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International Tax Law- Status Quo, Trends and Perspectives

Reuven Avi-Yonah[1]

1. Introduction: Why Tax Cross Border Income?

In 1992, the Stanford economist and former government official Charles McLure published a visionary paper on the future of taxation in the 21st century.[2] McLure envisaged a future in which all of governments' revenue needs would be fulfilled by VATs and by other consumption-based taxes. In such a world, McLure argued, the international tax regime could simply disappear: All taxation would be on a destination basis, and there would be no need for tax treaties or for the imposition of taxes on extraterritorial income. Moreover, since the consumer base is relatively immobile, there would be no tax competition, and each country could set its consumption tax rate independently of what other countries do.

If the only goal of taxation was revenue raising for the provision of public goods, McLure's vision would be appealing. But taxation has two other goals, which cannot be satisfied by taxing only consumption. Beyond revenue raising, the second goal of taxation is (re) distribution of resources from the rich to the poor, in order to achieve a more equal allocation of resources than a capitalist system typically produces if left unchecked. Consumption taxes are regressive and cannot easily achieve distributive goals. The personal income tax (PIT) is widely acknowledged as the best tax to achieve progressivity.[3]

The third goal of taxation is regulation. Taxes are frequently used to regulate market actors, and in many cases such regulation through taxation is more effective than direct command and control regulation or other types of market-based incentives (e.g., carbon taxes vs. cap and trade vs. direct regulation of emissions).[4] The most important regulatory tax is the corporate income tax (CIT), since corporations are the most important actors in the market. In addition, the corporate tax is a backstop for the progressivity of the personal income tax.[5]

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[1] Irwin I. Cohn Professor of Law, the University of Michigan. I would like to thank Kim Clausing for her very helpful comments.

[2] McLure, C.E. Jr., Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm, National Tax Journal (45) 1992, pp. 145-154.

[3] Avi-Yonah, *The Three Goals of Taxation*, 60 Tax L. Rev. 1 (2007).

[4] Avi-Yonah and Uhlmann, *Combating Global Climate Change: Why a Carbon Tax Is a Better Response to Global Warming than Cap and Trade*, 28 Stan. Envir. L. J. 3 (2009),

[5] Avi-Yonah, *Corporations, Society and the State: A Defense of the Corporate Tax*, 90 Va. L. Rev. 1193 (2004).

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If one assumes that countries in the 21st century will continue to rely on all three types of tax (consumption tax, PIT and CIT), then it becomes clear why cross-border income flows must be subject to tax. If foreign source income of individuals is untaxed, then the rich could defeat the progressivity goals of PIT by moving their income offshore (since they typically have more mobile types of income than the non-rich). And if foreign source income of corporations is untaxed, multinationals could defeat the regulatory and progressivity goals of CIT by moving their income offshore.

For these reasons, McLure's vision of a simple world with no income taxation must be rejected, and we must continue to work to improve the international tax regime (ITR).

2. The Single Tax Principle as the Goal of the ITR

The ITR is based on two principles: The Benefits Principle and the Single Tax Principle. The Benefits Principle was the compromise reached by the four economists in 1923 between the claims of residence and source jurisdictions. It gives the primary right to tax passive (investment) income to residence jurisdictions, and the primary right to tax active (business) income to source jurisdictions. The logic of the Benefits Principle is that most investment income is earned by individuals while most business income is earned by corporations, and the residence of individuals is determinable and meaningful in ways that corporate residence is not.[6]

The Single Tax Principle (STP) can be traced back to the adoption of the foreign tax credit by the US in 1918 and to the 1927 model tax treaty developed by the League of Nations Committee of Technical Experts.[7] The STP is a work in progress: Unlike the Benefits Principle, it is controversial and has not yet been fully realized, although as I will argue below it underlies the OECD BEPS project. The STP states that all cross-border income should be subject to the rate of tax determined by the Benefits Principle, which is the residence country rate for passive income (i.e., the PIT rate) and the average large source country rate for active income (i.e., the average G20 CIT rate, currently about 25%). The STP means that if the jurisdiction allocated the primary taxing right under the Benefits Principle does not impose an adequate level of tax on cross-border income, the other jurisdiction (source for passive income and residence for active income) should collect the tax up to the rate dictated by the Benefits Principle.

