The **BEPS**

Monitoring

Group

TAXING MULTINATIONALS:
THE BEPS PROPOSALS AND ALTERNATIVES

This briefing by the BEPS Monitoring Group (BMG) analyses the outcomes of the latest phase of the G20/OECD project on base erosion and profit shifting, and outlines options and alternatives, especially for developing countries. The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. This report has not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. It is based on our previous reports, and has been drafted by Abdul Muheet Chowdhary, Alex Cobham, Emmanuel Eze, Tommaso Faccio, Jeffery Kadet, Bob Michel, and Sol Picciotto

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SUMMARY

This Briefing summarises the likely outcomes of the latest stage of negotiations on reform of rules for taxing multinational enterprises (MNEs), and outlines options for measures that should be considered in response, especially by developing countries.

The mandate for the G20/OECD project on base erosion and profit shifting (BEPS) was to ensure taxation of MNEs ‘where their activities take place’. The only simple and effective way to ensure this is to tax them in accordance with the economic reality that they operate as unitary enterprises under common ownership and control, and to apportion their total global profits in proportion to their real activities for taxation in each country, as proposed in 2018 by the G-24 group of developing countries. The Two-Pillar package of proposals agreed in 2021 entailed acceptance in principle of this approach, and the technical work since then has established detailed standards for its implementation. However, the four specific measures now proposed are much more limited, and would be ineffective and unfair, especially for developing countries. It is essential that these countries adopt alternatives more appropriate for defending their source tax base, which can also be compatible with the BEPS package.

A key element already being gradually implemented is the global minimum tax (the GloBE), which aims to ensure that MNE profits are taxed at an effective minimum rate of 15% in each country to which they are attributed, by allocating rights to apply a top-up tax to other countries where they have a taxable presence. However, this right is given in priority to the home country or countries of residence of the MNE by applying an income inclusion rule

(IIR), while the host country's right to top-up tax on profits at source (undertaxed payments rule - UTPR) is only a fall-back. An additional right for a domestic minimum top-up tax (DMTT) has now been included, but would benefit countries where MNEs already attribute high levels of profit under current rules - jurisdictions which act as investment hubs or conduits for profit-shifting. Estimates show that most developing countries would gain little or no additional tax revenue directly from the GloBE, and since its rules are highly complex, joining the scheme would not be cost-effective for most of these countries. Implementation of the GloBE could nevertheless benefit all countries, putting a partial brake on the competition to reduce tax on MNEs to attract investment, although there is a danger that the 15% minimum could become the maximum.

In view of the unfair and ineffective design of the GloBE, developing countries must take action themselves. They should (i) review all their existing tax incentives and remove them unless there is clear evidence of benefits to the country's economy, and (ii) introduce appropriate measures to protect their right to tax profits at source, which would be more effective than the DMTT, under which countries are not able to tax profits that have been shifted out of their jurisdiction. Such measures can be carefully designed to be compatible with the GloBE, and with international obligations, including tax treaties, although this may entail negotiations with treaty partners due to differences of interpretation. While states should individually design measures suited to their own circumstances, they can learn from each other to achieve convergence, and develop a common approach, through appropriate regional and sectional organisations.

The aim should be to prevent the continuation and exacerbation of the present unfair and ineffective approach, and to maintain the momentum towards a more comprehensive reform. This should be based, as already signposted by the G-24, on unitary taxation of MNEs with formulary apportionment. This could finally benefit all countries and MNEs alike by establishing a simple, effective and fair system for MNE taxation.

INTRODUCTION

As the second phase of the G20/OECD project on base erosion and profit shifting (BEPS) draws towards a close, this Briefing outlines the current state of play, and identifies a set of choices and options for countries to reform taxation of multinational enterprises (MNEs). Part A outlines the outcomes to date and discusses their limitations, while Part B puts forward some additional or alternative measures that could be more effective for developing countries to protect their tax base.

