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Aligning the Location of Taxation with the Location of Value Creation: Are We There Yet!?!

In this 75th anniversary issue of the *Bulletin for International Taxation*, Angelo Nikolakakis examines critically the implications of the initiatives – the OECD/G20 Base Erosion and Profit Shifting Project and the (resulting) Pillars One and Two – that have been suggested as ways of reforming the international tax regime. The analysis is focussed in particular on the implications of these initiatives with regard to the goal of aligning the location of taxation with the location of value creation.

1. Introduction

In 2013, the OECD released its ambitious "Action Plan on Base Erosion and Profit Shifting" (the "Action Plan" and BEPS, respectively).[1] While the Action Plan set out 15 distinct Actions, a common theme among these was the objective of aligning, or realigning, the location of taxation with the location of "relevant substance" and "value creation". As such, this was stated most clearly with regard to what was then described as the "digital economy" (Action 1), and in respect of transfer pricing (Actions 8-10), but this objective permeates the entire Action Plan in various formulations.

However, it was never really clear that this was the only objective – in the sense that the Action Plan was somewhat ambivalent or equivocal with regard to the treatment of mere "double non-taxation" (and "no taxation") or even "low taxation", and the question of whether some form of minimum tax should be pursued more generally (i.e. beyond the context "profit shifting"), although this was also denied.

In 2015, the OECD released its the Final Reports[2] and the related materials[3] on the Action Plan. Some of these contemplated further work to be undertaken in various areas. We now know that the Inclusive Framework[4] is advocating the widespread adoption of "new nexus rules" ("Pillar One") as well as a "global minimum tax" ("Pillar Two").[5] This state of affairs goes well beyond the digital economy or even the digitalization of the economy. It also goes well beyond the traditional role of coordination and assistance among sovereigns, whether formally through bilateral arrangements or through multilateral organizations, like the OECD, or less formally, with regard to the administration of taxes.[6] The objectives of these measures go in the direction of the formal coordination of the imposition of taxation, even as to the rate – although it is a minimum rate – as well as the deliberate shifting or relocation of the location of taxation.

2. Base Alignment

The discussion in sections 4. and 5. reviews the Final Reports on the Actions that address substantive aspects of the BEPS initiative, i.e. Actions 2-10,[7] as well as the more recent Pillar One and Pillar Two developments, with a

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1. *See* OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013), Primary Sources IBFD [hereinafter the *Action Plan*]. The *Action Plan*, *supra* was somewhat of a culmination of a number of earlier reports and initiatives, including OECD, *Addressing Base Erosion and Profit Shifting* (OECD 2013), Primary Sources IBFD; *Hybrid Mismatch Arrangements: Policy and Compliance Issues* (OECD 2012), Primary Sources IBFD; *Tackling Aggressive Tax Planning through Improved Transparency and Disclosure* (OECD 2011); *The Application of the OECD Model Tax Convention to Partnerships* (OECD 1999), Primary Sources IBFD; *Harmful Tax Competition: An Emerging Global Issue* (OECD 1999); *Double Taxation Conventions and the Use of Base Companies* (OECD 1986), Primary Sources IBFD; and *Double Taxation Conventions and the Use of Conduit Companies* (OECD 1986), Primary Sources IBFD.
2. The *Final Reports on the Actions* are listed in Appendix A. *See also* Appendix B for a BEPS Action Plan Target Map.
3. *See*, for example, OECD/G20, *Explanatory Statement*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015).
4. The Inclusive Framework was established after the delivery of the Final Reports. *See* OECD Press Release, *All interested countries and jurisdictions to be invited to join global efforts led by the OECD and G20 to close international tax loopholes* (23 Feb. 2016), available at www.oecd.org/tax/all-interested-countries-and-jurisdictions-to-be-invited-to-join-global-efforts-led-by-the-oecd-and-g20-to-close-international-tax-loopholes.htm (accessed 11 Nov. 2021). As initially conceived, the mandate of the Inclusive Framework was not to develop alternative principles of taxation.
5. *See* the discussion in sec. 5. under the heading Pillar One and Pillar Two.
6. *See*, for example, the recent decision of the England and Wales High Court (EWHC) (Commercial Court) in the United Kingdom in UK: EWHC, 27 Apr. 2021, *Skatteforvaltningen (the Danish Customs and Tax Administration) v. Solo Capital Partners LLP (in special administration) and others*, [2021] EWHC 974 (Comm). This issue is not entirely new, as administration, and collection assistance agreements have been in place for a considerable time, including a multilateral one (*see Convention between the Member States of the Council of Europe and the Member Countries of The OECD on Mutual Administrative Assistance in Tax Matters* (25 Jan. 1988) (as amended through 2010), Treaties & Models IBFD).
7. The Final Reports on Actions 11-15 address more administrative or procedural aspects of the initiative, such as OECD/G20, *Measuring and Monitoring BEPS – Action 11: Final Report 2015* (OECD 2015), Primary Sources IBFD; OECD/G20, *Transfer Pricing Documentation and Country-by-Country Reporting – Action 13: Final Report 2015* (OECD 2015), Primary Sources IBFD; OECD/G20, *Making Dispute Resolution Mechanisms More Effective – Action 14: Final Report 2015* (OECD 2015), Primary Sources IBFD; and OECD/G20, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties – Action 15: Final Report 2015* (OECD 2015), Primary Sources IBFD.

focus on the implications of the various measures with regard to the degree to which they may contemplate or nevertheless result in a dislocation between the location of taxation and the location of value creation. This review is not intended to reflect a detailed examination of the proposed measures.[8] Rather, the discussion remains at a high level, aiming to identify architectural features of the measures, that may be inconsistent with aligning the location of taxation with the location of value creation.

In traditional parlance, one would distinguish between a "destination-based" approach, a "source-based" approach and a "residence-based" approach, to taxation. The current international tax framework with regard to income taxation is based on the source-based and residence-based approaches. The logic for this is value creation – with the source-based approach focussed on where the value was created, and the residence-based approach focussed on who created the value. Normally, the location of primary or even exclusive taxation is aligned with where the value was created, while the location of the person or entity that created the value may impose a residual taxation, whether directly or indirectly. Consumption taxes are based more on a "destination-based" approach, as the logic there is consumption, so taxation is aligned with the location of the consumption.

3. The Action Plan in General

The Introduction of the Action Plan says this:

> Over time, the current rules have also revealed weaknesses that create opportunities for BEPS. BEPS relates chiefly to instances where the interaction of different tax rules leads to double non-taxation or less than single taxation. It also relates to arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place. No or low taxation is not *per se* a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it. In other words, what creates tax policy concerns is that, due to gaps in the interaction of different tax systems, and in some cases because of the application of bilateral tax treaties, income from cross-border activities may go untaxed anywhere, or be only unduly lowly taxed.[9]

The first sentence of Chapter 3 of the Action Plan, which introduces the Actions, states as follows:

> Fundamental changes are needed to effectively prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it.[10]

Grammatically, this statement can be read in two ways.

It can be read as though it refers to a single overall category (with the sub-categories being "double non-taxation", "no taxation" and "low taxation"), all of which must be "associated with practices that artificially segregate taxable income from the activities that generate it".[11] This would be consistent with the statement in the Introduction, that:

> [n]o or low taxation is not *per se* a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it.[12]

But it can also be read as though it refers to two overall categories, with the first before the comma (being simply "double non-taxation") and the second after the comma (being "no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it"[13]). This, too, would be consistent with the introduction – in particular, the fact that the second sentence in the paragraph reproduced above states that "BEPS relates chiefly to instances where the interaction of different tax rules leads to double non-taxation or less than single taxation",[14] while "arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place"[15] are referred to in the third sentence, which states that BEPS "also relates" to this.

The difference is important because the first approach only targets practices that artificially segregate taxable income from the activities that generate it, not any and all cases and causes of double non-taxation, no taxation or low taxation. The second approach targets any and all double non-taxation, though one would have to distinguish between "double non-taxation" and "no taxation" in this context, as the latter would be in scope only where associated with artificial practices.