One could argue that until the 1980s, the ITR functioned reasonably well because there was not a lot of cross-border individual investment and therefore residence countries could collect PIT, and there was not a lot of tax competition so source countries could collect CIT. Both of those prongs of the ITR were undermined by globalization, the relaxation of exchange controls, and the increasing intangibility and mobility of active

[6] Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 Texas L. Rev. 1301 (1996).
[7] Avi-Yonah, *International Taxation of Electronic Commerce,* 52 Tax L. Rev. 507 (1997); Avi-Yonah, *Who Invented the Single Tax Principle? An Essay on the History of US Treaty Policy*, 59 NYLS L Rev 305 (2015).

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income, culminating in the digitalization of the global economy from 1995 on.[8] As a result, by the time the financial crisis of 2008-9 hit the global economy, PIT and CIT revenues were significantly undermined by tax evasion (as revealed for example by the Panama and Paradise Papers) and avoidance (e.g., the trillions in low-taxed income accumulated offshore by US-based multinationals).

This chapter will argue that developments in the past decade have significantly bolstered the ITR, so that it does a much better job in protecting PIT and CIT from erosion due to cross-border tax evasion and avoidance than it did before 2010. Specifically, the adoption of FATCA and the consequent development of Automatic Exchange of Information (AEI) and the Common Reporting Standard (CRS) have significantly protected PIT, while the OECD BEPS project has significantly improved CIT, especially if the current BEPS 2.0 effort is successfully concluded.

3. FATCA and the AEI Regime

Before 2010, cross-border flows of passive income were generally not subject to tax either at source or at residence. From a source tax perspective, globalization and the consequent decline in withholding taxes meant that it was possible to avoid withholding taxes not just on interest (because of unilateral abolition), royalties (because of the treaties) and capital gains (because of the source rules), but also on portfolio dividends because of the rise of derivatives, which enabled portfolio investors to receive the economic equivalent of the dividend without being subject to withholding taxes. In addition, it became clear that limits on the exchange of information such as bank secrecy, dual criminality, and the requirement that information only be exchanged on request meant that in most cases residence jurisdictions could not effectively tax foreign source portfolio income (earned primarily by the rich). In 2005, Joe Guttentag and I estimated that the US was losing $50 billion a year to such tax evasion, and that most other countries were in worse shape because the shadow economy was larger.[9]

The financial crisis of 2008-9 and the Great Recession that followed led to millions losing their jobs and their homes, and frequently their families as well. Moreover, in Europe the governments reacted to the pressure on the Eurozone by imposing austerity and sharply cutting the social safety net. While the Obama Administration made no such cuts, and the Affordable Care Act was a meaningful move toward bolstering the safety

[8] Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 Harv. L. Rev. 1573 (2000).

[9] Avi-Yonah, "Closing the International Tax Gap," in Max B. Sawicky (ed.), Bridging the Tax Gap: Addressing the Crisis in Federal Tax Administration (2005), 99 (with J. Guttentag). For more recent estimates see https://gabriel-zucman.eu/files/Zucman2013QJE.pdf and https://www.amazon.com/Hidden-Wealth-Nations-Scourge-Havens/dp/022624542X.

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net, the size of the US fiscal stimulus was too limited, and while the banks were saved millions of Americans suffered a decade of low growth and unemployment.[10]

The political reaction on both sides of the Atlantic was dramatic. It led directly to Brexit, the election of Donald Trump in the US and of other right-wing populists in the EU, and the prospect of serious limits to globalization in the form of immigration restrictions, tariffs, and the re-enactment of exchange controls.[11] The nation state was reasserting itself, and one of the instruments it used was taxation.[12] In the US the focus on taxation was limited to the first couple of years after the crisis, since the Republican takeover of the House in 2010 meant that no tax measures could be enacted before 2017. But in Europe austerity meant a continued political focus on taxing both the rich and MNEs. In the US, the "Double Irish Dutch Sandwich" was once described in detail in 2010 on the NBC Evening News, but the topic faded thereafter. In Europe, taxes became front-page matter for the whole period after 2008, and this political attention is still ongoing.

The result has been a series of developments that led to a significant enhancement in the ability of the ITR to capture cross-border income.

