some of the tax benefit of the relevant deductions (at the different 10 percent BEAT rate) without ever formally denying them. This legal assessment is untested, but see, for example, the arguments advanced in Avi-Yonah and Wells (2018).

[6] Measures affecting trade in goods (such as those affecting the cost of goods sold) also need to be carefully designed with regard to applicable WTO rules.

[7] The rule should cover a broad range of payments (for example, any payment giving rise to a deduction or tax base reduction in the hands of the payer) to avoid planning around the rule by taxpayers and should also combat "conduit" or "imported" arrangements.

2. The denial of tax benefits or the assessment of a minimum tax relating to base-eroding amounts should depend on those amounts not being subject to minimum effective taxation in the hands of the recipient (not minimum level of substance in recipient jurisdiction),[8] with the onus to be placed on taxpayers claiming the tax benefit to prove that adequate tax has been paid. This design feature will better mitigate against the risk of double taxation and more specifically target asymmetric related-party arrangements (that is, deduction for payment in the low-income country, without corresponding taxation of the payment in the hands of the related recipient); and
3. They should be nondiscriminatory (meaning provisions should apply equally to like domestic transactions).

Further, low-income countries should consider domestic law measures that seek to specifically target the taxation of location-specific rents in their jurisdiction.[9] The BEPS objective of "taxing where value is created" has in part had the effect of embedding existing norms in the allocation of taxing rights. The case for allocating the right to tax income from location-specific rents to the location country appears widely accepted—though putting this economic concept into legal language is challenging. It should be formulated to include—for example—location-specific rents clearly linked to natural resources and rights (such as those embodied in licenses) to explore for, develop, and exploit those natural resources. It could possibly be extended further to also cover income from rents linked to other national assets, such as from licenses to exploit public goods (for instance, electricity, gas, or other utilities; telecommunications and broadcast spectrum and networks and so on). Irrespective of the direction taken in terms of future reform options (Table 16.3), source/location countries should retain substantial taxing rights in relation to natural resources. Beyond this, however, is a longstanding tussle for taxing rights between "source" and "residence" countries—an issue of particular importance for low-income countries, which, though not the only ones acting as a source of income, rarely host the parent of significant multinational enterprises. Location-specific rents are an attractive tax base because they can in principle be taxed without distorting investor behavior. Although more common in the extractive sector, low-income countries could think about designing tax rules that specifically target location-specific rents more broadly. If one were to design a very simplified tax on location-specific rents (without detailed calculation rules), the basic skeleton might resemble the simplified provisions set out in Box 16.2. These basic provisions are very general in nature and do not take into account the individual circumstances of any particular tax system but provide a

[8] Given substance is now required for the purposes of both the OECD's Forum on Harmful Tax Practices and the EU listing of noncooperative tax jurisdictions, a carve-out simply based on substance would significantly erode the policy intent, impact, and effectiveness of the rule for low-income countries.

[9] The issue of taxing location-specific rents is also explored in the draft toolkit on the Taxation of Offshore Indirect Transfers which was published under the framework of the Platform for Collaboration on Tax (IMF, OECD, UN, WBG 2020).

Box 16.2. Location-Specific Rent (LSR) Tax

(1) LSR Tax (LSRT) is charged and payable by an entity for any year of income in which the entity has a positive accumulated net cash position from the conduct of an enterprise under an LSR right.
(2) The amount of LSRT payable under subsection (1) by an entity for a year of income is the aggregate of LSRT payable for the year with respect to each separate enterprise conducted by the entity under an LSR right.
(3) LSRT payable by an entity with respect to an enterprise conducted by the entity under an LSR right is calculated as [25 percent] of the accumulated net cash position of the entity for the year.
(4) LSRT is imposed in addition to any other tax or charge, including income tax.
(5) Payments made and received in respect of an LSR right have a source in [Source Country].
(6) In this section, "LSR right" means
  (a) an exploration, prospecting, development, or similar right relating to land or buildings, including a right to explore for mineral, oil or gas deposits, or other natural resources, and a right to mine, develop, or exploit those deposits or resources, from land in, or from the territorial waters of, [Source Country];
  (b) information relating to a right referred to in paragraph (b); or
  (c) a right or other authorization granted by or on behalf of the government (whether or not embodied in a license) to be an exclusive or semiexclusive supplier or provider of:
    (i) goods (such as radioactive material);
    (ii) utilities (such as electricity or gas); or
    (iii) other services (such as telecommunications and broadcast spectrum and networks).
  Countrywide or within a geographic area of [Source Country].