The Action Plan is also said to be framed around three main "pillars", although the boundaries between them are not entirely clear, and they have evolved to some extent. In this context, the Action Plan mentions the following three points:

(1) new international standards must be designed to ensure the coherence of corporate income taxation at the international level;[16]
(2) a realignment of taxation and relevant substance is needed to restore the intended effects and benefits of international standards, which may not have kept pace with changing business models and technological developments; and[17]
(3) the actions implemented to counter BEPS cannot succeed without further transparency, nor without certainty and predictability for business.[18]

However, under the rubric of the first pillar, the following is stated:

> BEPS issues may arise directly from the existence of loopholes, as well as gaps, frictions or mismatches in the interaction of countries' domestic tax laws. These types of issues generally have not been dealt with by OECD standards or bilateral treaty

8. For a more detailed review, *see*, inter alia, A Nikolakakis & P. Halvorson, *The Future of International Tax and Transfer-Pricing Planning in the Post-BEPS Global Environment*, in *2015 Conference Report* (Can. Tax Fund. 2015). This present article is also intended to be more of a perspectives piece, rather than a research piece, so it will not include references to the many excellent works in which I have not been involved.
9. OECD, *Action Plan*, *supra* n. 1, Introduction, at p. 10.
10. Id., ch. 3, at p. 13.
11. Id.
12. Id., Introduction, at p. 10.
13. Id., ch. 3, at p. 13.
14. Id., Introduction, at p. 10.
15. Id.
16. Id., at p. 13.
17. Id.
18. Id., at p. 14.

> provisions. There is a need to complement existing standards that are designed to prevent double taxation with instruments that prevent double non-taxation in areas previously not covered by international standards and that address *cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it*. Moreover, governments must continue to work together to tackle harmful tax practices and aggressive tax planning. [Emphasis added.][19]

The emphasized portion seems to be more consistent with the second pillar than with the first. But under the rubric of the second pillar, the following is also stated:

> Whilst bilateral tax treaties have been effective in preventing double taxation, there is a concern that they often fail to prevent double non-taxation that results from interactions among more than two countries. In particular, the involvement of third countries in the bilateral framework established by treaty partners puts a strain on the existing rules, in particular when done *via* shell companies that have little or no substance in terms of office space, tangible assets and employees.
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> In the area of transfer pricing, the rules should be improved in order to put more emphasis on value creation in highly integrated groups, tackling the use of intangibles, risks, capital and other high-risk transactions to shift profits. At the same time, there is consensus among governments that moving to a system of formulary apportionment of profits is not a viable way forward; it is also unclear that the behavioural changes companies might adopt in response to the use of a formula would lead to investment decisions that are more efficient and tax-neutral than under a separate entity approach.[20]

What is curious about this formulation is that preventing double non-taxation "that results from interactions among more than two countries"[21] seems to be more consistent with the first pillar than with the second. Also, while the references to "shell companies that have little or no substance in terms of office space, tangible assets and employees"[22] and to "the use of intangibles, risks, capital and other high-risk transactions to shift profits"[23] would be consistent with the second pillar, these items are sought to be addressed by specific Actions that fall under both the first pillar and the second pillar.[24]

Perhaps the way to reconcile all this is to observe that both coherence and substance, as well as transparency, should be viewed as elements of a singular ultimate objective of aligning the location of taxation with the location of value creation. However, as noted in section 1., the overall Action Plan is unclear or ambivalent toward its ultimate objectives.

And what of the Final Reports on the substantive Actions, and the Pillar One and Pillar Two initiatives? Are they concerned only with practices that artificially segregate taxable income from the activities that generate it, and are they committed to aligning the location of taxation with the location of value creation, either as a singular objective or at all?

4. Specific Actions

4.1. Action 2

Action 2 targets "hybrid mismatch arrangements". Deductions and exemptions, as well as treaty benefits, may be denied where there is a deduction and/or non-inclusion ("D and/or NI") or a double deduction ("DD") outcome. With regard to deductions and exemptions under domestic law, the Final Report on Action 2 states that:

> The recommended primary rule is that countries deny the taxpayer's deduction for a payment to the extent that it is not included in the taxable income of the recipient in the counterparty jurisdiction or it is also deductible in the counterparty jurisdiction. If the primary rule is not applied, then the counterparty jurisdiction can generally apply a defensive rule, requiring the deductible payment to be included in income or denying the duplicate deduction depending on the nature of the mismatch.[25]

With regard to treaty benefits, among other matters:

> Part II also deals with the application of tax treaties to hybrid entities, i.e. entities that are not treated as taxpayers by either or both States that have entered into a tax treaty (such as partnerships in many countries). The report proposes to include in the *OECD Model Tax Convention* (OECD, 2010) a new provision and detailed Commentary that will ensure that benefits of tax treaties are granted in appropriate cases to the income of these entities but also that these benefits are not granted where neither State treats, under its domestic law, the income of such an entity as the income of one of its residents.[26]

While this approach may be effective in addressing double taxation and double non-taxation, the effect may also be to undermine the alignment of the location of taxation with the location of value creation.

If you assume, for example, that the capitalization of a subsidiary is at a reasonable debt level, and that interest is charged at a reasonable rate, maybe even matching third-party indebtedness at the parent level, then the deduction in the operating company should be legitimate with regard to the location and amount of the deduction. Accordingly, the denial of the deduction results in the shifting of the location of taxation to the operating jurisdiction, which is not the proper taxing jurisdiction, at least not under the rubric of taxing operating income, if the income should be viewed as income that is derived from capital rather than as operating income. Extending into the notion of denying otherwise legitimate deductions because of "imported mismatch arrangements" represents an even further departure from tax base alignment. In those cases, the operating jurisdiction is taking tax base not because its counterparty jurisdiction had a hybrid position, but because some other jurisdiction, possibly many steps removed from the operating jurisdiction, had a hybrid mismatch position, and every other jurisdiction in the chain did not take action to defeat it.

19. Id., at p. 13.
20. Id., at pp. 13-14.
21. Id.
22. Id.
23. Id.
24. There is also a degree of confusion with regard to the placement of Action 5. In the OECD, *Action Plan*, *supra* n. 1, it seems to appear under the first pillar, but it is difficult to see this as a matter of coherence, and the OECD/G20, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance – Action 5: Final Report 2015* p. 24 (OECD 2015), Primary Sources IBFD [hereinafter the *Action 5 Final Report* (2015)] says that it relates to the second pillar.
25. OECD/G20, *Neutralising the Effects of Hybrid Mismatch Arrangements – Action 2: Final Report 2015* p. 12 (OECD 2015), Primary Sources IBFD [hereinafter the *Action 2 Final Report* (2015)].
26. Id.

With reference to the denial of treaty benefits, the Final Report on Action 2 recommends the introduction into the OECD Model[27] of a new article 1(2), which would preclude treaty benefits on an item of income to the extent that the income is not treated, for purposes of taxation by the recipient entity's jurisdiction or by the entity investor's jurisdiction, as the income of a resident of that jurisdiction.[28] This stance is interesting in many ways but in particular because it represents a shifting of the location of taxation relative to the source jurisdiction's general treaty commitments, whereby it would normally cede taxing authority in whole or in part in favour of what it views as the residence jurisdiction,[29] in accordance with the broader principle that the location of taxation with regard to income from capital should be determined according to a residence-based approach.

To add insult to injury, as it were, the Final Report on Action 2 also contemplates the possibility of the simultaneous denial of a deduction by the source jurisdiction and the denial by it of tax treaty benefits in respect of the same item of income:

> 407. A country will continue to levy withholding taxes on payments that are subject to adjustment under the hybrid mismatch rules in accordance with its domestic law and consistent with its treaty obligations. The function of withholding taxes under the laws of the payer jurisdiction is generally not to address mismatches in tax outcomes and a payment should not be treated as included in ordinary income simply because it has been subject to withholding at source. The primary rule denying the deduction may apply in cases in which the payer jurisdiction also imposes a withholding tax on the payment as it is still important to neutralise the hybrid mismatch in those cases. Withholding taxes alone do not neutralise the hybrid mismatch as withholding taxes, where applicable, often are imposed with respect to equity instruments.[30]

The stated justification for this position is curious because the denial of treaty benefits for payments to hybrid entities, under Part Two of the Final Report on Action 2,[31] is sought partly on the basis of neutralizing D and/or NI outcomes. It is also curious because it can result in effective double taxation by the source jurisdiction, which is difficult to justify.[32]

In brief, these regimes are largely indifferent to the location of taxation, or tax base alignment. They are focussed on defeating any and all forms of double non-taxation, provided that the cause is hybridity, such that they are satisfied, in general, by the presence of "single taxation" in any jurisdiction. Nevertheless, these regimes are generally more modest than the Pillar Two proposal, as discussed in section 5. in greater detail.

4.2. Action 3

Action 3 is more ambivalent. This is because, as noted in the Final Report on Action 3, there are "several policy objectives that jurisdictions may prioritise differently".[33] In brief, one must begin with the basic policy choice, for a residence jurisdiction, as between adopting a worldwide approach and a territorial approach to the taxation of its residents. Under a territorial approach, residence-based taxation mirrors source-based taxation in the sense that the jurisdiction taxes both residents and non-residents as a function of the geographical location of the source.