On the passive income front, a key development was the UBS scandal of 2006-8, which led directly to the enactment of FATCA in 2010. The UBS hearing before the US Senate Permanent Subcommittee on Investigations revealed that UBS sent bankers directly to the US to solicit rich individuals to set up shell companies in the Caymans and then reinvest the money through UBS into the US. UBS claimed that even though it was a "qualified intermediary" (QI) and knew who the real owner of the shells was, it was justified under the QI regulations in relying on a form that stated that the owner of the income was the Caymans shell and that it was foreign.[13]

The result was the enactment of the Foreign Account Tax Compliance Act (FATCA) in 2010, which imposes a 30% withholding tax on the US income of any foreign financial institution (FFI) that knows or has reason to know it holds accounts of US residents or citizens and does not reveal such information to the IRS. Because FFIs are frequently prohibited from directly revealing financial information to the IRS, the Obama Administration negotiated over 100 intergovernmental agreements (IGAs) that enable

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[10] Avi-Yonah, *Be Careful What You Wish For: Reducing Inequality in the 21st Century*, 116 Mich.L. Rev. 1001 (2018) (with O. Avi-Yonah).
[11] See Kim Clausing, Open: The Progressive Case for Free Trade, Immigration, and Global Capital (2019).
[12] "The current political priorities in international taxation highlight the need for ensuring that tax is paid where profits and value are generated. It is thus imperative to restore trust in the fairness of tax systems and allow governments to effectively exercise their tax sovereignty." COUNCIL DIRECTIVE (EU) 2016/1164 of 12 July 2016 (ATAD).
[13] Avi-Yonah, Testimony on Banking Secrecy Practices and Wealthy American Taxpayers, US House Committee on Ways and Means, Subcommittee on Select Revenue Measures (March 31, 2009); Avi-Yonah, Testimony for Hearing on Offshore Tax Evasion, U.S. Senate Finance Committee (May 3, 2007); Avi-Yonah, Testimony for Hearing on Offshore Transactions, U.S. Senate Permanent Subcommittee on Investigations (Aug. 1, 2006).

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the FFI to turn over the information to its own government, which then exchanges it with the IRS under tax treaties and tax information exchange agreements (TIEAs). Many of the IGAs are reciprocal, so that the US is also obligated (at least on paper) to exchange information about foreign residents.

The IGAs in turn made countries develop a Common Reporting Standard (CRS) for the automatic exchange of financial information, and the OECD then negotiated a Multilateral Agreement on Administrative Cooperation in Tax Matters (MAATM), which relies on the CRS to provide for automatic exchange of information (AEI) without the ability to rely on bank secrecy or dual criminality provisions. Most countries in the world, and all OECD members except the US have ratified the MAATM.[14]

The result has been that it is much more difficult to evade income taxation now than it was ten years ago. A potential evader has to worry that in almost every country information about her income may be collected and transmitted to her residence jurisdiction. In addition, she has to worry that the information may either be leaked by a whistleblower (as in the Panama Papers) or hacked (as in the Paradise Papers). I would estimate that FATCA alone has led to a significant decrease in the international tax gap in the US, well below my $50 billion estimate from 2005. Moreover, Thomas Rixen and his colleagues have shown that the average tax rate on dividends in OECD countries is 4.5 percentage points higher in 2017 than it would have been absent CRS and MAATM.[15] This suggests that cooperation in this area has achieved its desired results.

4. BEPS 1.0

Following FATCA, the next major development in international taxation was BEPS 1.0, from 2013 to 2015. While the US participated in BEPS 1.0, it was not the leader, ceding this role to the EU. The main reason was that the Great Recession was more severe in the EU than in the US and the austerity policies adopted by EU government led to public pressure on politicians to ensure than MNEs pay adequate tax. No such public pressure developed in the US despite similar Congressional hearings (compare, e.g., the Starbucks case in the UK to the Apple hearing in the US Senate- Starbucks was condemned for legally reducing its UK tax while Apple was celebrated for doing the same in the US). Nevertheless, it is clear that the US position influenced the outcomes of

[14] Avi-Yonah, *And Yet It Moves: Taxation and Labor Mobility in the Twenty-First Century*, 67 Tax L. Rev. 169 (2014); Avi-Yonah, *IGAs vs. MAATM: Has Tax Bilateralism Outlived Its Usefulness?* 66 CCH Global Tax Weekly 11 (Feb. 13, 2014) (with G. Savir).