The BEPS process during this phase has taken significant steps towards the broader aim stated by the G20 in 2013 to ensure that MNEs could be taxed 'where their activities take place'. Under the two pillar approach outlined in 2021, Pillar One aimed to directly curb profit-shifting by introducing a unitary approach to allocating MNE profits to market countries for taxation; while Pillar Two sought to limit the incentives for misalignment, by introducing a minimum effective tax rate for MNEs' profits regardless of where they are declared. The work on the two Pillars has laid the basis for a move towards unitary taxation of MNEs with formulary apportionment, by formulating detailed technical standards for all its components: (i) a taxable nexus based on a minimum threshold of sales revenue, (ii) a definition of global consolidated profits for tax purposes for MNE corporate groups, and (iii) definitions and methods for quantification of sales revenue by destination, physical assets, and employees, the three tangible and measurable factors relevant for formulary apportionment.

It should be recalled that, at the start of the second phase in 2018, the G24 (Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development) took the initiative to propose that MNEs should be taxable in every country where they have a 'significant economic presence' (SEP), by apportioning their global profits.[1] As regards the formula for apportionment, the G-24 argued that:

> 'both production and sales are essential for generation of profits, and neither can be ignored for the purpose of determining the profits that would be taxable in a jurisdiction. The jurisdiction that contributes towards demand by facilitating the economy, or by maintenance of markets, and the ability of its residents to pay that enable sales, as well as the jurisdiction that contributes to the production or supply of goods, contribute towards the business profits of an enterprise. In some cases, the market jurisdiction also contributes infrastructure networks that are used by the enterprise to perform its services or to deliver its products. This gives rise to a valid justification of taxation by them of the profits to which their economies have contributed.'

The G-24 therefore proposed the adoption of 'fractional apportionment', pointing out that this method has long been regarded as acceptable, and has been included in tax treaties, until its omission from the OECD model in 2010. Their submission continued:

> 'For this purpose, (a) the definition of the tax base to be divided; (b) the determination of the factors based on which that tax base is to be divided; and (c) the weight of these factors, need to be determined.'

This proposal was one of three summarised in a consultation document issued by the OECD Secretariat in February 2019.[2] While the other two also entailed acceptance of a new taxable nexus, they were much more limited in scope, focussing on specific modifications of profit allocation rules related only to sales: one on the value created by 'user participation' in the digitalised economy, and the second on 'marketing intangibles'. Elements of these three proposals became the basis of a 'new taxing right' that is intended to be created by a multilateral convention (MLC) to introduce what is called Amount A of Pillar One. Work also focused on designing a global minimum tax, which resulted in proposals under Pillar Two. In 2021 the OECD proclaimed the two Pillars as the solution to the reform of the international tax system, together with an Implementation Plan.[3]

The challenge now facing countries is (i) to assess which, if any, of the current BEPS outcome elements to implement; (ii) to respond to their likely implementation by some other countries; and (iii) to pursue possible options for further progress.

A. THE CURRENT PROPOSALS

The OECD/Inclusive Framework on BEPS aims this year to complete the work on the four components of the two Pillars outlined in October 2021. Here we explain and analyse these, as far as they are known at the time of writing this Brief.

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[1] G24 (2019). *Proposal for Addressing Tax Challenges Arising from Digitalisation*, 17 January. This was tabled at a meeting of the plenary of the Inclusive Framework in December 2018.
[2] OECD (2019). *Addressing the Tax Challenges of the Digitalisation of the Economy*. Public Consultation Document, 13 February.
[3] OECD (2021), *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*, 8 October.

1. Pillar One Amount A

This aims to provide a ‘new taxing right’ over an allocated part of the ‘residual’ profits of the largest and most profitable MNEs (around 100), based on sales regardless of physical presence, applying a new tax nexus rule (a simple quantitative threshold of sales revenues). It would be implemented through a Multilateral Convention(MLC), which the OECD hopes to release in July 2023, for willing countries to sign by the end of the year, although a number of issues remain to be resolved.