Source: Authors' formulation.

first insight into what sort of rights could give rise to income from location-specific rents when expressed in legal language. The ultimate form of any such provisions to be adopted by a given country would need to take into account the country's specific legal tradition and system—including any constitutional and international law limitations, including double tax agreements[10]—as well as its political and administrative structure and fiscal policies.

CONCLUSION

The proliferation of anti-avoidance rules following the BEPS Project has made domestic tax systems more complex and uncertain without addressing the fundamental shortcomings in the current international tax system. Tax competition issues remain fundamentally unaddressed, in particular through the continued

[10] To the extent that any existing double tax agreements constrain a country's policy intention of taxing location-specific rents in accordance with their domestic law, then that country should consider revising their tax treaty policy to address the misalignment, and existing tax treaties should also be reassessed and possibly renegotiated in line with that revised policy.

existence of no or nominal tax jurisdictions which, in combination with the existing arm's length principle, effectively enable substance (assets or risks) to be shifted to low-tax jurisdictions, leaving large residual profits subject to no or low levels of taxation. The increasingly digitalized economy—exacerbating the limitations of the current nexus requirement of a permanent establishment—further intensifies the debate surrounding the fair allocation of taxing rights and the need for fundamental reform.

These factors continue to inform the design of more novel unilateral international tax law reform measures that countries are adopting in the absence of longer-term multilateral solutions. Countries' newly designed or proposed unilateral tax law reform measures generally seek as a common objective to tax a greater portion of offshore residual profits that otherwise remain lightly taxed post BEPS, either on a destination basis (in the market jurisdiction) or as a residual minimum tax (in the country of residence of the parent company of multinational enterprises). However, few substantial multinational enterprises are headquartered in low-income countries, but many multinational enterprises operate in the relatively smaller markets that exist there—making inbound rules more critical for them.

Pending more fundamental reform of the international tax system (which gives rise to relatively more legal complexity and difficulty in reaching agreement with respect to adoption and implementation), low-income countries' primary focus should be on further strengthening their domestic legal framework (beyond BEPS) to counter base erosion and increase domestic revenue mobilization. Any such additional measures should be rules based to achieve greater tax certainty and designed to mitigate against distortions and the risk of double taxation. In this regard, the current trend is toward domestic tax law measures (to complement existing traditional measures) in the form of minimum taxes, particularly in respect of inbound investment, to counter the continued erosion of the corporate income tax base, especially of low-income countries. Care needs to be taken when designing these minimum taxes so that they achieve their policy objective without jeopardizing trade and foreign investment. Therefore, the current trend toward minimum taxes on inbound investment should conform to the general legal design principles outlined in the preceding section. Further, low-income countries should consider domestic law measures that seek to specifically and more comprehensively target the taxation of location-specific rents in their jurisdiction.

Greater legal implementation complexities arise whenever there is a need to establish new norms, such as ones that need to be embodied in double tax agreements (for example, altered allocation of existing taxing rights under a new nexus concept, or the reallocation of taxing rights based on a new formula or factor, and so on). This means that a more fundamental reform of the international tax system is likely to have a longer lead time, despite the recent extension of the goal of achieving a more comprehensive consensus-based solution within the Inclusive Framework on BEPS by mid-2021 (previously set for 2020). However, reform options that retain significant aspects of current norms and practice (for example, arm's length principle for routine returns) will be relatively less difficult to implement legally (for example, residual profit split will be relatively easier to implement legally when compared to full unitary taxation with formulary apportionment). While implementation of the DBCFT can draw on experience with the VAT, there are significant legal questions such as those relating to consistency with WTO rules and double tax agreements, which would need to be resolved before this solution can be implemented. It is possible that a DBCFT could be designed in alternative ways to make the case for WTO and double tax agreement consistency (for example, a new tax that treats imports and exports consistently, with separate measures to lower labor costs). However, an implementing country could expect to be challenged where material adverse spillovers arise. Alternatively, multilateral adoption of a DBCFT would imply some consensus on the need to overcome these legal obstacles and challenges.

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