[15] *Leo Ahrens, Fabio Bothner, Lukas Hakelberg, Thomas Rixen,* Capital Taxation and International Cooperation: The Causes and Consequences of Automatic Exchange of Information (Working paper, 2020); Lukas Hakelberg and Thomas Rixen, Is neoliberalism still spreading? The impact of international cooperation on capital taxation, REVIEW OF INTERNATIONAL POLITICAL ECONOMY, https://doi.org/10.1080/09692290.2020.1752769 (2020).

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BEPS 1.0, for example, in which actions were determined to be minimum standards (all acceptable to the US), and in the choices permitted (e.g., between the Primary Purpose Test and the Limitation on Benefits provision in action 7).

BEPS 1.0 was an implementation of the STP, as can be seen from the new preamble to the OECD model tax treaty:

(State A) and (State B)...Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital **without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance**...(emphasis added)

This language embodies the OECD and G20's official commitment to preventing both double taxation and double non- taxation, i.e., to the single tax principle. While there were also statements that the OECD was not against low taxation per se, just the artificial separation of profit from underlying activities, the ultimate goal was to protect the CIT of the G20. In introducing the final BEPS package on October 5, 2015, OECD Secretary General Angel Gurria stated that:

"Base erosion and profit shifting affects all countries, not only economically, but also as a matter of trust. BEPS is depriving countries of precious resources to jump-start growth, tackle the effects of the global economic crisis and create more and better opportunities for all. But beyond this, BEPS has been also eroding the trust of citizens in the fairness of tax systems worldwide. 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".

While this is no doubt over optimistic, it is clear that BEPS 1.0 was conceptually intended to implement the single tax principle. This goal can be seen in all of the BEPS action steps:

Action 1: Addressing the Tax Challenges of the Digital Economy

This step is designed to address the ability of multinationals to avoid taxation of active income at source by selling goods and services into an economy without having a PE. In a world in which most residence jurisdictions exempt or defer taxation of active income changing the PE physical presence standard is essential to prevent double non-taxation.

Action 2: Neutralizing the Effects of Hybrid Mismatch Arrangements

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This step is obviously designed to address double non- taxation by limiting tax arbitrage transactions designed to utilize hybrid mismatches to create double non-taxation. Check the box is a target.

Action 3: Designing Effective Controlled Foreign Company Rules

This step is intended to enforce effective residence-based taxation of income that is not taxed at source by limiting the scope of exemption and deferral to income that is subject to source based taxation.

Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

This step is designed to enforce source-based taxation of active income by limiting interest and related deductions that erode the corporate tax base without corresponding inclusions at residence.

Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

This step is intended to reinforce source-based taxation of active income by putting limits on harmful tax competition involving special regimes like patent boxes and cashboxes, and by requiring real investment that raises the transaction costs.

Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

This action adopts the US LOB position that treaty benefits should not result in reduction of tax at source unless there is effective taxation at residence, including a "primary purpose test" that states that the purpose of treaties is to prevent both double taxation and double non-taxation.

Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status

This action reinforces source-based taxation of active income and prevents the shifting of such income into low tax jurisdictions through commissionaire and similar arrangements.

Actions 8-10: Aligning Transfer Pricing Outcomes with Value Creation

These actions build on earlier OECD work by limiting the ability to shift income to low tax jurisdictions by transfer pricing.

Action 11: Measuring and Monitoring BEPS

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This action attempts to incentivize governments to act on BEPS by measuring its magnitude (between $100 and $240 billion reach year in tax avoided).

Action 12: Mandatory Disclosure Rules

This action seeks to prevent secret rulings that enable multinationals to pay very low effective tax rate in countries that appear to have high corporate tax rates.

Action 13: Guidance on Transfer Pricing Documentation and Country-by-Country Reporting

This action seeks to bolster transfer pricing by requiring country by country reporting by multinationals, so that tax avoidance can be measured and source taxation of active income upheld.[16]

Action 14: Making Dispute Resolution Mechanisms More Effective

This action builds on previous OECD work on mandatory arbitration in tax treaties to prevent double taxation. It is a necessary corollary to the steps that limit double non-taxation.

