

IFA Cape Town 2024: Topic 1

“Finding the meaning of nexus for taxes – past, present and future”

Outline for Branch Reporters

Background: Nexus is a term commonly used in international law to determine whether there is sufficient connection between a person, property, or an activity with a State so that the State has jurisdiction to tax. Jurisdiction concerns both the law-making and law-enforcing power of the State. Jurisdiction as a legal limitation in tax matters means essentially whether a State is from an international law perspective allowed to impose and enforce taxes that are enacted as sovereign laws. The goal of the general report is to assess and analyse, based on the branch reports what nexus means in the context of the main tax obligations imposed in countries represented among the branch reports. The general reporters aim to establish whether the notion of nexus for tax has remained stable or changed (and if so, how) in a defined period (2002-2022), while also looking to the future based on current proposals and developments that may alter notions of nexus in tax. The branch reports will not deal extensively with nexus for the purpose of tax enforcement, but the question of enforcement will be relevant when reporters discuss the reasons why nexus (or a proxy) has been drafted in specific ways in their national tax laws.

Leading principle: The branch reporters should answer the question of what factors trigger taxation from a domestic tax law perspective and provide background and context to the initial development, evolution, and reform of these factors. Moreover, from an international law perspective, it is important to understand that a State has jurisdiction only with respect to specific State action. Therefore, ownership of real estate might provide a sufficient connection (i.e. nexus) but only in order to create a limited tax liability; citizenship on the other hand might be a nexus sufficient to create unlimited tax liability. As a consequence, branch reporters are asked to always focus on the extent to which nexus justifies taxation. Branch reporters will be asked to refrain from outlining the main allocation principles in international tax law considering the OECD MTC, the UN MTC, or their national double tax treaty network. Therefore, branch reporters are explicitly asked to refer to domestic law only (with very few exceptions) and not to focus on taxation after applying double tax treaties.

Basic elements of the reports: It is our understanding that the reports should be organized by focusing on different taxes. The reason for this basic organization of the assessment phase of the project is to allow both branch and general reporters to highlight discrepancies and communalities among the represented jurisdictions but potentially also among the various taxes. Comparisons of this nature are underdeveloped. The current broad debate about what may be sufficient nexus to trigger corporate income tax does not refer to other taxes nor to questions such as whether proposals for a new nexus is in line with broader questions of jurisdiction in international law, the rule of law, universal human rights and consequently is at risk of incoherence. The branch and general reports will not assess all these areas that are lacking, but aims to lay the groundwork for further assessment based on a wider and deeper understanding of nexus in the overall architecture of national tax systems represented by the branch reports.

In order to develop a comprehensive understanding of the issue of defining nexus for the purpose of taxation, it is key that the branch reporters also outline the rationale behind defining a nexus in a certain manner in national legislation. National legislation often uses proxies that represent nexus. The task is to assess the background, context, developments, and recent actual or potential reform of legal proxies used to establish nexus in tax. As an example, the rationale for source-based income taxation of passive income (e.g. flat rate withholding tax on dividends or interest) historically included, among others, a lack of enforcement

capacity over foreign persons. These reasons could range from a lack of information about the identity of foreign recipients, or difficulty to assess the legitimacy of their expenses related to the earning of income, to reducing possibilities for tax avoidance or evasion. The same reasons have not been suggested as valid for taxing the earning of active income by foreign persons. In theory, the rapid expansion of legal infrastructure, both at the national and international level, for the gathering and sharing of taxpayer information, as well as the digitization of tax administration and enforcement may evidently impact the nexus rationale for such a form of taxation. Moreover, in the current debate of redefining the corporate income tax nexus, other goals such as achieving taxation in line with value creation have been suggested. The branch and general reporters will assess whether these developments have been integrated or not in the evolution of nexus in national tax systems in the defined period. The reports should be structured in the following manner:

I. Introduction

II. Current tax system

a. Income taxation (incl. corporate income taxation)

The reports should include as a minimum a description of (i) what triggers income taxation for non-residents (source tax nexus) and (ii) what nexus triggers income taxation as a resident (residence tax nexus). Therefore, this is in line with the main rationale of the general report, i.e. to outline what triggers taxation and to what extent a specific nexus justifies taxation.

The chapter should include reference to taxes or alternate collection mechanisms that replace the traditional (corporate) income tax for foreign taxpayers. Therefore, branch reporters will be asked to refer to the nexus for a variety of (likely) source taxes such as taxes on:

- Dividends
- Interest
- Royalties and related services (e.g. provision of know how or show how)
- Pensions
- Employment income (incl. director fees)
- Independent personal services income
- Active business income (i.e. permanent establishment, significant economic presence, fees for technical services, consulting or management fees, etc.)
- Capital gains

We are specifically not using the income categories in the OECD MTC or the UN MTC because branch reporters should be as comprehensive as possible about how the structure of their own national tax system is arranged in regard to nexus. The focus should not be on income which falls under one of the categories in the OECD MTC or the UN MTC.