The basic logic of either approach remains value creation. Under the territorial approach, the location of taxation is aligned with the location of the value creation – where was the value created? Under a world-wide approach, the location of residual taxation is aligned with the location (i.e. residence) of the person who created the value, although the location of primary taxation may be aligned with the location of the value creation where the residence jurisdiction provides foreign tax credit relief.

Consequently, some approaches to controlled foreign company (CFC) rules are more focussed on artificiality and diverted income, particularly income diverted from the jurisdiction where the CFC's shareholder is resident. It is typical also to focus on passive income from capital. In that sense, they are designed to back-stop residence-based taxation, even under territorial regimes. Other approaches are more focussed on no or low taxation, particularly involving highly mobile income, such as income from capital or from intangibles. This situation may be a concern even under a territorial approach (or even a deferral approach – which is a hybrid that defers taxation in the residence jurisdiction until repatriation, or at least extraction, from the source jurisdiction) where the underlying premise of the territoriality is an assumption that the foreign income will bear a reasonably comparable or even just a certain minimum rate of foreign tax. But

27. Most recently, *OECD Model Taxation Convention on Income and Capital* (21 Nov. 2017), Treaties & Models IBFD.
28. OECD/G20, *Action 2 Final Report* (2015), *supra* n. 25, at p. 139. Of course, this provision is also intended to require the granting of treaty benefits to the extent that the income is treated, for purposes of taxation by the recipient entity's jurisdiction or by the entity investor's jurisdiction, as the income of a resident of that jurisdiction. Much has been written about this particular measure.
29. It also represents a departure from the traditional approach to granting or denying treaty benefits based on the treatment in the jurisdiction that is applying the tax treaty. This position is acknowledged in the [Partnerships Report] Organisation for Economic Co-operation and Development, The Application of the OECD Model Tax Convention to Partnerships, Issues in International Taxation no. 6 (Paris: OECD, 1999), but disposed on the basis that the source jurisdiction should take the treatment in the residence jurisdiction into account as part of the context for the application of the tax treaty.
30. OECD/G20, *Action 2 Final Report* (2015), *supra* n. 25, at para. 407.
31. Id., at pt. 2.
32. A dividend (normally paid out of operating income) to a significant corporate shareholder would normally not be deductible in the source jurisdiction, but also not be taxable in the residence jurisdiction, such that the rate of taxation would be that of the source jurisdiction. If we assume that rate is 25%, and that the source jurisdiction also imposes a withholding tax of 25%, the cumulative effect of denying the deduction and imposing the withholding tax on an interest payment is taxation in the source jurisdiction – being the wrong jurisdiction – at the rate of 50% – being the wrong rate. In contrast, the OECD/G20, *Action 2 Final Report* (2015), *supra* n. 25, also contemplates taxation of the income in question under controlled foreign company (CFC) regimes as compensation for non-inclusion by the recipient jurisdiction, such that denial of deductibility by the source jurisdiction is not justified. *See* OECD/G20, *Action 2 Final Report* (2015), *supra* n. 25, at para. 36 et seq., "Inclusion under CFC regimes".
33. OECD/G20, *Designing Effective Controlled Foreign Company Rules – Action 3: Final Report 2015* para. 5 (OECD 2015), Primary Sources IBFD [hereinafter the *Action 3 Final Report* (2015)].

this would not be a concern where the underlying premise of the territoriality is simply a matter of policy principle.

Where the underlying premise of a residence jurisdiction is to prioritize the competitiveness of its multinationals in the foreign source jurisdiction or jurisdictions, the question becomes more complicated because one approach is to apply this principle on a Country-by-Country (CbC) basis and another is to apply it globally or in some respects even regionally. For instance, a CbC approach in the context of a deferral approach would trigger taxation in the residence jurisdiction once the income is extracted from the source jurisdiction, though not necessarily repatriated to the residence jurisdiction, and so we see "same country" requirements to address "foreign-to-foreign base erosion", as well as the use of hybrids to plan around such considerations. But, again, this is not a concern in the context of an exemption approach that is premised simply on policy principle.

Where the approach is more focussed on no or low taxation as such, it may result in a shift of the location of taxation to a higher-tier residence jurisdiction, and away from an intermediary residence or source jurisdiction, where that higher-tier residence jurisdiction would normally provide a participation exemption.[34] In some cases, this may even be considered to be inconsistent with tax treaty obligations, although there is considerable debate in this regard.[35]

All of this is acknowledged in the Final Report on Action 3, which includes the following:

> 13. If a jurisdiction has a worldwide tax system, its CFC rules could apply broadly to any income that is not being currently taxed in the parent jurisdiction and still remain consistent with the parent jurisdiction's overall tax system. If, however, a jurisdiction has a territorial tax system, it may be more consistent for its CFC rules to apply narrowly and only subject income that should have been taxed in the parent jurisdiction to CFC taxation. In reality, jurisdictions' tax systems are almost never purely worldwide nor purely territorial but fall within a spectrum between these two. This may influence the policy choices that jurisdictions make in terms of how they address international competitiveness and how they address base stripping.[36]

Accordingly, the bottom line is that there is no bottom line, so the Final Report on Action 3 goes on to set out alternatives and best practices with regard to individual building blocks of CFC regimes, rather than any particular recommended approach.

The most critical building block is the definition of CFC income – that is, the income that will be attributed to shareholders under the CFC regime. In this regard, the Final Report on Action 3 says this (footnotes indicated, but not reproduced):

> 73. This report recommends that CFC rules should include a definition of income that ensures that income that raises BEPS concerns is attributed to controlling shareholders in the parent jurisdiction. At the same time, it recognises the need for flexibility to ensure that jurisdictions can design CFC rules that are consistent with their domestic policy frameworks. Jurisdictions are free to choose their rules for defining CFC income, including from among the measures set out in the explanation section below. This choice is likely to be dependent on the degree of BEPS risk a jurisdiction faces.
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> 74. This section provides a non-exhaustive list of approaches that CFC rules could use to attribute income that raises BEPS concerns, which may include, among other things, income earned by CFCs that are holding companies, income earned by CFCs that provide financial and banking services, income earned by CFCs that engage in sales invoicing, income from IP assets, income from digital goods and services, and income from captive insurance and re-insurance.[1] These approaches could be applied on their own or combined with each other. CFC rules generally include income that has been separated from the underlying value creation to obtain a reduction in tax. Existing CFC rules use a variety of factors to identify income that raises these concerns. For example, some focus on whether the income is of a type that is more likely to be geographically mobile; some focus on whether the income was earned from or with the assistance of related parties; some focus on the source of the income; and some focus on the level of activity in the CFC. Depending on their policy priorities, different jurisdictions with CFC rules focus on different factors.[37]

This statement is relatively neutral. But then these words follow:

> 75. Regardless of which approach a jurisdiction applies, CFC rules should, *at a minimum*, capture the funding return allocated under transfer pricing rules to a low-function cash box if that cash box meets the requirements in the previous building blocks (although under CFC regimes that focus on preventing stripping from the parent jurisdiction, the extent of inclusion may depend on how much of the income has been shifted from the parent jurisdiction).[2] However, as mentioned in Chapter 1, different jurisdictions use CFC rules to achieve different policy outcomes, and an approach that focuses only on funding returns would not be consistent with the policy goals of all jurisdictions. The analyses set out below provide a number of options that could apply more narrowly or that could apply more broadly.[3] *Jurisdictions could also apply a full-inclusion system, which would target income raising BEPS concerns by treating all income earned by a CFC as CFC income regardless of its character.* Full-inclusion systems also aim to prevent long-term deferral of taxation, which is relevant in the context of worldwide tax systems. [Emphasis added.][38]

One gets the impression that the Final Report on Action 3 is not enamoured by territorial systems, and even flirts with full-inclusion systems. The reference to "at a minimum" having CFC rules that "capture the funding return allocated under transfer pricing rules to a low-function cash

34. Treaty cases on CFCs [please provide the relevant references].
35. *See* the discussion in A. Nikolakakis et al., *Some Reflections on the Proposed Revisions to the OECD Model and Commentaries, and on the Multilateral Instrument, with Respect to Fiscally Transparent Entities – Part 1*, 71 Bull. Intl. Taxn. 9 (2017), Journal Articles & Opinion Pieces IBFD and *Part 2*, 71 Bull. Intl. Taxn. 10 (2017), Journal Articles & Opinion Pieces IBFD; and in *Some Reflections on the Proposed Revisions to the OECD Model and Commentaries, and on the Multilateral Instrument, With Respect to Fiscally Transparent Entities*, [2017] Brit. Tax Rev. 3 (2017).
36. OECD/G20, *Action 3 Final Report* (2015), *supra* n. 33, at para. 13. Constraints under European Union law are also acknowledged. *See* OECD, *Action 3 Final Report* (2015), *supra* n. 33, at para. 19.
37. Id., at paras. 73 and 74.
38. Id., at para. 75.

box”[39] is also interesting, not only because it reflects a certain degree of recommendation, although it is taken back in the following sentences, but also because it appears to be inconsistent with the recommendations on transfer pricing practices under Actions 8-10, which would effectively eliminate or shift the income of a “low-function cash box”, as discussed in section 4.7. in greater detail.