Action 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

This action is intended to improve coordination of the previous steps and implement them through the treaty network.

Overall BEPS 1.0, despite its limitations (e.g., the failure to advance on action 1 and the limited nature of actions 8-10) was a very impressive achievement in a very short span of time.[17] Most importantly, while BEPS will not eliminate double non-taxation any time soon, it demonstrated significant political commitment by the G20 and OECD to the single tax principle.

In the EU, BEPS was introduced as the Anti-Tax Avoidance Directive (ATAD), which generally came into effect in January 2019 and which among other measures requires all EU members to adopt strict CFC rules (e.g., generally requiring residence-based taxation if the effective tax rate of the source jurisdiction is below 50% of the tax rate in the residence jurisdiction). This measure, in addition to the enactment of BEPS Action 2[18],

[16] For an excellent example of how these data can be used see Kimberly Clausing, 5 Lessons on Profit Shifting from U.S. Country-by-Country Data, 169 Tax Notes 925 (Nov. 9, 2020); see also https://www.taxjustice.net/reports/the-state-of-tax-justice-2020.
[17] On the limits of BEPS 1.0 see Avi-Yonah and Xu, *Evaluating BEPS: A Reconsideration of the Benefits Principle and Proposal for UN Oversight*, 6 Harv. Bus. L. Rev. 185 (2016).
[18] See COUNCIL DIRECTIVE (EU) 2017/952 of 29 May 2017 (ATAD II), applying the anti-hybrid rules to third countries.

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means that it is much harder now to shift profits artificially out of EU member states.[19] Another important measure in BEPS and ATAD is the primary purpose test (PPT), which requires that all tax treaties incorporate language that the treaty will not apply to transactions if a primary purpose of the transaction was tax avoidance.[20]

5. The TCJA and BEPS 1.0

Until 2017, it could be argued that the US was a laggard in terms of combating tax avoidance, because it took the position that it was already compliant with BEPS, rejected the PPT, and did not sign the MAATM.[21] But the 2017 tax reform (TCJA) dramatically changed that.

TCJA includes three measures that significantly increase taxation of US-based as well as foreign-based MNEs. First, TCJA imposed a one-time, hefty transition tax on the $3 trillion of past, accumulated earnings of US-based MNEs (although this tax was at 8-15.5% significantly lower than the full 35% pre-TCJA tax rate). Second, while TCJA provided for an exemption for certain future dividends from CFCs to their US parents, this exemption is strictly limited to a deemed 10% return on tangible property, which for most US-based MNEs is close to zero (because they rely heavily on intangibles). For any amount that exceeds this deemed return, TCJA imposes a current minimum tax of 10.5% (13.125% if foreign tax credits are included) on worldwide earnings of the MNE (GILTI). Third, TCJA imposes an alternative minimum tax (BEAT) of 10% on both US- and foreign based MNEs by disregarding interest, royalty and some other payments from the US to the related foreign entity.[22]

In addition, TCJA limits the deductibility of payments on hybrid instruments (treated as deductible in the US and exempt in the residence jurisdiction) or by hybrid entities (treated as corporations by the US and transparent in the residence jurisdiction, or vice versa). TCJA also disallows the new participation exemption for hybrid dividends that are treated as deductible payments at source. These provisions implement OECD BEPS Action 2 in accordance with the single tax principle.

The result of these developments (BEPS 1.0, ATAP ad TCJA) is that both US and foreign MNEs are likely to be subject to significantly higher levels of tax on cross-border active income than they were before 2010.[23]

[19] ATAD, supra.
[20] See Avi-Yonah, *BEPS, ATAP and the New Tax Dialogue: A Transatlantic Competition?* 46 Intertax 885 (2018) (with G. Mazzoni).
[21] Note, however, that the new US model tax treaty (2016) includes several provisions that directly implement BEPS 1.0, such as a rule that limits the reduction of withholding taxes at source if the income qualifies for a reduced tax rate at residence. See Avi-Yonah, *Full Circle: The Single Tax Principle, BEPS, and the New US Model*, 1 Global Taxation 12 (2016).
[22] Avi-Yonah, *BEPS, ATAP, supra.*
[23] See Clausing, *Profit Shifting Before and After the Tax Cuts and Jobs Act*

