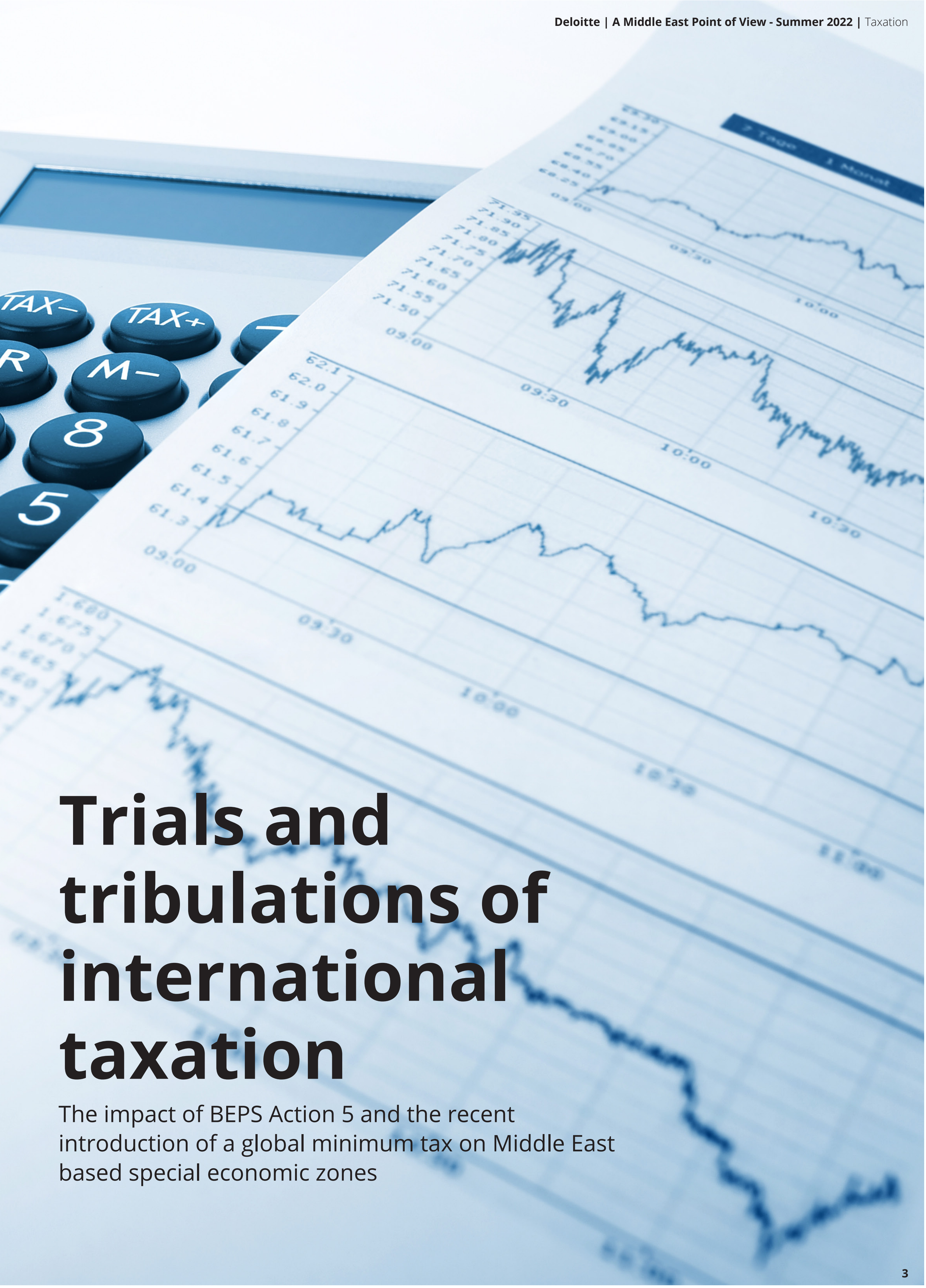

Trials and tribulations of international taxation

The impact of BEPS Action 5 and the recent introduction of a global minimum tax on Middle East based special economic zones

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Since international tax rules were written decades ago, there have been fundamental changes in the worldwide landscape due to globalization and digitalization of the modern economy. For this reason, it has been imperative for tax authorities and international organizations to address the issue of double taxation, profit shifting, and tax evasion. The international tax landscape has changed dramatically in recent years, so with the political support of G20 leaders, the international community has taken joint action to increase transparency and the exchange of information in tax matters, and address weaknesses of the international tax system that create opportunities for base erosion and profit shifting (BEPS).

