BEPS and the sovereignty of nations

Alex Postma[1)]
Leader EY Global International Tax Services (ITS)

and

Jonathan Schwarz[2)]
BA, LLB (Witwatersrand), LLM (UC Berkeley), FTII[3)]

This article examines the notions of sovereignty and its role in the establishment of the new international tax framework that will be the eventual outcome of the many current discussions. The root of the concept of sovereignty of nations is the starting point of the analysis, followed by a look at how it connects with tax law. The interaction between sovereignty and the OECD base erosion and profit shifting (BEPS) project follows. The article concludes with a discussion of the design principles for a revised taxation framework that respects the national sovereignty principle.

Dieser Artikel untersucht den Begriff der Souveränität und dessen Rolle bei der Schaffung der neuen internationalen Steuergesetzgebung, welche als Ergebnis der zahlreichen gegenwärtigen Verhandlungen erwartet wird. Ausgehend vom Ursprung des Konzepts der staatlichen Souveränität folgt ein Blick auf die Verbindung zum Steuerrecht sowie auf die Wechselbeziehung der Souveränität mit dem OECD Projekt über Base Erosion and Profit Shifting (BEPS). Abschlies-

1) *Alex Postma* leads EY's Global International Tax Services (ITS) business and is currently based in Tokyo, Japan. Alex has more than thirty years of experience with international tax issues at EY and is a senior adviser on international business transactions to a diverse client base.

2) *Jonathan Schwarz* is a Barrister of the Middle Temple. His practice at Temple Tax Chambers in London focuses on international tax disputes as counsel and as an expert and advises on solving cross-border tax problems. He is the author of *Schwarz on Tax Treaties 3rd Ed* and Booth and Schwarz: *Residence, Domicile and UK Taxation 18th Ed* among other publications. He was appointed to the EU Commission group of experts on removing tax problems facing individuals who are active across borders within the EU in June 2014 and is also a Visiting Professor at the Dickson Poon School of Law, King's College London.

3) The authors would also like to acknowledge Henrique de Alencar, Gábor Baranyai, Jivaan Bennett, Joanne Cheong, Vigdis Sigurvaldadottir and Sagar Wagh for their invaluable contributions to this article.

send werden Gestaltungsprinzipien für eine revidierte Steuerregulierung diskutiert, welche die Prinzipien staatlicher Souveränität respektieren.

Content

I. Introduction 00
II. Origins of sovereignty 00
III. Sovereignty and taxation 00
IV. Sovereignty and the base erosion and profit shifting project 00
V. Conclusions and suggestions 00

I. Introduction

The way in which multinational companies organize their tax affairs around the world has caught the attention of the media, politicians and the public. It is a widely heard concern that the manner in which the tax rules applying to international businesses are organized no longer does justice to a proper allocation of profits to the nations where those profits are generated; that the acceleration of technology, the pervasiveness of globalization, and the operating models of multinational companies permits an unfair advantage for international business. Since 2008, many governments have seen a dramatic deterioration of their finances. In this context the interest of the G20 in asking the Organisation for Economic Co-operation and Development (OECD) to undertake an urgent project to suggest improvements in the international tax system becomes clear.

If the outcome of the current debate is a more consistent global system of international taxation, with a fair allocation of taxation rights to all countries, it should benefit taxpayers and tax administrations. This article argues for a collaboration among nations that is principle based. One of those principles is the sovereignty of nations; that is, the right of a nation to decide its own tax laws and to determine who is taxed and on what amounts, and for this exercise to be respected by other nations. Although sovereignty appears to form an integral part of international law, there has never been a consensus on its precise meaning. From the inception of the concept of sovereignty, many commentators have written about the inherent conflicts in determining the character of state sovereignty.