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To give an example: The structure used by most US-based MNEs before 2017 for their foreign operations was to have a top-level CFC in a low-tax jurisdiction, with lower-tier CFCs in high tax jurisdiction. The parent would transfer intellectual property to the top CFC via a cost sharing agreement, and the top CFC would in turn would license the IP to the lower-tier CFCs. The key to this structure was that under the US "check the box" regulation, only the top CFC would be treated as a corporation, while all the lower CFCs would be disregarded (i.e., treated as branches of the top CFC).[24] As a result, while for foreign tax purposes deductible royalties from the lower CFCs to the top CFC would be effective in shifting profits to the low-tax jurisdiction of the top CFC (and not subject to withholding under treaties), for US tax purposes these royalties did not exist and so did not trigger a deemed dividend to the US parent. In addition, deductible cost sharing payments could be made from the US parent to the top CFC.

This structure does not work anymore, for three reasons. First, under BEPS Action 2, as implemented by the EU ATAP, the royalties from the bottom CFCs to the top CFC would not be deductible because they are to a hybrid entity. Second, the cost sharing payments from the US parent to the top CFC would be subject to the BEAT minimum tax. And finally, the top CFC as well as all the disregarded entities below it would be subject to the GILTI minimum tax (10.5% or 13.125% with foreign tax credits) on a current basis. The result is that US-based MNEs need to restructure their foreign operations and are likely to be subject to a significantly higher worldwide effective tax rate than before 2018, despite the fact that both check the box and IRC section 954(c)(6) have not been affected by the TCJA. There are in fact indications that the US tech companies as well as pharmaceuticals are paying significantly higher effective tax rates than before TCJA.[25]

While it is difficult to prove that the TCJA was influenced by BEPS 1.0 because the Republicans who wrote the law would not publicly acknowledge such an influence, it is hard to see TCJA as anything other than a move toward implementing the STP, which also underlies BEPS 1.0. Moreover, Lilian Faulhaber, who was at the OECD during the BEPS 1.0 negotiations, has written that GILTI was explicitly influenced by action 3

(2019) ("Estimates suggest that, once adjustment to the legislation is complete, it should reduce the U.S. affiliate corporate tax base in haven countries by about 20 percent, increasing the tax base in both the United States and in higher-tax foreign countries.") But the adoption of the participation exemption tends to cut in the opposite direction, and it should be abolished.

[24] Under IRC 954(c)(6), the payments would not trigger a deemed dividend even if they were not disregarded.

[25] See Martin A. Sullivan, TCJA Not Enough to Shift Big Pharma Profits to U.S., 100 Tax Notes Int'l 1034 (Nov. 23, 2020); Martin A. Sullivan, The Effect of the TCJA on Big Tech, 100 Tax Notes Int'l 605 (Nov. 2, 2020); Thomas Horst, FINANCIAL RESULTS AND EFFECTIVE TAX RATES FOR TEN LARGEST PHARMACEUTICAL MNEs AND THEIR IMPLICATIONS FOR U.S. INTERNATIONAL TAX REFORM (Tax Notes, forthcoming).

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(strengthening CFC rules) while action 2 inspired the limits on hybrid payments in the TCJA.[26]

6. BEPS 2.0.

BEPS 1.0 has some acknowledged limits. Specifically, consensus was not reached about taxing the digital economy (i.e., primarily the US and potentially the Chinese tech giants). In addition, transfer pricing was not meaningfully reformed and the PE threshold and arm's length standard (ALS) remained in place despite both being obsolete in a digital economy context. In addition, relatively few of the BEPS 1.0 actions were minimum standards that had to be adopted by all participants.

The political pressure to do something about BEPS in the EU and in the developing world has not lessened, as manifested by the fast rise and adoption of digital services taxes (DSTs) and equalizations levies (ELs) designed to bypass the treaty limits on taxing the digital economy. This in turn has led the OECD and G20, working with an inclusive framework of over 100 countries, to propose BEPS 2.0, which is supposed to be finalized in 2021.