But most importantly the references to a “low-function cash box” and to income “of a type that is more likely to be geographically mobile”[40] reflect not only a degree of indifference toward aligning the location of taxation with the location of value creation, but also the equally fundamental questions of whether the separate entity principle and the arm’s length principle should be discarded.[41] This position is also true, in particular, of the reference to having a full-inclusion system “which would target income raising BEPS concerns by treating all income earned by a CFC as CFC income”.[42] Here we are throwing the baby out with the bath water. One does not “target” something by capturing “all”. Indeed, in order to not throw the baby out with the bath water, one must even be prepared to tolerate that a degree of bath water will remain on the baby! There is a very big difference between “income raising BEPS concerns”, and “all income”, unless you think there is not, or that there should not be. There is also a very big difference between aligning the location of taxation with the location of value creation, and imposing “single taxation” on “all income”, unless you think there is not, or that there should not be.

4.3. Action 4

Action 4 is, essentially, the partial adoption of a global formulary apportionment approach, notwithstanding the general aversion to such approaches on the part of the OECD.[43] It is restricted to financing costs, which is only once piece of the profit calculation, but it allocates them based on a ratio of “tax EBITDA [earnings before interest, taxes, depreciation, and amortization]”, which in many cases may not be consistent with an arm’s length approach. There is also no effort to require a subsidiary jurisdiction to permit a deduction for shareholder-level financing costs where the subsidiary carries a lower rate of financing costs than the overall group.

The result is a considerable likelihood of dislocation, in particular cases, between the location of value creation and the location of taxation, where the activities in a particular jurisdiction would normally carry either more or less than the permitted ratio,[44] although on a macro level this may not result in very much dislocation, depending on how high or how low the ratio may be. In the Final Report on Action 2, there is a reference to “the collective tax base of countries”.[45] This is a novel proposition, but also would seem to be the basic logic of Action 4, and all formulary apportionment approaches, which all have in common that they allocate profit – and, therefore, align the location of taxation – with a predetermined or fixed set of criteria rather than in accordance with the arm’s length principle applied based on all relevant functions, assets and risks – that is, rather than in accordance with value creation. This is rather unambiguous.

4.4. Action 5

Action 5 is also unambiguous – on the basis that it seeks to set standards to judge the legitimacy and permissibility of incentive regimes, particularly for highly mobile sources of income. It adopts a “modified nexus” standard that does not align with the arm’s length principle.[46]

This position is unambiguous, but it is not entirely transparent. The Final Report on Action 5 says this:

> 24. Action 5 specifically requires substantial activity for any preferential regime. Seen in the wider context of the work on BEPS, this requirement contributes to the second pillar of the BEPS Project, which is to align taxation with substance by ensuring that taxable profits can no longer be artificially shifted away from the countries where value is created. The framework set out in the 1998 Report (OECD, 1998) already contains a substantial activity requirement. This requirement is grounded in particular in the twelfth factor (i.e. the eighth other factor) set out in the 1998 Report. This factor looks at whether a regime “encourages purely tax-driven operations or arrangements” and states that “many harmful preferential tax regimes are designed in a way that allows taxpayers to derive benefits from the regime while engaging in operations that are purely tax-driven and involve no substantial activities”. The 1998 Report contains limited guidance on how to apply this factor.[47]

However, the Final Report on Action 5 proceeds to provide guidance on how to apply this factor on the basis of a “modified nexus” approach, based on a ratio of development expenses incurred, excluding acquisition costs and development costs for activities that are outsourced to related parties.[48]

These exclusions, and other relevant factors, are essentially why this approach cannot be consistent with the arm’s length principle, which is one approach that was considered but not the approach that was adopted by the Final Report on Action 5 (footnotes indicated, but not reproduced):

> 27. The FHTP considered three different approaches to requiring substantial activities in an IP regime. The first approach was a value creation approach that required tax-

39. Id.
40. Id., at para. 74.
41. This situation is discussed below in greater detail in the context of Actions 8-10 in sec. 4.7.
42. OECD/G20, *Action 3 Final Report* (2015), *supra* n. 33, at para. 75.
43. *See*, inter alia, the statements in OECD, *Action Plan*, *supra* n. 1, at p. 13, which is reproduced in sec. 3.
44. Even where a group ratio permits a higher ratio than a lower fixed ratio, the subsidiary might normally carry a higher ratio – particularly where the overall group is a conglomerate.
45. OECD/G20, *Action 2 Final Report* (2015), *supra* n. 25, A2, Introduction to Part I, at para. 2.
46. *See also* OECD/G20, *Action 5: Agreement on Modified Nexus Approach for IP Regimes*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), available at www.oecd.org/ctp/beps-action-5-agreement-on-modified-nexus-approach-for-ip-regimes.pdf (accessed 11 Nov. 2021).
47. OECD/G20, *Action 5 Final Report* (2015), *supra* n. 24, at para. 24.
48. *See*, in particular, OECD/G20, *Action 5 Final Report* (2015), *supra* n. 24, at paras. 42, 49 and 52.

> payers to undertake a set number of significant development activities. This approach did not have any support over the other two. The second approach was a transfer pricing approach that would allow a regime to provide benefits to all the income generated by the IP if the taxpayer had located a set level of important functions in the jurisdiction providing the regime, if the taxpayer is the legal owner of the assets giving rise to the tax benefits and uses the assets giving rise to the tax benefits, and if the taxpayer bears the economic risks of the assets giving rise to the tax benefits. A few countries supported the transfer pricing approach, but many countries raised a number of concerns with the transfer pricing approach, which is why the work of the FHTP did not focus further on this approach. The third approach was the nexus approach, which has been agreed by the FHTP and endorsed by the G20.[2,49]

This situation does not directly shift the location of taxation. However, it is intended to reduce the prevalence of no or low taxation resulting from deliberate policy choices – reflected by the introduction of incentive regimes – through a "naming and shaming" approach, focussed on what are described as "harmful" practices. Except here, the harmful practices are adopted by governments, focussed mainly on attracting highly mobile sources of income. Be that as it may, this approach reflects a perspective that is not consistent with or committed to the arm's length principle, and, therefore, is not committed to the alignment of the location of taxation with the location of value creation.

4.5. Action 6

The Final Report on Action 6[50] is focussed mainly on "treaty shopping arrangements" and other situations in which it is said that a person "seeks to circumvent treaty limitations", such as through the splitting-up of contracts, the hiring-out of labour, transactions intended to avoid dividend characterization, dividend transfer transactions, transactions that circumvent the application of article 13(4) of the OECD Model, the use of dual-resident entities, and permanent establishments (PEs) situated in third jurisdictions. It also speaks to the application of tax treaties to restrict a jurisdiction's right to tax its own residents, as well as the use of tax treaties "to generate double non-taxation".

The main prescription is the introduction of limitation on benefits (LOB) rules, or the principal purpose test (PPT) rules, or both. LOB rules target treaty shopping, essentially by supplementing the residence determination in article 4 of the OECD Model, with a higher standard, involving the notion of a "qualified" resident. The approach is prescriptive, or mechanical, in the sense that it tests for the degree of third-country ownership of the treaty resident, and for the availability of equivalent benefits under a tax treaty with a third jurisdiction, or substantial presence in the treaty jurisdiction (such as being a publicly listed entity or conducting an active trade or business in the treaty jurisdiction), and does not involve a determination of "purpose". As such, this approach is not particularly apt with regard to other situations – in which arrangements or transactions are entered into or structured in order to obtain treaty benefits or to avoid treaty limitations in respect of particular items of income or gain. In this regard, a broader and more amorphous PPT is suggested – which tests for whether "one of the principal purposes" of an arrangement or transaction was to obtain treaty benefits, and whether the granting of treaty benefits in the circumstances "would be in accordance with the object and purpose" of the relevant treaty provisions.