II. Origins of sovereignty

The Peace of Westphalia is generally considered a landmark in the emergence of an international system based on independent sovereign states.[4)] Providing for mutual recognition of the rules and thereby guaranteeing their autonomy, the Peace of Westphalia recognized the full territorial sovereignty of its participat-

[4)] *Perrez, Franz Xavier,* Cooperative Sovereignty: From Independence to Interdependence in the Structure of International Environmental Law, Kluwer Law International 2000, page 39.

ing states granting each of them independence in the area of foreign policy.[5) From there the concept of sovereignty evolved until the 19th century when it reached its absolutist content.[6) This evolutionary outcome implied that sovereignty was a territorially bound principle, where states are, with respect to the community of nations as a whole, completely independent.[7) However, the Peace of Westphalia itself already included certain limitations on state conduct, such as a dispute settlement procedure providing for a moratorium on war for three years if a settlement of disputes by means of negotiations proved impossible.[8)

With the establishment of international organizations in the 20th century, competences that historically had been considered essential to the sovereignty of a state were transferred from the states to the key international organizations.[9) The League of Nations, predecessor to the United Nations, is generally seen as the first attempt to establish such a universal international organization following the First World War, and the first international organization with the principal mission to maintain peace through limitation on the sovereignty of member states.[10) Its successor, the United Nations (UN), today a nearly universal international organization, has more or less effectively achieved the transfer of its member states' right to engage in legal war (l. jus ad bellum) to the UN.[11) The transfer of this right, which had historically been considered to be a core feature of sovereignty, marks a profound impact on the concept. For the first time since the emergence of the concept of sovereignty, UN member states accepted limitations on a core right by agreement. This development is often referred to by commentators as the beginning of a change that raises, at minimum, significant questions around the classical formulation that sovereignty is an absolute and unlimited concept.[12) Other restrictions on the absolute exercise of state power through universal human rights conventions and the establishment of international organizations, such as the World Trade Organization (WTO) and new legal orders such as the European Union (EU), have required modification of the classical proclamation that sovereignty is an absolute and unlimited concept where the freedom of a sovereign state can only be limited by its own resolve. This has today been substituted by the general acceptance of the binding force of international law.[13)

From the second half of the 20th century commentators have debated whether the increasing international obligations and interdependence of states have

5) *Shinoda, Hideaki*, Re-Examining Sovereignty: From Classical Theory to the Global Age, Palgrave Macmillan 2000, page 14.

6) *Perrez, Franz Xavier* (Fn. 2), page 40.

7) *Isenbaert, Mathieu,* EC Law and the Sovereignty of the Member States in Direct Taxation, IBFD 2008, pages 47-48.

8) Article 123 and 124 of the Treaty of Munster.

9) P*errez, Franz Xavier* (Fn. 2), page 57.

10) *Isenbaert, Mathieu* (Fn. 5), page 54-55.

11) *Hinsley, F.H., Sovereignty,* Cambridge University Press, 1986 (2nd ed.), page 230.

12) *Perrez, Franz Xavier* (Fn. 2), page 47.

13) *Perrez, Franz Xavier* (Fn. 2), page 59.

simply rendered the concept of sovereignty redundant or whether it has evolved to accommodate such increasing international obligations.[14] It has become clear that states can no longer be considered the sole wielders of ultimate authority, and it is also obvious that a variety of international organizations such as the WTO, OECD, and NATO and new affiliations such as the EU, MERCOSUR and NAFTA are putting significant pressure on the concept of unlimited sovereignty.[15] However, sovereignty of states is still an important starting point because all of these institutions are established by the agreement of sovereign states.

III. Sovereignty and taxation

From the early days of written history, there has been the notion that raising taxes is a right of recognized political authorities. Much of the early definition of the «state» has been about how far an authority could extend its reach on taxation. Sovereignty and taxation therefore are inextricably linked. An understanding of what is meant by «taxation» is necessary in order to address the relationship between sovereignty and the levying of taxes. For this purpose, tax may be defined as a compulsory levy, imposed by the state, for a public purpose.[16] It may be distinguished from a charge for a public service.[17] A service may be provided by the state or by private economic operators for remuneration, but only the state or its subdivisions may levy taxation without such consideration.