BEPS 2.0 consists of two pillars, Pillar One and Pillar Two. Pillar One is designed to address the problem of taxing corporate income at source in accordance with the Benefits Principle. Pillar One allows source jurisdictions to tax a limited amount of income without regard to the PE and ALS limits, and to tax an additional amount in the market jurisdiction subject to the PE and ALS limits. Pillar Two then directly implements the STP by ensuring a minimal level of tax in the residence jurisdiction if the source country tax is insufficient, and if that is not enough, by ensuring a minimal level of tax in the source jurisdiction of the residence country tax is insufficient. These provisions are based on but represent an improvement over GILTI and the BEAT.

Pillar One is a set of proposals to revisit tax allocation rules in a digitized economy. The intention is that a portion of multinationals' residual profit over and above normal returns that are subject to the ALS should be taxed in the market jurisdiction.[27] Pillar One applies to Automated Digital Services (ADS) businesses and Consumer-Facing Businesses (CFB). The scope is intended to be broad and covers businesses that are able

[26] Lilian Faulhaber, Diverse Interests and International Legitimation: Public Choice Theory and the Politics of International Tax, Am. J. Int'l L. https://www.cambridge.org/core/journals/american-journal-of-international-law/article/diverse-interests-and-international-legitimation-public-choice-theory-and-the-politics-of-international-tax/DD28634CB3DB07094ACDA2566D7B3B87 (2020).

[27] This concept is similar to the proposal developed in Avi-Yonah, Clausing and Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 Fla. Tax Rev. 497 (2009) and Avi-Yonah, *Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation*, 2 World Tax J. 3 (2010).

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to profit from significant and sustained interaction with customers and users in the market. Pillar One links taxing rights in respect of these businesses to their sources of revenue, which do not depend on physical presence in the jurisdiction.

Pillar One permits market jurisdictions to impose tax on two amounts, A and B. Amount A represents a "new taxing right" that allocates high value profits to the market jurisdiction based on a formula, and explicitly ignoring the PE threshold and the ALS. Amount A covers profits earned from activities with an automated digital (mainly online) character or goods / services commonly sold to consumers (as well as associated IP licenses). Amount A is allocated based on local revenues (determined via sourcing rules) with double taxation elimination measures. Amount B represents a standard arm's length remuneration for "baseline" routine marketing and distribution activities, and requires a PE.

Many details of Pillar One remain to be finalized. The scope of covered businesses is not yet final, but importantly, it will not be limited to just to highly digitalized business models (such as the US tech giants Amazon, Facebook, Google and Netflix). Much of the detail remains to be agreed including scale thresholds, how the proposals are intended to apply to CFB**,** and how the nexus and revenue sourcing rules will operate.

Pillar Two has four new rules granting jurisdictions additional taxing rights where other jurisdictions have not exercised their primary taxing rights or income is subject to low rates of tax:

a. An Income Inclusion Rule (IIR) that would subject foreign income of branches and controlled entities to an agreed minimum tax in the parent jurisdiction.
b. An Undertaxed Payments Rule (UTPR) that acts as a backstop to the IIR denying deductions or introducing source-based taxation under certain conditions.
c. A Subject to Tax Rule which complements the UTPR in certain cases.
d. A Switch-over Rule that applies where a PE is "undertaxed" switching off a treaty-based exemption in the head office jurisdiction and replacing it with a credit-based method of taxation.

The intention for most practical purposes is that these rules should only apply to MNE groups with a total consolidated group revenue above €750 million or equivalent. Like GILTI and BEAT, the rules are designed to focus on "excess income", particularly intangible-related income, which is regarded as most susceptible to diversion. The proposals therefore include a "carve- out" and simple fixed return for payroll and certain tangible asset costs. To limit the compliance burden on low-risk businesses, simplification options are proposed which may be based on some or all of CbC data, *de minimis* profits, or low local tax risk.

While a lot remains to be determined, and the US has pushed back (e.g., by arguing that any Pillar One Amount A should be an elective safe harbor and that GILTI inclusions

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should be grandfathered under Pillar Two), it seems plausible that some version of BEPS 2.0 will be adopted in 2021, especially given most countries' need for more revenue to address the shortfalls from COVID-19 and the ensuing recession. If so, BEPS 2.0 would be a major improvement in the ITR and a significant step toward implementing both the Benefits Principle and the STP. Pillar One is an update to the Benefits Principle that brings source taxation of active income into alignment with 21st century business realities. Pillar Two is a direct implementation of the STP up to the minimum tax thresholds (yet to be determined).