In a sense, it may be said that the focus of these aspects of the Final Report on Action 6 is to develop approaches to restricting treaty benefits to what may be referred to as legitimate treaty residents and legitimate arrangements or transactions,[51] given that income taxation and the application of tax treaties are normally premised on the recognition of the separate entity principle,[52] and the recognition of the legal form of an arrangement or transaction (in Canada, we like to refer to "legal substance") rather than its "economic substance". The establishment of a separate legal entity that is treaty resident in a different jurisdiction than its stakeholders is normally not particularly difficult to accomplish. Likewise, it is often relatively easy to identify more than one legal form for an arrangement or transaction that would have an equivalent or nearly equivalent economic substance (at least in relevant respects), but with different tax consequences. This situation is referred to as "substitutability". Indeed, these are among the basic building blocks of tax planning, whether with reference to domestic laws or tax treaties.

The problem, of course, is that there are competing principles – as between equity, efficiency, certainty, simplicity, and so on, as well as that governments sometimes use tax laws and tax treaties to encourage certain types of investments, or investments in certain places. Income tax laws and tax treaties are replete with formalistic distinctions, and taxpayers are therefore inclined to arrange their affairs in a manner that minimizes tax costs or maximizes tax benefits, while tax authorities are sometimes inclined to tolerate or even facilitate this, and other times inclined to oppose it. Putting aside cases involving illegality, debates and disputes in this regard can sometimes become rather philosophical.[53]

This is a perennial problem in taxation – involving what are essentially unresolvable tensions between principles, and as between rules and principles, as well as tensions between reliance on the rule of law and a more discretion-

49. OECD/G20, *Action 5 Final Report* (2015), *supra* n. 24, at para. 27.
50. OECD/G20, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances – Action 6: Final Report 2015* (OECD 2015), Primary Sources IBFD [hereinafter the *Action 6 Final Report* (2015)].
51. *See* A. Nikolakakis, *A Perspective on the Principal Purpose Test*, Can. Tax J. (2021), pending.
52. *See* A. Nikolakakis, "The Ambivalent relationship Between the Income Tax Act and the Separate Entity Principle", in *Income Tax at 100 Years: Essays and Reflections on the Income War Tax Act* ch. 12, pp. 1-19 (J (Jinyan) Li, J. Scott Wilkie & L.F. Chapman eds., Can. Tax Fund. 2017).
53. Some will recall the quip by Margaret Hodge, the former Chair of the UK Public Accounts Committee, to Matt Brittin, a Google Vice President for Sales and Operations, during formal committee hearings into the tax affairs of Amazon, Google and Starbucks that: "We are not accusing you of being illegal – we are accusing you of being immoral".

ary approach in tax administration.[54] The tensions in this area are demonstrated quite eloquently by the difficulty of elaborating a set of examples that reflect a high degree of coherence and predictability.[55]

It seems to be difficult to classify these measures as tending or being indifferent toward a dislocation between the location of taxation and the location of value creation. Rather, they seem to be more focussed on promoting a better alignment of actual and intended taxation, as well as a better alignment of taxation and economic substance, at the cost of a degree of certainty and a decreased reliance on the rule of law. It is also perhaps worth noting that an increased reliance on purpose tests and discretion may compromise horizontal equity, given that two taxpayers in exactly the same economic circumstances may have different tax consequences simply because of different purposes or different exercises of discretion. This is not ideal.

Finally, the most significant disappointment with regard to the Final Report on Action 6 is that it reflects an inability to achieve a widespread consensus or true multilateralism with regard to the taxation of cross-border trade and investment, in accepting the perpetuation of the differential taxation of income based on the identity and residence of the taxpayer. That is, dividends, interest, royalties, capital gains and other types of income, may be taxed differently by the source jurisdiction depending on whether they are attributable to a resident of one foreign jurisdiction or another. Imagine taking that approach domestically – where income may be taxed differently depending on whether the taxpayer's name is Peter or Paul. There was an opportunity here to harmonize the taxation of non-residents, which would have been the best solution – and even a complete solution – to treaty shopping, as well as the best approach to promoting efficiencies both as to tax compliance and administration and as to capital and other forms of resource allocation. Instead, we have a result that reinforces bilateralism and the complexity, inefficiency, uncertainty and discrimination that are inevitable by-products of that approach. Again, not ideal.

4.6. Action 7

The Final Report on Action 7[56] is couched in terms of "artificiality" – specifically, the "artificial avoidance of PE status". It focusses on several types of circumstance, including the reliance on commissionaire arrangements, the specific activity exemptions in article 5(4) of the OECD Model, the fragmentation of activities between closely related parties, the splitting-up of contracts and contractual arrangements for selling insurance in a jurisdiction without having a PE.

But calling something artificial does not make it so. There is a difference between being keenly deliberate toward arranging one's affairs in order to remain outside the fiscal boundaries established in accordance with the law of a particular jurisdiction and engaging in a "sham". Arguably, referring to the former as artificiality is a bit like complaining about and seeking to give a speeding-ticket to a driver, who sets the cruise control at exactly the speed limit, on the basis that the driver would likely have strayed over the limit if the driver had been less deliberate about the limit and focussed only on the destination.

Admittedly, the splitting-up of contracts may involve more difficult examples. But even in this context, there will be cases in which this does not reflect artificiality. Although corporations and other entities are "legal fictions", it does not follow that relying on the separate entity principle is necessarily artificial in a pejorative sense, particularly in a context that does not have a grouping rule.[57] Consider, for example, the case of two related entities where each has the genuine capacity to perform on a portion of a project. What if each has a different form of expertise, and the project involves both types of expertise? Is it artificial if each enters into a separate contract rather than one of them contracting to deliver both portions and then subcontracting a portion to the other? What if they were unrelated? Would it be artificial for the project owner to contract with separate and unrelated parties in a manner that is deliberate about the 12-month threshold? If not, then why does it matter if they are related, in the absence of a grouping rule? Is it artificial for the parties to agree to a 12-month project period and to arrange their affairs in order to perform genuinely within that period (for example, by deploying a greater number of staff than they might otherwise have done), with a view to avoiding PE status, if they would likely have agreed to a more comfortable and less stressful 14-month project period in the absence of their awareness of this arbitrary threshold?

With regard to the relationship between some of these measures and the alignment of the location of taxation with the location of value creation, it is rather interesting to follow this aspect of the BEPS saga through the related attempts to achieve consensus in respect of the attribution of profits to PEs, especially those relating to the agency PE rules in article 5(5) and (6) of the OECD Model (2017). The OECD's 2016 Discussion Draft on "Additional Guidance on the Attribution of Profits to Permanent Establishments" (the "2016 PE Attribution Draft")[58] set out a series of examples, with numerical calculations, including four examples involving a dependent agent PE. In Example 1 of the 2016 PE Attribution Draft, total enterprise-wide profits were 132, but, of this, only 2 was allocated to the jurisdiction of the dependent agent PE.[59] A revised discussion draft was then released in 2017 (the "2017 PE Attri-

54. *See* A. Nikolakakis, *Tax Law: Rules or Principles – Madness or Genius? Mind the Gaps!*, in *Tax Polymath: A life in international taxation: Essays in honour of John F. Avery Jones* (P. Baker & C.S. Bobbett eds., IBFD 2010), Books IBFD.
55. *See* the numerous but inconclusive examples developed in relation to the PPT, at *Action 6 Final Report* (2015), *supra* n. 50, at p. 55 et seq., as well as in the commentaries to article 29(9) of the *OECD Model* (2017).
56. OECD/G20, *Preventing the Artificial Avoidance of Permanent Establishment Status – Action 7: Final Report 2015* (OECD 2015), Primary Sources IBFD.
57. Compare article 5(3) of the *OECD Model* (2017), which does not have a grouping rule, with the grouping rules in article 5(4) and (4)(1).
58. *See* OECD, *Base Erosion and Profit Shifting (BEPS): Public Discussion Draft: BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments* (OECD 4 July-5 Sept. 2016), Primary Sources IBFD [hereinafter the 2016 PE Attribution Draft].
59. Id., at p. 11.

bution Draft"),[60] and a final report was released in 2018 (the "2018 PE Attribution Report").[61] The 2017 PE Attribution Draft had only three examples of a dependent agent PE (involving a *commissionaire* arrangement, the sale of advertising on a website, and procurement arrangements), and the numerical calculations had been deleted. The 2018 PE Attribution Report adopted the same approach of excluding numerical calculations. The high-level observations that emerge from a review of these documents and their evolution are, first, that it seems difficult to characterize 2:132 as a material difference in the location of taxation;[62] and, second, that the deletion of the numerical calculations illustrates an inability to achieve a consensus on the questions of the location of value creation and the location of taxation. This is why Action 14 is very important!

