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The International Tax Regime at 100: Reflections on the OECD's BEPS Project

Reuven Avi-Yonah[1]

ABSTRACT

This essay will consider the outcome of Pillars One and Two, as reflected in the October 2021 statement by the Inclusive Forum, in light of the history of international taxation since the foundation of the international tax regime in 1923. Specifically, it will consider how Pillar One fits with efforts to redefine the source of active income in light of the digital revolution, and the ways in which Pillar Two implements the single tax principle, which can be traced back to the first model treaty from 1927. Both of those ideas were already articulated and developed in my own early writing on international taxation from the 1990s, when the Internet was in its infancy.

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1. The Two Pillars of BEPS 2.0: Evolution or Revolution?

   In *L'ancien Regime et la Revolution* (1856) Alexis de Tocqueville argued that the major innovations of the French revolution were prefigured in developments during the old regime, so that the revolution was less of a sharp dividing line than previously thought. This essay will make a similar argument for the current revolution in international taxation contained in the two pillars of BEPS 2.0, as laid out in the October 2021 statement by the Inclusive Forum. Specifically, I will argue that Pillar One derives from efforts to redefine the source of active income in light of the digital revolution, which build on US state taxation use of sales factors since 1911 as a source of corporate income, while Pillar Two implements the single tax principle, which can be traced back to the first model treaty from 1927. Both of those ideas were already articulated and developed in my own early writing on international taxation from the 1990s, when the Internet was in its infancy.

2. The Origins of Pillar One

   a. Pillar One[2]

      The OECD/ Inclusive Forum Statement on the outcome of the BEPS 2.0 negotiations (October 8, 2021), describes Pillar One as follows:

      Pillar One

      Scope

      In-scope companies are the multinational enterprises (MNEs) with global turnover above 20 billion euros and profitability above 10% (i.e. profit before tax/revenue) calculated using an averaging mechanism with the turnover threshold to be reduced to 10 billion euros, contingent on successful implementation including of tax certainty on Amount A, with the relevant review beginning 7 years after the agreement comes into force, and the review being completed in no more than one year.

      Extractives and Regulated Financial Services are excluded.

      Nexus

      There will be a new special purpose nexus rule permitting allocation of Amount A to a market jurisdiction when the in-scope MNE derives at least 1 million euros in

[2] This part is based on OECD, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy (8 October 2021) (the "Statement").

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revenue from that jurisdiction. For smaller jurisdictions with GDP lower than 40 billion euros, the nexus will be set at 250 000 euros. The special purpose nexus rule applies solely to determine whether a jurisdiction qualifies for the Amount A allocation. Compliance costs (incl. on tracing small amounts of sales) will be limited to a minimum.

Quantum

For in-scope MNEs, 25% of residual profit defined as profit in excess of 10% of revenue will be allocated to market jurisdictions with nexus using a revenue-based allocation key.

Revenue sourcing

Revenue will be sourced to the end market jurisdictions where goods or services are used or consumed. To facilitate the application of this principle, detailed source rules for specific categories of transactions will be developed. In applying the sourcing rules, an in-scope MNE must use a reliable method based on the MNE's specific facts and circumstances.

Tax base determination

The relevant measure of profit or loss of the in-scope MNE will be determined by reference to financial accounting income, with a small number of adjustments. Losses will be carried forward.

Segmentation

Segmentation will occur only in exceptional circumstances where, based on the segments disclosed in the financial accounts, a segment meets the scope rules.

Marketing and distribution profits safe harbour

Where the residual profits of an in-scope MNE are already taxed in a market jurisdiction, a marketing and distribution profits safe harbour will cap the residual profits allocated to the market jurisdiction through Amount A. Further work on the design of the safe harbour will be undertaken, including to take into account the comprehensive scope.

Elimination of double taxation

Double taxation of profit allocated to market jurisdictions will be relieved using either the exemption or credit method. The entity (or entities) that will bear the tax liability will be drawn from those that earn residual profit.

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Tax certainty

In-scope MNEs will benefit from dispute prevention and resolution mechanisms, which will avoid double taxation for Amount A, including all issues related to Amount A (e.g. transfer pricing and business profits disputes), in a mandatory and binding manner. Disputes on whether issues may relate to Amount A will be solved in a mandatory and binding manner, without delaying the substantive dispute prevention and resolution mechanism.

An elective binding dispute resolution mechanism will be available only for issues related to Amount A for developing economies that are eligible for deferral of their BEPS Action 14 peer review1 and have no or low levels of MAP disputes. The eligibility of a jurisdiction for this elective mechanism will be reviewed regularly; jurisdictions found ineligible by a review will remain ineligible in all subsequent years.