Due to its design the MLC would require *ratification* by a significant number of countries *before* it could come into effect.[4] These should include the main MNE home countries, particularly the US (which accounts for around one-third of the profits that would be reallocated), as well as at least some of the main ‘investment hubs’, which would be required to surrender profits (e.g. Bermuda, Ireland, Isle of Man, Liechtenstein, Singapore, South Africa, Switzerland, Thailand).[5] US ratification is key, but it requires approval by two-thirds of the Senate, so it would need bipartisan support, which is highly problematic in the present state of US politics. Hence, the MLC is very unlikely to come into force, certainly not in the immediate future.

Even if the scheme could be implemented, available estimates suggest that the net benefits to lower-income countries would be very small.[6] In exchange, participating countries would be required to give up digital services taxes (as defined in the MLC) for all MNEs, not just those in scope of Amount A.[7] Amount A itself applies formulary apportionment, starting from the consolidated profits of the MNEs (adjusted for tax purposes), and allocating a share of profits based on the location of sales (applying detailed sourcing rules, including for services). However, it would leave in place the existing ‘transfer pricing’ rules based on the radically different independent entity principle, for allocating the remaining profits of in-scope MNEs, and for all the profits of those not in scope.

Participation in the scheme has wider implications beyond the revenue involved. The rules for administration of Amount A are highly complex,[8] largely due to its design (e.g. scope of application, interactions with existing transfer pricing rules, allocation of the obligation to ‘relieve double taxation’).[9] There will be a ‘tax certainty framework’, to administer the process, which will give the MNE’s home country the main role, subject to panels and arbitration to prevent and resolve disputes. This will apply not only in relation to Amount A itself, but also to ‘related’ issues, which could extend to *any* questions regarding transfer

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[4] This is unlike the multilateral instrument (MLI) on BEPS, which applies between pairs of countries to modify their bilateral treaties; the MLC will apply a joint scheme for taxation of the in-scope MNEs, hence it requires participation of all countries in which those MNEs declare any significant income.

[5] See M. Barake and E. Le Pouhaer (2023) ‘Tax Revenue from Pillar One Amount A: Country-by-Country Estimates.’ EU Tax Observatory, Appendix A.

[6] The IMF estimates a net reallocation of $12b of profits (based on 2019 data), the OECD somewhat higher, an average of $12-25b per year (over 2017-2021); this would mean for low-income countries around 0.0-0.7% of their corporate income tax (CIT) revenues, while the OECD again is higher, suggesting 0.7-1.7% (IMF 2022, OECD 2022). Analysis by the EU Tax Observatory is similar, and they also provide some estimates for individual countries (Barake and Le Pouaher 2023).

[7] The draft MLC provisions on DSTs (released for comment in December 2022) proposed a relatively narrow definition of DTSs, to cover a tax not treated as an income tax under domestic law or otherwise considered outside the scope of a tax treaty, as well as applying explicitly or in practice ‘exclusively or almost exclusively to non-residents or foreign-owned businesses’ and ‘primarily by reference to the location of customers or users, or other similar market-based criteria’. For analysis and comments see BEPS Monitoring Group (2023), *Withdrawal of Digital Services Taxes and Relevant Similar Measures*, 25 January.

[8] The most extensive, although still partial, draft that has been released is the July 2022 Update, in which the substantive rules covered 20 pages, followed by ten Schedules of over 60 pages.

[9] See BEPS Monitoring Group (2022), *Progress Report on Amount A of Pillar One*, 19 August.

pricing for in-scope MNEs.[10] Thus, participation would entail significant obligations, as well as administrative time and other costs, which would be onerous, making it hard to provide an effective check on the home countries of the MNEs affected which will primarily run the scheme. Low-income countries in particular should consider whether this would be the most appropriate way to deploy their scarce tax administration capacity.