4.7. Actions 8-10

This is where the Action Plan begins to really slip away from the arm's length principle and, therefore, the alignment of the location of taxation with the location of value creation, especially with regard to the treatment of so-called "cash boxes". The Final Report on Actions 8-10 says this:

> The guidance is linked in a holistic way with other Actions. As mentioned above, this guidance will ensure that capital-rich entities without any other relevant economic activities ("cash boxes") will not be entitled to any excess profits. The profits the cash box is entitled to retain will be equivalent to no more than a risk-free return. Moreover, if this return qualifies as interest or an economically equivalent payment, then those already marginal profits will also be targeted by the interest deductibility rules of Action 4. In addition, it will become extremely difficult to structure the payments to the country where the cash box is tax-resident in a way that avoids withholding taxes, due to the guidance provided on preventing treaty abuse (Action 6). Finally, a cash box with limited or no economic activities is likely to be the target of CFC rules (Action 3). With that, the holistic approach provided by the BEPS Action Plan will secure that the role of cash boxes in BEPS strategies is seriously discouraged.[63]

To understand this perspective, it is important to return to the OECD's revised conception of "substance" – which now relates to "substance in terms of office space, tangible assets and employees".[64]

Normally, under the arm's length principle, value creation is determined on the basis of an analysis of the functions, assets and risks associated with or resulting in economic value. This continues to be true in general, in the sense that it continues to be the OECD's mantra. Even in the revised Chapter I, section D of the OECD Transfer Pricing Guidelines of 2017[65] contemplated by the Final Report on Actions 8-10, we see the following statements:

> 1.51 In transactions between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed). Therefore, in delineating the controlled transaction and determining comparability between controlled and uncontrolled transactions or entities, a functional analysis is necessary. This functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions.
>
> ...
>
> 1.54 The functional analysis should consider the type of assets used, such as plant and equipment, the use of valuable intangibles, financial assets, etc., and the nature of the assets used, such as the age, market value, location, property right protections available, etc.[66]

As a result, value is attributed not only to functions and tangible assets, but also to intangibles and financial assets.

Moreover, the functional analysis is normally carried out in accordance with a recognition of the separate entity principle, and not in a way that effectively attributes the intangibles and financial assets of a particular entity to other members of the corporate group. In contrast, the summary to the revisions to the OECD Transfer Pricing Guidelines says the following:

> The guidance set out in this chapter of the Report responds to the mandate under Actions 8-10 of the BEPS Action Plan requiring the development of transfer pricing rules which create transfer pricing outcomes in line with value creation. More specifically, Actions 9 and 10 mandate the development of:
>
> (i) "rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation."
>
> (ii) "rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: (i) clarify the circumstances in which transactions can be recharacterised."
>
> The guidance ensures that:
> – actual business transactions undertaken by associated enterprises are identified, and transfer pricing is not based on contractual arrangements that do not reflect economic reality
> – contractual allocations of risk are respected only when they are supported by actual decision-making
> – capital without functionality will generate no more than a risk-free return, assuring that no premium returns will be allocated to cash boxes without relevant substance
> – tax administrations may disregard transactions when the exceptional circumstances of commercial irrationality apply.
>
> In combination, the changes make a key contribution to aligning transfer pricing outcomes with the value creating activities

60. OECD, *Base Erosion and Profit Shifting (BEPS): Public Discussion Draft: BEPS Action 7 Additional Guidance on Attribution of Profits to Permanent Establishments* (OECD 22 June-15 Sept. 2017), Primary Sources IBFD [hereinafter the 2018 PE Attribution Draft].
61. OECD, *Additional Guidance on the Attribution of Profits to Permanent Establishments: BEPS Action 7* (OECD 22 Mar. 2018), Primary Sources IBFD [hereinafter the 2017 PE Attribution Draft].
62. Although the other examples featured a slightly higher attribution to the jurisdiction with the dependent agent PE.
63. OECD/G20, *Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: Final Report 2015* p. 11 (OECD 2015), Primary Sources IBFD [hereinafter the *Actions 8-10 Final Report* (2015)].
64. OECD, *Action Plan*, *supra* n. 1, at p. 13.
65. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2017), Primary Sources IBFD.
66. OECD, *Actions 8-10 Final Report* (2015), *supra* n. 63, at paras. 1.51 and 1.54.

performed by the members of an MNE [multinational enterprise] group.[67]

The problem with this approach is that it substitutes the trinity of functions, assets and risks, with a different trinity, being functions, functions and functions. Ownership and risk "for transfer pricing purposes" should be aligned with legal ownership, not some sort of extraneous factor intended to remunerate functions in excess of market rates.

It is legal ownership that determines the right to control an asset, and not delegated control that determines the ownership an asset. Of course, the OECD is forced to acknowledge this point in their example involving fully discretionary investment management services, featured in paragraph 1.70 of the revised OECD Transfer Pricing Guidelines, although the point is not conceded as such (footnotes indicated, but not reproduced):

1.70 Assume that an investor hires a fund manager to invest funds on its account.[3] Depending on the agreement between the investor and the fund manager, the latter may be given the authority to make portfolio investments on behalf of the investor on a day-to-day basis in a way that reflects the risk preferences of the investor, although the risk of loss in value of the investment would be borne by the investor. In such an example, the investor is controlling its risks through four relevant decisions: the decision about its risk preference and therefore about the required diversification of the risks attached to the different investments that are part of the portfolio, the decision to hire (or terminate the contract with) that particular fund manager, the decision of the extent of the authority it gives to the fund manager and objectives it assigns to the latter, and the decision of the amount of the investment that it asks this fund manager to manage. Moreover, the fund manager would generally be required to report back to the investor on a regular basis as the investor would want to assess the outcome of the fund manager's activities. In such a case, the fund manager is providing a service and managing his business risk from his own perspective (e.g. to protect his credibility). The fund manager's operational risk, including the possibility of losing a client, is distinct from his client's investment risk. This illustrates the fact that an investor who gives to another person the authority to perform risk mitigation activities such as those performed by the fund manager does not necessarily transfer control of the investment risk to the person making these day-to-day decisions.[68]

While this example is perfectly realistic, it is not credible to state that the investor is the one who controls the investment risk in the sense that the OECD uses the notion of control in the context of a so-called "cash box". It is also difficult to see how a so-called "cash box", with a real board of directors, does not likewise make the kinds of decisions described previously in this section.

This situation has been recognized by Canadian courts – in particular, in the decision of the Tax Court of Canada (TCC) in *Cameco Corporation* (2018)[69] (footnotes indicated, but not reproduced):

[455] With respect to the separation of the functions performed by the Appellant (i.e., the above-described services) and the price risk, Doctors Shapiro and Sarin state that price risk is an inherent characteristic of an asset that varies depending on the degree of uncertainty associated with the future cash flows from the asset. This risk is borne by the owner of the asset because the owner is entitled to the future cash flows from the asset. Potential owners of an asset will discount the price of that asset to reflect the risk they must bear if they buy the asset. A person who manages an asset but is not the owner of the asset does not bear the price risk.

[456] Doctors Shapiro and Sarin opine that, even if the Appellant monitored and managed CEL's risk through the various service functions that it performed for CEL, that fact is not relevant to the question of which company bore the price risk:

In the case of CEL and CCO, the CRA believes that CCO monitored and managed CEL's price risk through Contract Administration, General Administrative, and Market Forecasting and Research Services, and that this means that CEL could not have borne the price risk. Even if the CRA's assertion that CCO monitored and managed CEL's price risk is true, this is irrelevant to the question as to who bore the price risk. The CRA confuses risk monitoring with risk-bearing. If an investor hires a broker who recommends stocks based on research performed by the broker's company, the investor is still the one who gains (or loses) if the stock price rises (or falls). The performance of brokerage functions does not shift investment risk from the investor to the broker. Similarly, an investor may buy gold from a company that also provides gold transfer and storage, but this logistics support does not shift investment risk; the investor still bears the risk. Likewise, a financial advisor may monitor and track the risk in an investment portfolio and prepare investment statements, but this does not change the fact that the investor bears the risk of the portfolio's investments rising or falling in value.[70]

This decision reflects an extensive analysis of the relevant facts and circumstances, and traditional transfer pricing considerations, involving certain long-term uranium purchase contracts entered into between a Canadian producer parent and its foreign sales subsidiaries.