Amount B

The application of the arm's length principle to in-country baseline marketing and distribution activities will be simplified and streamlined, with a particular focus on the needs of low capacity countries. This work will be completed by the end of 2022.

Administration

The tax compliance will be streamlined (including filing obligations) and allow in-scope MNEs to manage the process through a single entity.

Unilateral measures

The Multilateral Convention (MLC) will require all parties to remove all Digital Services Taxes and other relevant similar measures with respect to all companies, and to commit not to introduce such measures in the future. No newly enacted Digital Services Taxes or other relevant similar measures will be imposed on any company from 8 October 2021 and until the earlier of 31 December 2023 or the coming into force of the MLC. The modality for the removal of existing Digital Services Taxes and other relevant similar measures will be appropriately coordinated. The IF notes reports from some members that transitional arrangements are being discussed expeditiously.

Implementation

The MLC through which Amount A is implemented will be developed and opened for signature in 2022, with Amount A coming into effect in 2023.

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b. How Original is Pillar One?

The main conceptual innovation in Pillar One is Amount A, which is to be taxable in the market jurisdiction regardless of the permanent establishment threshold and the arm's length standard.

This idea is conceptually derived from the use of the sales factor by U.S. states to allocate corporate income as part of formulary apportionment. All US states that tax corporate income use a sales factor with no requirement for physical presence, and over half of them use a sales factor exclusively (i.e., tax all corporate income on the basis of sales). The use of sales as part of the allocation formula dates all the way back to the first state corporate income tax in 1911.[3]

In 1993, I first proposed applying this method to international taxation.[4] I further developed this idea in a more extensive fashion in 1996.[5] In 1997, I incorporated it into the first extensive article on how to tax "electronic commerce", i.e., Internet-based digital activities.[6] I wrote as follows:

> The permanent establishment threshold, as Jeffrey Owens points out, may have represented an acceptable compromise when it was first crafted because it dates back to a period in which physical presence was necessary to conduct significant business operations. Solicitation through the mail, or through independent agents, was certainly possible, but had obvious drawbacks: no direct negotiation with the company's representative, limited ability to customize orders in the case of mass mailings, and orders took a long time to be fulfilled. As pointed out above, electronic commerce fundamentally changes these limitations. Interactivity, speed, and electronic payment mean that commerce on a much grander scale can be conducted without any physical presence in the consumer's jurisdiction.

[3] Joan Weiner, *Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada* (2005). According to the Willis Commission Report (1964) as of 1929, 10 of the 17 states with corporate income taxes employed a sales factor. The current count of states with single-factor sales formulas is 23 (plus DC) and it will increase to 24 effective 2022. See Walter Hellerstein, THE TRANSFORMATION OF THE STATE CORPORATE INCOME TAX INTO A MARKET-BASED LEVY, J. Taxation 1 (2019).

[4] Avi-Yonah, *Slicing the Shadow: A Proposal for Updating U.S. International Taxation*, 56 Tax Notes 1511 (March 15, 1993).

[5] Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 Texas L. Rev. 1301 (1996).

[6] Avi-Yonah, *International Taxation of Electronic Commerce,* 52 Tax L. Rev. 507 (1997).

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> It thus appears that if the goal is to tax the income from electronic commerce in a way that preserves the underlying rationale of the permanent establishment rule and the Benefits Principle, a different type of threshold is required, one that is not linked to physical presence. Such a threshold could be a de minimis amount of sales into the jurisdiction, as suggested by Walter Hellerstein and others in the state tax context. For example, the rule could be that if a seller in electronic commerce has gross sales of $ 1 million or less from a given tax jurisdiction (adjusted for inflation), it would not be subject to taxation at source. The same rule also could be used to define a U.S. trade or business for electronic commerce purposes (in fact, it would be highly advisable to have a uniform definition of these two terms, as is the norm in many other countries).
>
> The figure chosen should be high enough to exclude most small businesses. The growth of electronic commerce enables many small business to sell internationally, and the burden of compliance with various countries' tax laws could be too much to bear for that kind of business. In addition, the threshold should be high enough to ensure that, in most cases, the income derived from the jurisdiction would exceed the costs of complying with its tax laws.
>
> My recommendation is for a gross sales threshold, rather than a net income threshold, for administrability reasons: A net figure would require that a tax administration know the taxpayer's income from sales into a jurisdiction, which it typically would not have the information to determine, while the gross amount can be determined from the records of other parties (the customers). For the same reason, a threshold based on a percentage of total sales worldwide seems impracticable since it requires knowledge available only to the taxpayer.[7]

