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The New International Tax Regime

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ABSTRACT

On October 8, 2021, over 130 countries committed themselves to the most far-reaching changes in the international tax regime since its inception in 1923. Slated to begin on the anniversary year of 2023, this new regime (ITR 2.0) adopts significant changes from the old one (ITR 1.0). Specifically, ITR 2.0 eliminates the physical presence requirement and the arm's length standard for a significant portion of the profits of large multinationals that have been essential elements of ITR 1.0 since the 1930s, in a way that is more consistent with ITR 1.0's Benefits Principle (BP). ITR 2.0 also explicitly implements the Single Tax Principle (STP) that has formed part of ITR 1.0 from the beginning but had only been partially implemented. Overall, ITR 2.0 is a victory for the attempts to make multinationals pay their fair share in taxes and to update the ITR for the 21st century.

1. Introduction

On October 8, 2021, 136 countries that formed part of the OECD's Inclusive Forum (IF) to implement the Base Erosion and Profit Shifting (BEPS) project signed a statement (the Statement) that embodies the most far-reaching revolution in international taxation since 1923.[1] The Statement marks the beginning of a new international tax regime fit for the 21st century, ITR 2.0.

In what follows, we will summarize the main feature of ITR 2.0 as outlined in the Statement and discuss how ITR 2.0 implements the two principles underlying ITR 1.0, namely the Benefits Principle (BP) and the Single Tax Principle (STP).

The BP, which is based on the compromise reached by the four economists in 1923, states that active (business) income should be taxed primarily at source and passive (investment) income should be taxed primarily at residence. The STP, which was originally stated in 1927 but has been gradually developing since then, states that when the primary taxing country (source for active income and residence for passive income) does not tax, the residual country should tax to prevent double non-taxation. The rate of tax for the STP is the residence tax rate for passive income (earned mostly by

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

individuals) and the average OECD source tax rate for active income (earned mostly by corporations).[2]

2. Pillar One and the Benefits Principle

The Statement outlines 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 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

[2] On the BP see Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 Texas L. Rev. 1301 (1996). On the STP see Avi-Yonah, *International Taxation of Electronic Commerce,* 52 Tax L. Rev. 507 (1997).

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.

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.

The main conceptual innovation in Pillar one is Amount A, which is 25% of residual profit (defined as profit in excess of 10% of revenue) of in-scope MNEs (MNEs with revenues over 20 billion euros and a pre-tax profit margin of 10%). Amount A will be allocated to market jurisdictions with nexus (at least 1 million euros in revenue) using a revenue-based allocation key, i.e., a single factor sales formula.[3]

Amount A eliminates the two features of ITR 1.0 that have long been identified as obsolete: The requirement that a MNE have a permanent establishment (PE) in a source jurisdiction and the arm's length standard (ALS) for calculating the amount of income attributable to the PE. The PE requirement is obsolete in a word in which MNEs can earn

[3] These features are similar to the proposals in Avi-Yonah, Electronic Commerce, supra; 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).

billions in a market jurisdiction with no physical presence. The ALS is unworkable for the residual profits of MNEs (defined here as profits above 10%) because there are typically no comparables, so that a formula is the best way to allocate them. The PE requirement and the ALS were both introduced into ITR 1.0 at an early stage, primarily through the work of Mitchell Carroll in the 1930s. It is high time for both to go in a way that ensures that large MNEs like Amazon, Apple, Facebook and Google pay tax in the source country they derive billions of profits from.

Amount A is fully consistent with the BP. While it can be argued that residence country should also get a share since typically the algorithms that underlie the business model were developed there, this is reflected by the fact that 75% of the residual profit is not taxed in the market jurisdiction and therefore should be taxed in other jurisdictions based on Pillar Two.

3. Pillar Two and the Single Tax Principle

The Statement outlines Pillar Two as follows:

> **Pillar Two**
>
> ***Overall design***
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> Pillar Two consists of:
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> • 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

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.

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

Pillar Two fully implements the STP. The STP was already envisaged in the original League of Nations Model from 1927 but was first implemented in the 1960s and then gradually accepted (with some steps back like the US portfolio interest exemption in 1984 and check the box in 1997) and implemented in BEPS 1.0 (2013-15) and the TCJA (2017).[4]

The IIR reflects the ability of residence countries to implement the STP by taxing their MNEs on a residence basis. Since 95% of large MNEs are resident in G20 countries, this is expected to be highly effective. The UTPR and STTR are designed to enable residual source taxation when residence taxation is ineffective.

The minimum tax rate of 15% is low but was the best that can be expected from including so many countries. The G20 can be expected to use a higher rate for the IIR, especially if the US takes the lead in raising the GILTI rate. The substance carve out is unfortunate (since it allows for some double non-taxation in violation of the STP) but is quite limited.

Together with the CRS regime that implements the STP for individuals, Pillar Two will ensure that the STP will apply to large MNEs as well.

4. Conclusion

In March 1923, the four economists (Profs. Bruins, Einaudi, and Seligman and Sir Josiah Stamp) reached the compromise on the BP that created ITR 1.0. In the 1960s, Stanley Surrey first practically implemented the STP by inventing the CFC rules and including the STP in US tax treaties. A century later, the birth of ITR 2.0 builds on their work in updating the ITR for the business realities of the 21st century. We should all hope that in face of the pressures of deglobalization and rising nationalism, ITR 2.0 will survive and

[4] For antecedents to Pillar Two see Avi-Yonah, Electronic Commerce, supra; 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).

enable all countries to overcome tax competition and maintain a robust social safety net for their citizens.[5]

[5] On the importance of curbing tax competition to maintain democracy and the social safety net under globalization see Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 Harv. L. Rev. 1573 (2000); *Globalization, Tax Competition and the Fiscal Crisis of the Welfare State: A Twentieth Anniversary Retrospective,* in Thinker, Teacher, Traveler: Reimagining International Tax, Essays in Honor of H. David Rosenbloom (Georg Kofler, Ruth Mason Alexander Rust, eds.), 39 (2021).