5. Pillar One and Pillar Two

Essentially, the Final Report on Action 1[71] concluded that no measures should be adopted that are specific to what was then referred to as the digital economy. The logic for this was as follows:

Because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes. The digital economy and its business models present however some key features which are potentially relevant from a tax perspective.[72]

The Final Report on Action 1 then goes on to discuss how other Actions would address certain of the concerns that arise in this context.

67. Id., at p. 13.
68. Id., at para. 1.70.
69. CA: TCC, 26 Sept. 2018, *Cameco Corporation v. Her Majesty the Queen*, 2018 TCC 195; 455 and 456, Case Law IBFD, aff'd by the Federal Court of Appeal (FCA) in CA: FCA, 26 June 2020, *Cameco Corporation v. Her Majesty the Queen*, A-349-18; A-193-19, 2020 FCA 112, Case Law IBFD. Leave to appeal to the Supreme Court of Canada (SCC) has been denied.
70. *See also* the analysis in TCC, *Cameco Corporation* (2018), *supra* n. 69, at paras. 804-856.
71. OECD/G20, *Addressing the Tax Challenges of the Digital Economy – Action 1: Final Report 2015* (OECD 2015), Primary Sources IBFD.
72. Id., at p. 11.

Clearly, that was seen as insufficient by certain members of the Inclusive Framework. So where do we stand at this time? The latest developments, as at the time of writing, include the release on 8 October 2021, of a "Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy" (the "October 2021 Statement").[73] The October 2021 Statement builds on the October 2020 Pillar One and Pillar Two Blueprints.[74] The October 2021 Statement announces that:

> [t]he OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (IF) has agreed a two-pillar solution to address the tax challenges arising from the digitalisation of the economy.[75]

However, as it has evolved over time, this initiative is now tilted toward, but is no longer targeted at, the digital economy, nor even at the digitalization of the economy.

Rather, under Pillar One, the scope is much broader in certain respects, while being narrower in other respects, in that it is determined, in general, by size and profitability instead of industry sector:

> In-scope companies are the multinational enterprises (MNEs) with global turnover above 20 billion euros and profitability above 10% (i.e. profit before tax/revenue) calculated using an averaging mechanism with the turnover threshold to be reduced to 10 billion euros, contingent on successful implementation including of tax certainty on Amount A, with the relevant review beginning 7 years after the agreement comes into force, and the review being completed in no more than one year.[76]

With regard to new nexus rules, the following should be noted:

> There will be a new special purpose nexus rule permitting allocation of Amount A to a market jurisdiction when the in-scope MNE derives at least 1 million euros in revenue from that jurisdiction. For smaller jurisdictions with GDP lower than 40 billion euros, the nexus will be set at 250 000 euros.
>
> The special purpose nexus rule applies solely to determine whether a jurisdiction qualifies for the Amount A allocation. Compliance costs (incl. on tracing small amounts of sales) will be limited to a minimum.[77]

As for quantum and sourcing, the following is stated:

> Quantum
>
> For in-scope MNEs, 25% of residual profit defined as profit in excess of 10% of revenue will be allocated to market jurisdictions with nexus using a revenue-based allocation key.
>
> Revenue sourcing
>
> Revenue will be sourced to the end market jurisdictions where goods or services are used or consumed. To facilitate the application of this principle, detailed source rules for specific categories of transactions will be developed. In applying the sourcing rules, an in-scope MNE must use a reliable method based on the MNE's specific facts and circumstances.[78]

Accordingly, Pillar One has the objective of shifting the location of taxation in favour of market jurisdictions, i.e. adopting more of a destination-based approach, rather than a source-based or residence-based approach.[79] Although, at times, there have been somewhat half-hearted attempts to justify Pillar One based on notions like value creation that are the foundation of a source-based approach,[80] Pillar One contemplates new nexus rules that are based purely on revenues. This may be closer to alignment with value creation for business models that create profits from user data (i.e. in the digital economy), though farther in traditional business models.

The main problem with a destination-based approach is that it confounds value creation with value exchange. The sale transaction that results in revenues is not a value creation transaction. It is a transaction by which the parties exchange values, i.e. created separately from and prior to the exchange transaction. In that sense, this measure tends toward a complete dislocation of the location of taxation from the location of value creation.

On the other hand, perhaps the more important form of dislocation in the modern economy is that between value creation and value perception. It used to be that there was a strong or at least stronger relationship between brand and quality. In the modern age, the brand is increasingly becoming the commodity itself, at least in the context of consumer goods. Viewed in that light, it is not surprising that jurisdictions are focussed on taxing intangibles, as even exchange transactions increasingly result in the

73. OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 8 Oct. 2021), available at www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf (accessed 11 Nov. 2021) [hereinafter the *October 2021 Statement*]. The related press release, OECD, *International community strikes a ground-breaking tax deal for the digital age* (OECD 8 Oct. 2021), available at www.oecd.org/tax/international-community-strikes-a-ground-breaking-tax-deal-for-the-digital-age.htm (accessed 11 Nov. 2021) [hereinafter the *October Press Release*], states that this "updates and finalises" the July 2021 OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 1 July 2021), available at www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf (accessed 11 Nov. 2021).
74. *See* OECD, *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2020) and *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2020).
75. OECD, *October 2021 Statement*, *supra* n. 73.
76. OECD, October Statement. However, "Extractives and Regulated Financial Services are excluded".
77. Id.
78. Id.
79. OECD, *October Press Release*, *supra* n. 73, states that "taxing rights on more than USD 125 billion of profit are expected to be reallocated to market jurisdictions each year".
80. *See*, for example, the discussions in OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018, Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2018), Primary Sources IBFD; *Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note, as approved by the Inclusive Framework on BEPS on 23 January 2019* (OECD 2019); *Public Consultation Document, Secretariat Proposal for a "Unified Approach" under Pillar One, 9 October 2019* (OECD 2019); and *Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy – January 2020*, OECD/G20 Inclusive Framework on BEPS (OECD 2020).

escape of value, in transactions involving non-essential goods, or non-essential aspects of important goods.[81]

Pillar Two has not evolved very much, and it does not have the shifting of the location of taxation as an objective as such, but it is more than prepared to sacrifice tax base alignment in favour of tax base expansion, as "single taxation" at any rate by definition is not double non-taxation or no taxation, although it may be low against some standard. In brief, Pillar Two is focussed on the coordinated introduction of a global minimum tax, and has abandoned the proposition in the Action Plan that "[n]o or low taxation is not *per se* a cause of concern".[82] Pillar Two would consist of:

- two interlocking domestic rules (together the Global anti-Base Erosion (GloBE) rules: (i) an Income Inclusion Rule (IIR), which imposes top-up tax on a parent entity in respect of the low taxed income of a constituent entity; and (ii) an Undertaxed Payment Rule (UTPR), which denies deductions or requires an equivalent adjustment to the extent the low-tax income of a constituent entity is not subject to tax under an IIR; and
- a treaty-based rule (the Subject to Tax Rule (STTR)) that allows source jurisdictions to impose limited source taxation on certain related-party payments subject to tax below a minimum rate, with the STTR being creditable as a covered tax under the GloBE rules.

This measure shares some features with other measures contemplated by the Action Plan – in particular, Action 2, Action 3 and Action 6 – but it goes much further, in the sense that it is not conditioned, for example, on the existence of any hybrid mismatch arrangement, nor on any type of purpose test. It also dispenses with the caveat in the Final Report on Action 3 that a jurisdiction's perspective on these issues may depend on its perspective with regard to territoriality. Most importantly for present purposes, by advocating the possibility of taxation by any jurisdiction in the chain, Pillar Two is demonstrably indifferent toward the alignment of the location of taxation with the location of value creation. The objective of this measure is not the alignment of the location of taxation with the location of value creation, nor even the single taxation of all income, but rather the single taxation of all income at a "minimum rate", being 15% for the so-called GloBE rules, and 9% for the STTR.[83]

6. Conclusions

So, tax base alignment, or tax base expansion? The answer is both, but with an overriding determination to curtail no or low taxation, even at the expense of the dislocation of the location of taxation from the location of value creation.