Importantly, it has already been shown that countries can implement Pillar One and Pillar Two unilaterally. Pillar One is similar to the proposal by India to apply direct taxation to the digital giants via a formulary system, as well as to the EU Substantial Digital Presence proposal. Pillar Two is similar to the combination of GILTI and BEAT already adopted by the US. Thus, if the G20 and OECD fail to reach consensus, it is likely that countries will implement both Pillars unilaterally.

7. Conclusion: Whither the ITR?

The last decade has seen significant limits to tax evasion and avoidance and an advance toward achieving the STP. These steps are crucial to achieve the goals of the ITR and to protect both PIT and CIT. But in order to prevent further political damage, more needs to be done. First, additional changes to bolster the ITR are required. Second, the added revenues should be used to bolster the social safety net and prevent another Great Recession.

There are three additional measures that I believe would strengthen the ITR.

1. In regard to passive income, despite CRS and MAATM, I do not think the solution can depend entirely on exchange of information and residence-based taxation. There are too many residence countries to cooperate effectively, and there will always be some non-cooperative tax havens to attract evaders. But the key point is that portfolio investments are limited to a small number of large jurisdictions. If the US, EU and Japan could cooperate to re-institute withholding taxes on interest, a large part of the problem could be resolved.[28]
2. In regard to active income, there are a limited number of residence countries of MNEs (over 90 of the Fortune 100 are resident in the G20). If all the G20 could agree to further strengthen CFC rules to eliminate exemption or deferral, most MNE income would be taxed currently.[29] In the US this would mean that the GILTI provision should be revised to eliminate the 10% deemed return exemption and

[28] Avi-Yonah, What Goes Around Comes Around: Why the USA is Responsible for Capital Flight (and What It Can Do About it), Haifa L. Rev. (2019).
[29] Avi-Yonah, "Hanging Together: A Multilateral Approach to Taxing Multinationals," in Thomas Pogge and Krishen Mehta (eds.), Global Tax Fairness, 113 (2016)

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increase the rate to 21%.[30] Strict anti-inversion rules (e.g., a managed and controlled residency test) would eliminate the ability of MNEs to artificially move out of the US.

3. Since active income should be taxed at source, and since tax competition does not affect the market jurisdiction, the EU proposals for eliminating the PE standard and substituting a virtual PE threshold for "significant digital presence" should be adopted.[31] In addition, a formula should be used to allocate residual profits under the arm's length standard between source jurisdictions.[32] These ideas build on BEPS 2.0 but advance it further. The key issue is that the US and other G20 countries should grant foreign tax credits to such taxes. The fact that most G20 countries have similar tax rates should make such FTCs acceptable.

What should be done with the added revenues? I believe the first and necessary step would be to enhance the social safety net that was deeply hurt by the Great Recession and by the COVID-19 pandemic. In the US, this requires universal health insurance, additional investment in education, and a massive infrastructure program.

The world faces a crucial choice in the 2020s. We can either continue retreating from globalization in favor of xenophobic nationalism, tariffs, immigration restrictions, and exchange controls. That road leads ultimately to war, as it did in the 1930s. Or we can revive globalization by investing in a robust social safety net, infrastructure, education, and job creation. While more needs to be done, we have made significant progress in curbing tax competition in the last decade. The key move now is to take the added revenue and spend it wisely.

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[30] Clausing, Profit Shifting, supra.

[31] Avi-Yonah, *The International Implications of Wayfair*, 91 Tax Notes International 161 (July 9, 2018); Walter Hellerstein et al., *Digital Taxation Lessons From Wayfair and the U.S. States' Responses*, Tax Notes (Apr. 15, 2019).

[32] Avi-Yonah, *Formulary Apportionment- Myths and Prospects,* 3 World Tax J. 371 (2011) (with Ilan Benshalom); Avi-Yonah, *Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation*, 2 World Tax J. 3 (2010); Devereux et al., Residual Profit Allocation by Income, WP 19/01 (March 2019).

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