It is vital that the branch reporters explain in detail what nexus means with respect to these different kinds of income and include a discussion of the underlying rationale. For instance, the legal rule used to establish nexus for triggering a source tax on interest might refer to the payor's residence but it could be that the rationale for nexus is to locate whether the funds were actually used or applied for financing activities in the territory of the State levying source taxes. In such a case, the payor's residence acts as a proxy for nexus because the true rationale is to locate the place where capital is employed (the assumption via the proxy being the debtor resides where the capital was employed). Equally, when considering the rationale for the nexus over taxing employment income, domestic income tax law may refer to the place where the employment

service is actually rendered. Such a rule too can be a proxy, as the underlying rationale could be to establish the place where labour (a form of capital) was employed.

b. VAT (or GST)

VAT systems aim in general at taxing domestic consumption. Therefore, branch reporters will be asked to outline what the actual nexus is for triggering VAT. The question about the meaning of domestic consumption is in particular acute for non-physical supplies such as services. Is it sufficient if the formal recipient of the invoice is a domestic person or is the nexus defined in a more substantive manner? If a jurisdiction adopts a substantive approach, what is the definition of domestic consumption as a nexus? Importantly, the goal is not to provide details on who the taxpayer is (i.e. the recipient or the foreign supplier) or on the VAT system in general but only to outline the nexus for assuming domestic consumption triggering VAT. Again, the rationale including background and context for defining nexus in a certain manner should be highlighted as well.

We are aware that several VAT systems would have seen significant reforms in recent years to address digitized economic activity. Often these reforms may have been driven by avoidance or enforcement concerns, such as to ensure that foreign suppliers register and/or account for VAT. Questions of VAT enforcement or avoidance are not the primary concern of the study, but branch reporters may comment to the extent that such matters may impact on or illustrate the notion of domestic consumption and nexus for VAT.

c. Real estate taxes

This section should focus on how real estate taxes (or taxes on immovable property) define nexus. This might be a surprising task for some as the location within a territory of real estate per se seems to be “the” nexus. In actual fact, real estate transfer taxes or real estate capital gains taxes may, for instance, be triggered by factors which have *prima facie* no relation to the location of the real estate. This is in particular true with respect to a transfer by, to or between non-residents of the economic ownership in real estate. Branch reporters should outline the nexus which is required and, for instance, what transfer of economic ownership means. Is it sufficient if an indirect transfer of ownership occurs? Even beyond, States apply other taxes with reference to real estate. For instance, some countries apply specific taxes if a loan between two foreign parties is secured by domestic real estate. Therefore, branch reporters shall outline if the location of real estate is used as a nexus for other taxes as well.

d. Natural resources taxation

Natural resources may raise special issues about nexus for tax. Similar to real estate, the assumption may be that the place of extraction will always be used to establish nexus, but the reality is that there are variations in national taxes. Taxes that are specific to natural resources may refer to the place of production, or to the location where (refined) natural resource are transferred. These connecting factors may justify a limited extent of natural resource taxation. Branch reports should comment on these special considerations for nexus and natural resources to the extent relevant for their jurisdictions.

e. Other (indirect) taxes

With respect to significant taxes other than those specifically addressed above, branch reporters will be asked to outline how these taxes define nexus and to what extent the nexus justifies taxation. The following taxes should be in the focus and moreover branch reporters will be asked to refer to other taxes if interesting conclusions can be drawn for purpose of the general report:

- Financial transfer taxes
- Stamp duties
- Digital services taxes

III. Compatibility with international law

The branch reports should outline whether there is any debate in their jurisdiction about whether their various definitions and/or proxy rules to establish nexus for tax is in line with international law obligations (except for double tax treaty obligations). This could be particularly relevant for new types of national taxes on digitized economic activity. The main question concerns the 'genuine link' doctrine. In terms of this doctrine, a sufficient connection or link (i.e. nexus) must exist between a taxpayer, property or an activity and a State in order for that State's tax jurisdiction to be legitimate in the eyes of international law. What are the arguments against and in favor of the conclusion that a certain nexus is justified or not?

IV. Outlook and current policy debates

This section shall include an outline of the current discussions on how to redesign the nexus for any of the taxes covered by the branch report. Such outlook should of course include reference to relevant aspects of the most recent international policy projects. Therefore, branch reporters will discuss how their country will implement the most recent proposals of the OECD with respect to Pillar 1, in particular the proposed sourcing rules. The reports should not contain a broad or general discussion on the topic. Rather the focus is on how nexus may be defined, how easy or challenging may implementation be in national tax regimes. For branch reports affected by regional bodies such as the European Union or African Tax Administrations Forum, reporters should comment whether there is any difference, as regards nexus, between the proposals of the OECD/Inclusive Framework and proposals emanating from these regional bodies (e.g. such as in respect of unilateral taxes on digital economic activity). Moreover, in such last chapter, branch reporter shall briefly discuss whether and how the most recent debate has impacted the tax treaty policy of their country. For example, whether the most recent tax treaties signed contain provisions that incorporate new ideas about nexus to justify source taxes (be it a clause similar to Art. 12B UN MTC or a new Article in relation to Pillar 1).

Branch Reports: The present outline shows that branch reporters should be experienced professionals (practitioners or academics) who have a solid understanding of their entire tax system. It is important that branch reporters are able to outline their results in a concise format and they are able to refer and assess the most recent policy developments. Moreover, we expect that branch reporter will need to refer to historical documents for answering some of the questions.

The General Reporters plan to convene virtual meetings with branch reporters over the period allocated for drafting reports (March to October 2023) to assist with questions, to discuss preliminary findings or to address concerns. Further details will be communicated in due course.

Conclusion: We thank IFA branches for their willingness to participate in this project and look forward to fruitful and meaningful collaboration.

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