This is similar to the way Amount A is defined for purposes of Pillar One, except that it envisages that all of the income of the multinational would be taxed in this way without regard to the PE threshold or the Arm's Length Standard. In later work, I proposed limiting the sales-based amount to excess returns, and to keep the arm's length standard for normal returns, similarly to Pillar One.[8]

3. The Origins of Pillar Two

The Statement describes Pillar Two as follows:

Pillar Two

[7] Avi-Yonah, Electronic Commerce (1997), supra.

[8] Avi-Yonah, *Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation*, 2 World Tax J. 3 (2010); Avi-Yonah, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 Fla. Tax Rev. 497 (2009) (with K. Clausing and M. Durst). The latter paper was cited by the IMF as the oldest original source of Pillar One. IMF, CORPORATE TAXATION IN THE GLOBAL ECONOMY (2019), 40-41.

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Overall design

Pillar Two consists of:

• two interlocking domestic rules (together the Global anti-Base Erosion Rules (GloBE) rules): (i) an Income Inclusion Rule (IIR), which imposes top-up tax on a parent entity in respect of the low taxed income of a constituent entity; and (ii) an Undertaxed Payment Rule (UTPR), which denies deductions or requires an equivalent adjustment to the extent the low tax income of a constituent entity is not subject to tax under an IIR; and

• a treaty-based rule (the Subject to Tax Rule (STTR)) that allows source jurisdictions to impose limited source taxation on certain related party payments subject to tax below a minimum rate. The STTR will be creditable as a covered tax under the GloBE rules.

Rule status

The GloBE rules will have the status of a common approach.

This means that IF members:

• are not required to adopt the GloBE rules, but, if they choose to do so, they will implement and administer the rules in a way that is consistent with the outcomes provided for under Pillar Two, including in light of model rules and guidance agreed to by the IF;

• accept the application of the GloBE rules applied by other IF members including agreement as to rule order and the application of any agreed safe harbours.

Scope

The GloBE rules will apply to MNEs that meet the 750 million euros threshold as determined under BEPS Action 13 (country by country reporting). Countries are free to apply the IIR to MNEs headquartered in their country even if they do not meet the threshold.

Government entities, international organisations, non-profit organisations, pension funds or investment funds that are Ultimate Parent Entities (UPE) of an MNE Group or any holding vehicles used by such entities, organisations or funds are not subject to the GloBE rules.

Rule design

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The IIR allocates top-up tax based on a top-down approach subject to a split-ownership rule for shareholdings below 80%.

The UTPR allocates top-up tax from low-tax constituent entities including those located in the UPE jurisdiction. The GloBE rules will provide for an exclusion from the UTPR for MNEs in the initial phase of their international activity, defined as those MNEs that have a maximum of EUR 50 million tangible assets abroad and that operate in no more than 5 other jurisdictions.2 This exclusion is limited to a period of 5 years after the MNE comes into the scope of the GloBE rules for the first time. For MNEs that are in scope of the GloBE rules when they come into effect the period of 5 years will start at the time the UTPR rules come into effect.

ETR calculation

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 (with agreed adjustments consistent with the tax policy objectives of Pillar Two and mechanisms to address timing differences).

In respect of existing distribution tax systems, there will be no top-up tax liability if earnings are distributed within 4 years and taxed at or above the minimum level.

Minimum rate

The minimum tax rate used for purposes of the IIR and UTPR will be 15%.

Carve-outs

The GloBE rules will provide for a formulaic substance carve-out that will exclude an amount of income that is 5% of the carrying value of tangible assets and payroll. In a transition period of 10 years, the amount of income excluded will be 8% of the carrying value of tangible assets and 10% of payroll, declining annually by 0.2 percentage points for the first five years, and by 0.4 percentage points for tangible assets and by 0.8 percentage points for payroll for the last five years.
The GloBE rules will also provide for a *de minimis* exclusion for those jurisdictions where the MNE has revenues of less than EUR 10 million and profits of less than EUR 1 million.

Other exclusions

The GloBE rules also provide for an exclusion for international shipping income using the definition of such income under the OECD Model Tax Convention.

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Simplifications

To ensure that the administration of the GloBE rules are as targeted as possible and to avoid compliance and administrative costs that are disproportionate to the policy objectives, the implementation framework will include safe harbours and/or other mechanisms.