Sovereignty in the context of tax encompasses two connected but separate areas of law. Firstly, as a matter of national constitutional law, entitlement to levy taxes is typically reserved to the sovereign (the embodiment of the state), as an indication of that sovereignty. Tax forms part of the «hard core of public-authority prerogatives.»[18]

Secondly, the sovereignty of states is a basic element of public international law and a core concept in the modern international legal order. A key consequence of sovereignty as a matter of public international law is that a state (or its government) has exclusive jurisdiction over its territory. This, by implication, carries with it, an obligation on other states not to intervene in the area of exclusive jurisdiction. Part of that exclusive jurisdiction is the right to impose taxes. In *Finanzamt Köln* vs. *Schumacker*, Advocate General Léger ob-

[14] *Lauterpacht, E.,* Sovereignty – Myth or Reality, 79 International Affairs (1997), page 137; *Walker, N.,* «Late Sovereignty in the European Union,» in Relocating Sovereignty, *N. Walker* (ed.) Ashgate Publishing Ltd., 2006, page 6; *Isenbaert, Mathieu* (Fn. 5), page 60.

[15] *Isenbaert, Mathieu* (Fn. 5), pages 60-68.

[16] *Lee, N,* ed. Revenue Law: Principles and Practice, 32nd Ed, p 4.

[17] Case 63-74 *W. Cadsky SpA v Istituto nazionale per il Commercio Estero* [1975] ECR 281 (ECJ).

[18] *Ferrazzini* vs. Italy (no. 44759/98), European Court of Human Rights (Grand Chamber) at paragraph 29.

served that «direct taxation powers are *retained* by the member states.»[19] Thus, taxing power is inherent in the concept of sovereignty.

One consequence of this principle of exclusive territorial jurisdiction in the area of taxation is the «Revenue Rule» by which one state does not give effect to the tax laws of another.[20] Although a private international law issue, this doctrine derives from the notion of sovereignty, in that certain aspects of foreign public law are not given effect by domestic courts (i.e., territorial limitation). This rule may be viewed as a defense of the state's exclusive jurisdiction over its territory. The opposite, namely extra-territoriality, is more difficult in that its outer limits are less clear or settled. In the UK, for example, the territorial principle that legislation should not be interpreted as having extra-territorial effect unless the contrary is expressly enacted or plainly implied, is a rule of statutory construction.[21]

Sovereignty in the direct tax context reflects the territorial principle. Most tax systems impose liability either on a personal basis, where persons are within the territory of a state as residents, or by reference to some similar criterion, or because the source of the income, that is the originating cause of the income, is within the territory of a state.[22]

State sovereignty also carries with it the ability of a state to pursue a tax policy of its choice, unfettered by external influences.[23] Thus, a state may choose not to impose direct taxation, or to limit it to particular persons or to particular sources. By the same token, a state is also able to impose a broad and comprehensive tax if it so decides. By extension, the absolute character of sovereignty means that a state may impose tax liability on income from foreign sources owned by a foreign person. Controlled foreign companies (CFC) legislation is an example of this. As a commercial and legal matter, the profits of such companies are usually neither from a source nor owned by a person within the state seeking to tax the profits. A variety of legislative devices are used to impose the liability on the shareholders of such a company who are, themselves, within the state seeking to tax the profits. These might include treating the profits as those of the shareholder or deeming the profits to have been distributed.

The coexistence of different national tax systems means that disparities inevitably arise. This is not limited to CFC legislation, but will also arise around the rights to tax persons; for instance, between states that rely solely on incorporation (e.g., the United States) and states that have a management and control test for corporate residence. Similar source or nexus conflicts arise; for

[19] C-279/93 *Finanzamt Köln v Schumacker* Case [1995] ECR I-225 at paragraph 21.

[20] *Collins, L, et al.,* Dicey and Morris on the Conflict of Laws, 16th Ed, Vol 1, paragraph 5-027.