As a brief background, following the 2008 financial crisis, G20 countries put tax at the top of their agenda and have conscientiously led the fight against tax evasion and avoidance ever since. BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no tax locations where there is little or no economic activity or erode tax bases through deductible payments, such as interest or royalties. On the same note, aggressive tax planning and enabling policies and practices of states have featured prominently on the agendas of international organizations, which have led to the Organization for Economic Co-operation and Development's (OECD's) initiative on Harmful Tax Competition, as well as to the establishment of the EU Code of Conduct on Business Taxation.

Both the OECD and EU have sought to establish standards to assess if the tax regime of a country can be considered as harmful in the sense that it may contribute to the erosion of other countries' tax bases. Most aggressive tax planning structures rely on low or no tax jurisdictions. For example, a company that invests in a subsidiary in another country can set up an intermediary financing company in a tax haven (typically without any significant business activities) to defer taxation on income from the investment. Many countries, including in the Middle East, offer low tax rates or tax exemptions for business conducted within special economic zones (SEZs), such as the Qatar Financial Center (QFC), Dubai International Financial Center (DIFC), Abu Dhabi Global Market (ADGM), etc. Hence, a company established in an SEZ can fulfill a similar function as a tax haven company in a multinational enterprise's (MNE's) tax structure. Thus, SEZs have also become the object of the OECD's and EU's initiatives for tackling aggressive tax planning.

The OECD's work on harmful tax practices was in its initial stages in 1998 and confined to its member states and tax haven jurisdictions during the 2000s. However, the scope of OECD's work significantly expanded with the endorsement of BEPS Action 5 as one of the four "minimum standards" in 2015 and the creation of BEPS Inclusive Framework (IF) in 2016. Almost all 130+ IF members have committed to complying with the BEPS minimum standards. The standard of BEPS Action 5 mandates that countries must not resort to "harmful tax practices" and establishes a review process of tax regimes.

Similarly, back in 2016, the EU Code of Conduct Group (COCG) began investigating the tax policies of non-EU countries against "good tax governance" standards, including tax transparency and fair taxation. Then, in 2017, the COCG received commitment from certain low-tax jurisdictions (2.2 jurisdictions) to introduce legal substance requirements to ensure that tax advantages were not granted to entities with no substantial economic presence. Subsequently, in December 2017, the EU Code of Conduct Group assessed the tax policies of offshore jurisdictions with no or only nominal tax (NOONs) against the criterion of economic substance. The criterion stated that a jurisdiction should not facilitate offshore structures or arrangements aimed at attracting profits which do not reflect real economic activity in the jurisdiction.

Impact of a global minimum tax on SEZs

Fast-forward to today, since the introduction of BEPS Action 5 and the EU Code of Conduct Group to address economic substance issues, there remains to be even greater challenges that SEZs must deal with. Unlike the BEPS project that addresses harmful tax competition, the proposed global minimal tax under Pillar 2 mandates all countries to require a minimum effective tax rate (ETR) of 15%. To the extent a country's ETR is less than 15%, there is the possibility that other jurisdictions can have taxing rights equivalent to that shortfall in the rate. In the long run, this can be a potential problem for countries that have SEZs that provide tax incentives and tax holidays. The concern is to what extent the minimum tax will result in less investment in developing countries, since companies carrying out investment in these countries may not get the benefit of a tax incentive anymore as the minimum tax has to be paid somehow regardless.

The use of SEZs has been historically promoted by countries not only to support the development of exports, foreign direct investment (FDI), and local employment, but also to promote investment and competitiveness in specific geographical areas. If the new global minimum tax of 15% comes into picture, and assuming all countries implement this rule, there will cease to be tax motivation for companies to shift their businesses from high tax rate jurisdictions to low tax rate jurisdictions or SEZs. As most of the 139 inclusive framework member countries have already endorsed the Pillar 2 proposal, countries with presence of heavy SEZ regimes have to properly coordinate and solve any fundamental tax policy differences between its tax authority and other SEZ administrative bodies.

While the mechanics of Pillar 2 are being worked out by the OECD and international tax community, it is currently unclear how to mitigate the impact of a global minimum tax on foreign direct investment (FDI), and how countries with heavy focus on SEZ regimes in the past can benefit and make amendments as a result of sweeping reform on the global tax landscape.

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