GILTI co-existence

It is agreed that Pillar Two will apply a minimum rate on a jurisdictional basis. In that context, consideration will be given to the conditions under which the US GILTI regime will co-exist with the GloBE rules, to ensure a level playing field.

Subject to tax rule (STTR)

IF members recognise that the STTR is an integral part of achieving a consensus on Pillar Two for developing countries.3 IF members that apply nominal corporate income tax rates below the STTR minimum rate to interest, royalties and a defined set of other payments would implement the STTR into their bilateral treaties with developing IF members when requested to do so.

The taxing right will be limited to the difference between the minimum rate and the tax rate on the payment.

The minimum rate for the STTR will be 9%.

Implementation

Pillar Two should be brought into law in 2022, to be effective in 2023, with the UTPR coming into effect in 2024.

4. How Original is Pillar Two?

Pillar Two is based on what I called in 1997 the "Single Tax Principle". The Single Tax Principle can be traced all the way to the adoption of the foreign tax credit by the US in 1918 and the development of the first model tax treaty by the League of Nations in 1927. In previous work, I have described the historical evolution of the Single Tax Principle from its origins through the tax treaties developed by Stanley Surrey in the 1960s, and ultimately to Pillar Two.[9]

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[9] Avi-Yonah, *Who Invented the Single Tax Principle? An Essay on the History of US Treaty Policy*, 59 NYLS L Rev 305 (2015); Avi-Yonah, *Stanley Surrey, the 1981 US Model, and the Single Tax Principle*, 49 Intertax 729 (2021) (with G. Mazzoni).

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The first full theoretical statement of the Single Tax Principle can be found in my 1997 article on electronic commerce, in which I wrote as follows:

> International income taxation involves two basic questions: What is the appropriate level of taxation that should be levied on income from cross-border transactions? How are the resulting revenues to be divided among taxing jurisdictions? The answer to the first question is the Single Tax Principle: Income from cross-border transactions should be subject to tax once (that is, neither more nor less than once). The Single Tax Principle thus incorporates the traditional goal of avoiding double taxation, which was the main motive for setting up the international tax regime in the 1920's and 1930's. Taxing cross-border income once also means, however, that it should not be undertaxed or (at the extreme) be subject to no tax at all.
>
> The appropriate rate of tax for purposes of the Single Tax Principle is determined by the second principle of international taxation, the Benefits Principle. The Benefits Principle, discussed below, assigns the primary right to tax active business income to source jurisdictions and the primary right to tax passive income to residence jurisdictions. Therefore, the rate of tax for purposes of the Single Tax Principle is generally the source rate for active business income and the residence rate for passive (investment) income. When the primary jurisdiction refrains from taxation, however, residual taxation by other (residence or source) jurisdictions is possible, and may be necessary to prevent undertaxation. Such residual taxation means that all income from cross-border transactions, under the Single Tax Principle, should be taxed at least at the source rate (which tends to be lower than the residence rate), but at no more than the residence rate.
>
> What is the normative basis for the Single Tax Principle? As an initial matter, this Article assumes that most countries would like to maintain both a personal income tax and a corporate income tax. The reasons for having both a personal income tax and a corporate income tax have been discussed extensively elsewhere, and are not repeated here. For purposes of justifying the Single Tax Principle, it is sufficient that most countries in fact maintain their existing personal and corporate income taxes.
>
> Given a preference for imposing both a personal and a corporate income tax on domestically derived income of individuals and corporations, it becomes relatively easy to establish why the Single Tax Principle is justified as a goal of the international tax regime, on both theoretical and practical grounds. From a theoretical perspective, if income derived from cross-border transactions is taxed more heavily than domestic income, the added tax burden creates an inefficient incentive to invest domestically. This proposition is widely accepted

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and underlies the effort, which by now is about a century old, to prevent or alleviate international multiple taxation.

The corollary also holds true: If income from cross-border transactions is taxed less heavily than domestic income, this creates an inefficient incentive to invest internationally rather than at home. The deadweight loss from undertaxation is the same as that from overtaxation.

In addition, there is also a strong equity argument against undertaxation of cross-border income, which applies to income earned by individuals. From an equity perspective, undertaxation of cross-border income violates both horizontal and vertical equity when compared to higher tax rates imposed on domestic source income, and in particular on domestic labor income. In this case, the argument that equity violations tend to turn into efficiency issues does not hold, because labor is less mobile than capital and wage earners typically do not have the ability to transform their domestic wages into foreign source income.