[21] *Agassi vs. Robinson* (*HM Inspector of Taxes*) [2006] UKHL 23 at paragraphs 16 and 21.

[22] See generally: International Fiscal Association, Source and residence: the new configuration of their principals Cahiers de Droit Fiscal International volume 90 A. (2005), General report.

[23] *McLure, C.E.* (*Jr.*), Globalization, tax rules and national sovereignty, Bulletin for International Fiscal Documentation (2000), p 328.

example, the position of India on fees for technical services performed outside India. Such disparities result, on the one hand, in either double or multiple taxation, or may, on the other, give rise to non-taxation. Traditionally the focus in international tax law of these disparities throughout the 20th century has been on resolving such conflicts between national tax systems. International tax law in this respect now refers to international and domestic tax provisions relating specifically to situations involving the territory of more than one state.[24)]

Public international law in the sphere of taxation is found in treaties that address taxation issues. In general they address the allocation of jurisdiction where states agree who will have taxing rights over which persons and over which items of income. There are various model treaties of which the OECD model and the UN model are likely to be the most used and well-known precedents. While treaties are clearly part of public international law, there is some academic debate about the status of the Commentary to the OECD Model Tax Convention[25)] and whether certain principles of taxation exist as a matter of customary international law binding on states.[26)] Either way, the 21st century international community of nations is made up of a large number of states that rely on a huge network of bilateral and multilateral treaties to establish agreed rules for taxing cross-border situations and for collaboration among tax administrations.

In the negotiation of tax treaties, sovereignty in principle also embraces the concept of equality of states, in that, in the relationship between states, all have a uniform legal personality to enter into legal relations.[27)] In economic and political reality, states are not all equal however. Unequal states coexist that are large and small, rich and poor, developed and undeveloped, resource endowed and resource deprived, democratic and undemocratic, and high tax and low tax. Special issues may also arise for dependent territories of former colonial powers, both where they have some independent domestic law-making power, particularly relating to tax, but where the state on which they are dependent has capacity in relation to external relations.

It is not only the factual inequality of states that erodes the principle of uniform legal personality. Today organs of international organizations, such as the OECD Committee on Fiscal Affairs and the United Nations Committee of Experts on International Cooperation in Tax Matters increasingly play a role in shaping international tax policy. These are not law-making institutions but exert considerable influence on tax law. All member countries in these taxation committees have an equal vote, the work product of the committees must naturally be

24) *Klaus Vogel,* Klaus Vogel on Double Taxation Conventions, 4th Ed, Introduction, paragraph 6.

25) See, e.g., *Douma, S and Englen F,* The Legal Status of the OECD Commentaries (IBFD) 2008.

26) See, e.g., *Avi-Jonah, R,* International Tax Law as International Law (Cambridge) 2007, who argues that there is a customary international tax law; *Schwarz, J,* Schwarz on Tax Treaties, 3rd Ed, Chapter 1, who argues that there is not.

27) *Brownlie, I,* Principles of Public International Law, 7th Ed, Chapter 6.

the result of compromise where the more powerful exert more influence. The international legal order established under the treaties constituting the EU, the WTO and others even go a step further in that, in these instances, states are sharing, and some would even say have transferred, their law-making authority.[28)]

Throughout the 20th century, the traditional focus of international tax law in resolving conflicts between national tax systems was on avoiding double taxation. The current 21st century focus, as reflected in the BEPS agenda, is on the disparities that give rise to non- or low taxation. Where states choose limited taxation or to grant incentives or other reliefs, state sovereignty is less impacted by measures to avoid double taxation than in the context of concerns relating to non- or low taxation. It is particularly in the latter case, that careful consideration needs to be given to the ability of states to choose a tax system appropriate to their own needs independently, if this involves lesser taxation than states that choose higher tax or more comprehensive tax bases considered appropriate to their needs.