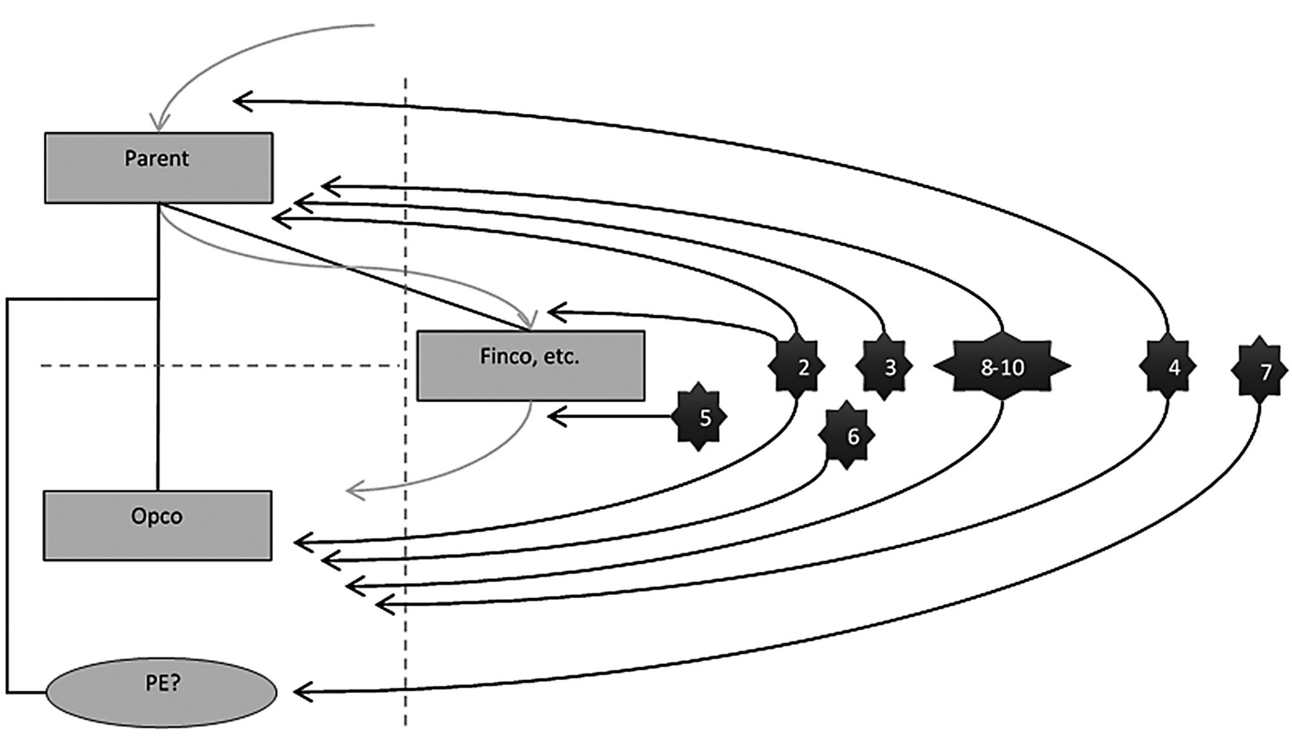
To be fair, the multiplication of deductions and certain other no or low taxation outcomes at the corporate level also result in dislocation, but not to the extent or always in the directions portrayed by the BEPS initiative. Indeed, the ultimate implications of these outcomes with regard to the location of taxation, and the location and distribution of wealth, relative to the location of value creation, are more complicated than taxation at the corporate level. Taxation at the corporate level can itself have dislocation implications that reflect an inordinate allocation of tax base to certain jurisdictions. These implications can only be fully and properly understood in the context of a broader perspective which includes visibility into the application of personal income taxes and their coordination with corporate income taxes.[84] Unfortunately, the BEPS initiative has so far approached these issues only from the narrower perspective of taxation at the corporate level, and even in some respects only from the even narrower perspective of the taxation of the largest corporations. This situation is understandable to some extent from a political perspective, but it ignores considerations involving the substantive economic incidence of taxation. It, however, does not inspire confidence that everyone will in substance end up paying, and that every country will in substance obtain, their "fair share".

7. Appendix A – BEPS Action Plan Final Reports

OECD/G20, *Addressing the Tax Challenges of the Digital Economy – Action 1: Final Report 2015*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), Primary Sources IBFD (the *Action 1 Final Report* (2015)); OECD/G20, *Neutralising the Effects of Hybrid Mismatch Arrangements – Action 2: Final Report 2015*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), Primary Sources IBFD (the *Action 2 Final Report*

81. To some extent, by targeting "profit in excess of 10% of revenue", the scope of the measure seems to be tilted toward business models that rely heavily on high-value intangibles.
82. *See* Action Plan, p. 10. OECD, *October Press Release*, *supra* n. 73, states that "[t]he global minimum tax agreement does not seek to eliminate tax competition, but puts multilaterally agreed limitations on it, and will see countries collect around USD 150 billion in new revenues annually".
83. In fairness, it should be noted that there would be "a formulaic substance carve-out that will exclude an amount of income that is 5% of the carrying value of tangible assets and payroll" (subject to a transition period of 10 years, during which "the amount of income excluded will be 8% of the carrying value of tangible assets and 10% of payroll, declining annually by 0.2 percentage points for the first five years, and by 0.4 percentage points for tangible assets and by 0.8 percentage points for payroll for the last five years"). Accordingly, the tilt is more toward income from intangibles, proprietary processes, know-how, capital, etc. Scope would target "MNEs that meet the 750 million euros threshold as determined under BEPS Action 13 (country by country reporting)", subject to an exclusion from the UTPR for multinational enterprises (MNEs) in the initial phase of their international activity, defined as those MNEs that have a maximum of EUR 50 million tangible assets abroad and that operate in no more than five other jurisdictions, as well as a "*de minimis* exclusion" under the so-called GloBE rules for those jurisdictions where the MNE has revenues of less than EUR 10 million and profits of less than EUR 1 million. However, "[c]ountries are free to apply the IIR to MNEs headquartered in their country even if they do not meet the [EUR 750 million] threshold". There would also be an exclusion for "international shipping income using the definition of such income under the OECD Model Tax Convention", and "Government entities, international organisations, non-profit organisations, pension funds or investment funds that are Ultimate Parent Entities (UPE) of an MNE Group or any holding vehicles used by such entities, organisations or funds are not subject to the GloBE rules". However, no carve-out has been announced for Action 5 compliant incentive regimes.
84. This will be the subject of a forthcoming article by me, which will adopt a more empirical approach to evaluating the distributional implications of various models of international taxation.

Diagram – BEPS Action Plan Target Map



Note: Actions indicated in blue stars.

(2015)); OECD/G20, *Designing Effective Controlled Foreign Company Rules– Action 3: Final Report 2015*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), Primary Sources IBFD (the *Action 3 Final Report* (2015)); OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments – Action 4: Final Report 2015*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), Primary Sources (the *Action 4 Final Report* (2015)); OECD/G20, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance – Action 5: Final Report 2015*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), Primary Sources IBFD (the *Action 5 Final Report* (2015)); OECD/G20, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances – Action 6: Final Report 2015*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), Primary Sources IBFD (the *Action 6 Final Report* (2015)); OECD/G20, *Preventing the Artificial Avoidance of Permanent Establishment Status – Action 7: Final Report 2015*, OECD/G20 Base Erosion and Profit Shifting Project OECD Publishing (OECD 2015), Primary Sources IBFD (the *Action 7 Final Report* (2015)); OECD/G20, *Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: Final Report 2015*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), Primary Sources IBFD (the *Actions 8-10 Final Report* (2015)); OECD/G20, *Measuring and Monitoring BEPS – Action 11: Final Report 2015*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), Primary Sources IBFD (the *Action 11 Final Report* (2015)); OECD/G20, *Mandatory Disclosure Rules – Action 12: Final Report 2015*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), Primary Sources IBFD (the *Action 12 Final Report* (2015)); OECD/G20, *Transfer Pricing Documentation and Country-by-Country Reporting – Action 13: Final Report 2015*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), Primary Sources IBFD (the *Action 13 Final Report* (2015)); OECD/G20, *Making Dispute Resolution Mechanisms More Effective – Action 14: Final Report 2015*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), Primary Sources IBFD (the *Action 14 Final Report* (2015)); and OECD/G20, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties – Action 15: Final Report 2015*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), Primary Sources IBFD (the *Action 15 Final Report* (2015)).

8. Appendix B – BEPS Action Plan Target Map[85]

Together, the potential impact of the Technical Actions and the TP Reports could be depicted as in the Diagram.

Each of the arrows leading from an Action item illustrates the level at which taxation would be modified in a typical multinational structure.

Pillar One goes beyond this configuration. The closest alignment between this configuration and Pillar Two is with regard to Action 2, Action 3 and Action 6.

85. This BEPS Action Plan Target Map was first published in Nikolakakis & Halvorson, *supra* n. 8.