On a practical level, the Single Tax Principle can be justified because double taxation leads to tax rates that can be extremely high and tend to stifle international investment. Zero taxation, on the other hand, offers an opportunity to avoid domestic taxation by investing abroad, and therefore threatens to erode the national tax base. T.S. Adams, the architect of the foreign tax credit and a major influence in shaping the international tax regime, recognized both of these propositions in the 1920's. In justifying the foreign tax credit, Adams wrote "the state which with a fine regard for the rights of the taxpayer takes pains to relieve double taxation, may fairly take measures to ensure that the person or property pays at least one tax." Contrary to an exemption system, Adams' credit operated to eliminate double taxation by both source and residence jurisdictions, but preserved residual residence-based jurisdiction to enforce the Single Tax Principle.

The practical justification for the Single Tax Principle can be seen most easily if one imagines a world with only two countries, A and B, and only two companies, X (a resident of A) and Y (a resident of B). If both A and B tax the foreign source income of their residents and domestic source income of foreigners, and neither gives relief from double taxation, then both X and Y would minimize their taxes by only deriving domestic source income (since any foreign tax would by definition be an added burden). The result would be adequate revenues collected by both A and B, but no cross-border trade or investment.

On the other hand, suppose both A and B exempted from tax both foreign source income and domestic source income of foreigners (a not inconceivable proposition in many developing countries, which tax residents territorially and

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> grant tax holidays to foreign investors). In that case, the way for both X and Y to minimize their taxes would be to derive their entire income from cross-border transactions. The result would be adequate cross-border trade, but no revenues for A or B. In a world in which international trade and investment are important, but taxes (unlike tariffs) cannot be reduced to zero, the Single Tax Principle is the best option.[10]

It is clear that the underlying idea of Pillar Two can be traced back to the concept of the Single Tax Principle, as contained in these earlier developments.[11] Specifically, Pillar Two envisages residual taxation by the residence (or source) jurisdiction when the tax imposed by the source (or residence) jurisdiction falls below a specified level. This is the same idea as the one I developed in 1997: "When the primary jurisdiction refrains from taxation, however, residual taxation by other (residence or source) jurisdictions is possible, and may be necessary to prevent undertaxation."[12]

5. Conclusion

This essay has tried to show that the current revolution in international taxation, as reflected in BEPS 2.0 Pillars One and Two, is less revolutionary than some have argued.[13] Specifically, it argues that the main innovation of Pillar One builds on US state sales based apportionment, which dates to 1911 and which I have argued since the 1990s should be applied to international taxation. Pillar Two is based on the Single Tax Principle, which dates back to the origins of the international tax regime in the 1920s and which I articulated and developed since the 1990s. Thus, as de Tocqueville argued for another revolution in 1856, the revolution in international taxation builds on elements that existed in the old regime it seeks to replace.

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[10] Avi-Yonah, Electronic Commerce (1997), supra. I later developed a different normative argument for the single tax principle, basing it for corporate taxation on the need to curb the power of the largest multinationals. See Avi-Yonah, *Corporations, Society and the State: A Defense of the Corporate Tax*, 90 Va. L. Rev. 1193 (2004); Avi-Yonah, *A New Corporate Tax*, Tax Notes 653 (July 27, 2020).

[11] This similarity has been noted by other authors. See, e.g., Elizabeth Gil García, *The Single Tax Principle: Fiction or Reality in a Non-Comprehensive International Tax Regime*? World Tax Journal (August 2019), 305; Ruth Mason, "The Transformation of International Tax," 114 *Am. J. Int'l L.* 353 (2020): "Because states already faithfully adhered to the no-double-tax norm, growing acceptance of full taxation as a goal of international tax brings states closer to implementing Avi-Yonah's "single-tax principle"; Wolfgang Schoen, *Is There Finally an International Tax System?* In Kofler, Mason and Rust (eds)., Thinker, Teacher, Traveler: Reimagining International Tax, Essays in Honor of H. David Rosenbloom (2021), 475 ("What can one say about the "single tax principle"? Has it gained the status of a guiding and binding principle of international tax law? Here, it is evident that the BEPS Action Plan adopted Avi-Yonah's findings to a large extent. International taxation – it claims – should ensure that income from cross-border transactions is taxed exactly once – not more, not less.").

[12] Avi-Yonah, Electronic Commerce (1997), supra.

[13] See, e.g., Ruth Mason, "The Transformation of International Tax," 114 *Am. J. Int'l L.* 353 (2020).

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