IV. Sovereignty and the base erosion and profit shifting project

The OECD BEPS project proceeds on the basis that international tax law has not kept pace with developments such as the globalization of business, the advancements in technology, the changing business philosophies around operating models such a centralization of finance functions and regionalization of supply chains. The combination of these developments and the current international tax framework are judged to allow multinational companies to allocate profits away from where it is said those profits belong. Consequently, at the request of the G20, the OECD is aiming to provide countries with instruments, domestic and international, that better align national rights to tax with where real economic activity is regarded as taking place. The OECD Action Plan on BEPS aims to reform 15 areas of international tax law and practice.

The project is primarily driven by large, mostly industrialized, states with high tax regimes, even though there are a number of countries currently participating. The OECD Secretary General report to G20 finance ministers and central bank governors during their meeting in Istanbul, Turkey held in February 2015, stated that about 61 countries are actively participating in the G20 project.[29)] The OECD has undertaken various steps or initiatives to engage developing countries, and the UN Committee of Experts on International Coopera-

28) *Hernández Guerrero, V,* Defining the Balance between Free Competition and Tax Sovereignty in EC and WTO Law: The «due respect» to the General Tax System, German Law Journal Vol. 05 No. 01, p 87 (2004).

29) OECD (2015), OECD Secretary-General Report to G20 Finance Ministers, OECD Publishing, February 2015.
http://www.oecd.org/ctp/oecd-secretary-general-tax-report-g20-finance-ministers-february-2015.pdf

tion in Tax Matters has established a Subcommittee on Base Erosion and Profit Shifting Issues for Developing Countries.[30] The G20 countries that have initiated and sponsored the BEPS project account for about 85% of the gross world product, 75% of world trade and two thirds of world population. By contrast, the UN has 191 member countries, the majority of which fall outside this group and account for a very small percentage of gross world product. The UN Committee has not reported on the issue and its member countries do not yet have an agreed way forward.[31] The BEPS project outcomes will reflect policies influenced by the economic, social and political circumstances and objectives of its sponsors. The remaining countries may enjoy equality under international law, but are unlikely to be in a position to exert independent influence on the process. Perhaps this extends to some smaller OECD members,

Common adoption of the BEPS proposals is an objective of the project, and by all countries – whether part of G20, OECD or not – adjusting their domestic tax legislation or tax treaties in line with the recommendations given by the BEPS project outcomes, in order to ensure the uniform implementation of the new common international tax regime.

BEPS actions propose reform to domestic laws as well as to tax treaties. The extent to which smaller states may be deprived of independence in determining tax policy is best illustrated in Action 5, Countering Harmful Tax Practices More Effectively.[32] Consumption taxes are explicitly excluded from harmful tax competition but direct taxation is at its heart.[33] On this basis, states would not be free to choose to finance their programs by indirect taxes, but may feel compelled to adopt corporate income taxes of a kind that was not «low» in order to escape the «harmful» label, regardless of the economic circumstances of the particular state. Similarly, exempting foreign source income from residence country taxation is a factor in determining whether a preferential regime is potentially harmful.[34] Foreign business profits are frequently exempt and, particularly in the case of a state with little capital export activity and limited capacity to administer worldwide taxation could be precluded from appropriate policy choices. Thus, although tax forms part of the hard core of public author-

[30] United Nations Economic and Social Council, Report of the Secretary-General: Further strengthening the work of the Committee of Experts on International Cooperation in Tax Matters, 11 March 2015, at paragraph 15. http://www.un.org/esa/ffd/wp-content/uploads/2015/03/2015_Tax_SGR_SC_110315AUV.pdf

[31] Report of the Secretary-General: Further strengthening the work of the Committee of Experts on International Cooperation in Tax Matters (Fn. 28) at paragraph 30. http://www.un.org/esa/ffd/wp-content/uploads/2015/03/2015_Tax_SGR_SC_110315AUV.pdf

[32] OECD (2014), Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing. http://dx.doi.org/10.1787/9789264218970-en

[33] Countering Harmful Tax Practices More Effectively (Fn. 30), page 21.

