University of Michigan Law School
University of Michigan Law School Scholarship Repository

Other Publications Faculty Scholarship

2021

The New International Tax Framework: Evolution or Revolution?

Reuven S. Avi-Yonah

Available at: https://repository.law.umich.edu/other/220

Follow this and additional works at: https://repository.law.umich.edu/other

Part of the Tax Law Commons

insights

Volume: 25 Issue: 11

By: **Reuven S. Avi-Yonah**

July 7, 2021

The New International Tax Framework: Evolution or Revolution?

Introduction

On July 1, 2021, 130 countries signed on to a new framework for reforming international corporate taxation.[1] This outcome, which still needs to be finalized and implemented in national legislation, represents the culmination of over a decade of attempts to bring the 100-year old international tax regime into the 21st century. This *Insight* will explain the background to the new framework and assess its prospects for success.

The past decade has witnessed the beginning of a revolution in international taxation that is as decisive a break from the past as the formation of the international tax regime a century ago. In the wake of the financial crisis of 2008-2010, countries that had been content to live with rules developed in the 1920s and 1930s (even though these rules drastically constrained their ability to tax 21st century multinationals) decided that the rules must be changed. Under political pressure, the twenty largest economies in the world, the G20, requested the Organization for Economic Cooperation and Development (OECD), the unofficial "world tax organization," to begin redrafting the ground rules of international taxation. The result was the first Base Erosion and Profit Shifting (BEPS) project, which from 2013 to 2015 advanced fifteen actions designed to counter multinationals' ability to engage in BEPS.[2] In 2015, OECD Secretary General Angel Gurria declared that—

> The measures we are presenting today represent the most fundamental changes to international tax rules in almost a century: they will put an end to double non-taxation, facilitate a better alignment of taxation with economic activity and value creation, and when fully implemented, these measures will render BEPS-inspired tax planning structures ineffective.[3]

This declaration was over-optimistic: The G20 and OECD failed to reach a consensus on a number of issues. Most prominently, there was no consensus on Action 1, how to address the digital economy. While France and other EU countries were pushing for more source-based taxation of profits from the digital economy which could not be taxed at source (where the income is generated) under existing rules because there was no "permanent establishment" (PE) in the source jurisdiction, the United States (U.S.) resisted any attempt to impose tax on Big Tech (Amazon, Apple, Facebook, Google, and Netflix).

In the absence of consensus in the OECD, countries started to adopt unilateral measures. The pioneer was the United Kingdom (UK), which in 2015 adopted a "Diverted Profits Tax" (DPT) which taxed Big Tech on the profits of the "avoided PE" they would have had if the rules were different. The UK was followed by Australia's "Netflix tax" and India, which adopted the first "Digital Services Tax" (DST), a tax on the provision of digital services as well as the use of local consumer data to sell targeted advertising (thus applying to Amazon's, Facebook's and Google's business models). France then adopted its own DST, which was followed by 30 other jurisdictions as well as a proposed EU-wide DST.[4]

The U.S. responded by adopting trade sanctions on France (currently suspended pending OECD negotiations) and threatening to do the same to other jurisdictions. Meanwhile, the U.S. enacted the Tax Cuts and Jobs Act (TCJA) in 2017, which for the first time imposed current taxation at a reduced rate on the profits of all U.S. multinationals from "global intangible low-taxed income" (GILTI).

The G20 and the OECD responded to these developments in 2018 by beginning work on BEPS 2.0, which has two pillars. Pillar One seeks to address the digital economy directly, while Pillar Two addresses it indirectly.

Pillar One has two components: amount A, which would allocate a portion of a multinational enterprise's (MNE) deemed residual profits to jurisdictions where they operate in proportion to the benefit they derive from these different markets (fractional apportionment); and amount B, which would standardize a fixed return for routine marketing and distribution activities taking place physically in a market jurisdiction. It is still a work-in-progress, but what transpires are far-reaching changes to the international tax regime, primarily by partially abandoning the arm's length principle (ALP) and the permanent establishment threshold (PE) in order to provide more taxing rights to market jurisdictions. Neither of these changes are driven by the U.S., and it remains to be seen whether they will succeed in averting the widespread adoption of DSTs.

Pillar Two, on the other hand, is a direct extension of the U.S. approach in the TCJA. It envisages the implementation of a global anti-base-erosion tax (GloBE) to be levied on MNEs regardless of the jurisdiction where they are headquartered or operating. The GloBE proposal builds on the TCJA's GILTI and Base Erosion Anti-Abuse Tax (BEAT) in implementing the single tax principle by: (a) requiring residence taxation at a minimum rate if the source country does not impose tax and (b) denying deductions at source if the residence country does not tax. Specifically Pillar Two consists of the income inclusion rule (IIR) and the undertaxed payment rule (UTPR), which would operate together to tax MNEs at an agreed minimum tax rate. These two rules are supplemented with a switch-over rule (SOR) that would remove any treaty obstacles, and the subject-to-tax rule (STTR) that would permit taxing outbound payments to affiliates in low tax jurisdictions.

Both Pillar Two proposals represent an improvement over the TCJA. The residence-based proposal is an improvement over GILTI if it denies cross-crediting, which fosters tax competition between jurisdictions. The source-based proposal is an improvement over BEAT because it explicitly links the denial of deductions to whether the income is taxed at residence, which the BEAT does not do.

The July 2021 statement provides crucial details about the implementation of both pillars, which as noted above now have the support of 130 jurisdictions, including the G20, but not some of the smaller countries in the Inclusive Framework, such as Ireland and Hungary.