[34] Countering Harmful Tax Practices More Effectively (Fn. 30), page 23 .

ity prerogatives[35] and the power to tax is an incident of sovereignty,[36] smaller countries may be compelled to adopt tax policies inimical to their own interests, but in the interests of preventing profits from shifting from high tax, advanced economies. Although the objectives of Action 5 and other BEPS anti-avoidance measures can be understood, there is a significant risk that they may cause small countries to have tax systems that are not appropriate to their needs. The careful balancing of these tensions does not seem to have received the attention it deserves.

The same concern about the ability of states to determine their own tax policies applies to CFC regimes. The OECD proposals[37] primarily view the problem from the perspective of the state of residence of shareholders in CFCs. This one-sided perspective is reinforced by their rejection of arguments that treaties, based on the OECD Model may prevent the application of CFC rules.[38] Recognizing this would respect the sovereignty of both states and provide the framework for agreement for the states concerned to agree the appropriate scope of CFC rules by negotiation between them, in light of their respective tax policies.

V. Conclusions and suggestions

The BEPS project presents a huge opportunity for governments and business alike to coordinate the taxation of international corporate activity. The project aims at building a new international tax regime, which involves framing rules for the division of the tax base and allocation of income among countries in which multinational enterprises (MNEs) operate[39]. If well executed, this would benefit everyone. However, it also presents a significant risk that it results in tax legislation that is not globally aligned, making the cure worse than the ailment, and potentially harmful to the global economy and global welfare. In order to succeed, it must allow all nations to exercise their legal sovereignty effectively, in a manner that serves their own national policies and interests, not just those of the main proponents of the project. Taxation is not an end in itself. Ultimately, social and economic prosperity and political stability of all nations should result. What could some of the ground rules for a well-executed BEPS project that respected national sovereignty be? The following may be a potential starting point for this discussion:

[35] *Ferrazzini vs. Italy* (no. 44759/98), European Court of Human Rights (Grand Chamber) at paragraph 29.

[36] *New Delhi Municipal commissioner vs. State of Punjab 7* SCC 339 Supreme Court of India.

[37] OECD, Public Discussion Draft BEPS Action 3: Strengthening CFC Rules ,12 May 2015.

[38] OECD (2014), Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, http://dx.doi.org/10.1787/9789264219120-en.

[39] *A.H Rosenweig,* Building a framework for post-BEPS world, Tax Notes International, 23 June, 2014.

1. The international tax system (and therefore the BEPS actions) should be conducive to global welfare and global trade.
2. A proper framework for division of income should reflect the economic diversity of all states.
3. Each country has the right to determine its own tax laws.
4. Countries should respect each other's tax law and policies, and the laws of other jurisdictions should not be cause for discrimination against them or their taxpayers[40].
5. Freely negotiated treaties should form the basis of an agreed international tax framework.

Whether all countries have the capacity or willingness to negotiate tax treaties is a question worth contemplating.

The same questions may be asked about states ensuring that tax treaty obligations are fully effective in domestic law. The introduction of tax measures inspired by BEPS into domestic law that have an impact on other states but operate outside the scope of tax treaties, will increase complexity and inhibit cross-border trade and investment. Further, whether the economic and social objectives of all the countries can be taken into consideration in a multilateral tax treaty needs to be addressed. Nonetheless, a solidly grounded, principle-based, multilateral tax instrument, where in particular the rights and needs of the smaller nations are protected[41] and their concerns are met,[42] could be of interest to all countries.[43]

[40] How far countries would be required to meet mutually agreed standards in order to command such respect, goes to the heart of the debate over national fiscal sovereignty and a coherent international tax system .

[41] Meet Europe's newest tax haven and micro-state (http://www.cnbc.com/id/102645422).

[42] And in effect according them the benefits that Rosenweig states that they would otherwise hold out for (Fn. 37).

[43] Global efforts against tax erosion can help India strengthen it tax treaties, Mint Report, 28 November 2014.