On Pillar One, the July 2021 statement defines the scope of application as limited to MNEs with global turnover above 20 billion euros and profitability above 10 percent (i.e., profit before tax/revenue). Extractives and Regulated Financial Services are excluded. For these MNEs, there will be a new special purpose nexus rule permitting allocation of Amount A to a market jurisdiction when the company derives at least 1 million euros in revenue from that jurisdiction. Revenue will be sourced to the end market jurisdictions where goods or services are used or consumed. The relevant measure of profit or loss of the in-scope MNE will be determined by reference to financial accounting income. The statement calls for "appropriate coordination between the application of the new international tax rules and the removal of all Digital Service Taxes and other relevant similar measures on all companies." The agreement will be implemented through a multilateral instrument coming into effect in 2023.

On Pillar Two, the GloBE rules will apply to MNEs that meet the 750 million euros threshold as determined under BEPS Action 13 (country by country reporting). The GloBE

rules will operate to impose a top-up tax using an effective tax rate test that is calculated on a jurisdictional basis and that uses a common definition of covered taxes and a tax base determined by reference to financial accounting income. The minimum tax rate will be at least 15%.[5] Pillar Two is likewise supposed to be implemented by 2023.

It is doubtful that the Pillar One proposal will succeed as the July statement envisages because countries are unlikely to give up on an established tax instrument. DSTs are gross-based taxes imposed at relatively low rates on the provision of digital services, regardless of whether they are provided for free (like Google and Facebook) or for payment (like Amazon and Netflix). In this author's opinion, the critique that DSTs are discriminatory towards U.S. Big Tech is baseless, or perhaps even ironic. U.S. Big Tech dominates the world market in digital services; if and when an Alibaba or a Tencent become truly global providers, they too would be subject to the same DST. Further, the allegation that DSTs are passed on to consumers varies from case to case; even if it were true in a particular case, it would be akin to a VAT, which is already prevalent in most parts of the world. Finally, DSTs cannot be dismissed solely because they are unilateral; after all, sovereign countries cannot be prevented from imposing taxes on income that they sincerely believe has been derived from their jurisdiction. Also, the unilateral move is not contrary to the "first bite at the apple" rule of international taxation, whereby source countries have primacy in taxation because source comes before residence in time. In fact, the U.S. has carried out unilateral moves for decades, without seeking or awaiting consent from any other country (for example, foreign tax credits, controlled foreign corporations, denying treaty benefits to hybrid entities, etc.). To demonize DSTs simply because they are "unilateral" (and enacted without the consent of the U.S.) is unjustified. If the use of DSTs becomes more widespread, perhaps the U.S. ought to consider providing foreign tax credits to prevent double taxation.

The Pillar Two proposal is quite complex and possibly flawed since it accords primacy to the country of residence, inasmuch as the source country's tax will only be applicable if the residence country chooses not to tax. Perhaps the proposal could be tweaked in order to ensure that countries can tax MNEs on both inbound and outbound investments. This can possibly be done by: 1) applying a substance-based test (fractional apportionment) for allocating profits that have not been effectively taxed amongst all countries in which an MNE has a taxable presence, and 2) allowing each country to impose tax on such profits according to their own respective tax rates. Such an alternative would not require the application of the complex IIR and UTPR, but would instead rely on fractional apportionment based on assets, personnel, and sales revenue (by locations of customers/users). Whilst the GloBE imposes a top-up tax only in the country of residence,

this alternative would allow all affected countries to impose tax based on their respective shares of the undertaxed profits.

Overall, however, the entire framework represents a remarkable step forward in implementing an international tax regime fit for the 21st century. Pillar One eliminates for Amount A the obsolete PE requirement as well as the unworkable arm's length standard for transfer pricing, and finally recognizes the crucial role of market jurisdictions in generating income. All of these are decisive breaks from the past, which have been suggested for 25 years but until now have gained little traction.[6] Pillar Two is an implementation of the Single Tax Principle, i.e., that corporate profits should be subject to a minimum tax, and that if the country with the primary right to tax such income (source or residence) does not impose tax at the minimum level the other country involved should tax it.[7]

Pillars One and Two together represent a revolution in international taxation. However, they both build on the past. In fact, the Single Tax Principle can be traced back to the origins of the international tax regime in the early 20th century. Thus, the new framework, like most historical developments, encompasses both revolution and evolution.

About the Author: Reuven Avi-Yonah is the Irwin I. Cohn Professor of Law and director of the International Tax LLM program at the University of Michigan. He is the author of numerous books and articles on international taxation.

---

[1] OECD/G20 Base Erosion and Profit Shifting Project, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy (July 1, 2021), https://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.

[2] BEPS refers to a variety of tax planning strategies designed to decrease or eliminate corporate entities' tax liability by exploiting the gaps and differences between tax regimes in different jurisdictions. For example, manipulating their accounting practices to redirect profits to low tax jurisdiction.

[3] "OECD presents outputs of OECD/G20 BEPS Project for discussion at G20 Finance Ministers meeting" (May 5, 2015), https://www.oecd.org/tax/oecd-presents-outputs-of-oecd-g20-beps-project-for-discussion-at-g20-finance-ministers-meeting.htm.

[4] DST Global Tax Tracker, https://www.avalara.com/us/en/index-b.html.

[5] This rate will be used for purposes of the IIR and UTPR. The GloBE rules will provide for a formulaic substance carve-out that will exclude an amount of income that is at least 5% of the carrying value of tangible assets and payroll.

[6] *See, e.g.*, Reuven Avi-Yonah, *International Taxation of Electronic Commerce,* 52 TAX L. REV. 507 (1997).

[7] *See, e.g.*, Reuven Avi-Yonah, *Who Invented the Single Tax Principle? An Essay on the History of US Treaty Policy*, 59 NYLS L. REV. 305 (2015).