2. Pillar One, Amount B

This aims at a simplified application of the arm's length principle to 'baseline' marketing and distribution activities. The last published draft proposed a version of the transactional net margin method (TNMM) widely used in transfer pricing, by applying benchmarks based on statistical analysis, applying to wholesale marketing and distribution.[11] This applies a 'one-sided' methodology, allocating only a 'routine' level of profit to affiliates performing the covered functions, which allows high shares of profit to be attributed to affiliates in other countries for functions closely tied to distribution (e.g. marketing, logistics, sales). This version of Amount B would continue to allocate low levels of profit to countries where sales are made. Any simplification that it might achieve would be at the cost of locking source countries into acceptance of relatively low levels of tax revenue. Work is continuing on the guidance, and much remains to be done.

Implementation is independent of Amount A, and could be done by amending the OECD Transfer Pricing Guidelines, and perhaps the UN Manual. These are not binding on states, but many lower-income countries have enacted legislation which incorporates them into domestic law, which may occur automatically as they are updated. It would be undesirable for Amount B to become a standard de facto binding even on non-OECD members, so it should not be included in the OECD Guidelines, and certainly not in the UN Manual.

3. Pillar Two: the Global Anti-Base Erosion tax (GloBE).

The GloBE will implement a minimum effective tax rate on MNE groups with over €750m turnover, by allowing countries to apply a top-up tax to ensure that the group's affiliates in each country pay the minimum of 15%, on the GloBE income in the jurisdiction. This is the net income or loss declared in each jurisdiction under financial accounting standards, and applying existing transfer pricing rules, with specified adjustments to arrive at the GloBE tax base. This will place a floor on the competition to reduce corporate tax rates, although it risks becoming a ceiling, and is significantly lower than the current average nominal weighted rate of 25%.[12]

Adherence to the scheme is voluntary, but to ensure coordination a participating country would be expected to join the implementation framework. This will entail a rigorous review of the rules it adopts, to verify if they can be treated as 'qualified' under GloBE rules. It is also planned to provide a single point of filing for each MNE of the GloBE Information Return, which would then be supplied to other relevant participating countries through information exchange arrangements.[13]

Adoption of some or all elements of the GloBE has begun in several major states, particularly through its uniform and coordinated application under a Directive among the 27 EU member

[10] See BEPS Monitoring Group (2022), *Tax Certainty Issues Related to Amount A*, 10 June.

[11] The concept was originally put forward by two MNEs, Procter & Gamble and Johnson & Johnson, which proposed a different methodology, that included a fractional apportionment element: see BEPS Monitoring Group (2023), *Pillar One Amount B*, 25 January.

[12] See https://taxfoundation.org/publications/corporate-tax-rates-around-the-world/

[13] OECD (2022), *Pillar Two – GloBE Information Return*, Public Consultation Document 20 December 2022 – 3 February 2023, para. 15.

states, which will give it momentum.[14] Instead of the GloBE, the US Congress in 2022 enacted a corporate alternative minimum tax (CAMT), which applies a 15% minimum tax on profits based on financial accounts, in tax years beginning from 2023, to corporations with revenues over $1b p.a. (around 150).[15] This is not aligned to the GloBE rules, but will be treated in the same way as a tax on controlled foreign corporations (CFCs), i.e. taken into account as covered tax in calculating the GloBE's ETR. The Biden administration's proposals to amend the GILTI to align with the GloBE seem unlikely to be adopted in the near future, as Republicans are very hostile to the GloBE, and some are threatening retaliatory measures.

The GloBE creates complex interacting rules, giving the primary right to tax undertaxed profits to the (ultimate, or failing that intermediary) home countries of MNEs, to apply the income inclusion rule (IIR), while the right of host countries to apply the undertaxed profits rule (UTPR) is only a backstop.[16] However, countries can also apply a domestic minimum top-up tax (DMTT), on the profits that MNE affiliates declare in that country. A Qualified DMTT (one which is accepted under the implementation framework to be in accordance with the GloBE rules) would be deducted from the top-up tax otherwise payable under the IIR (or the UTPR). Hence it would have priority over both.

Some have suggested that lower-income countries could benefit from introducing a DMTT. However, the DMTT applies to the GloBE income declared in the country *under existing transfer pricing rules*. For source countries the problem is that MNEs can easily shift profits out under these rules, for example by avoiding having a PE, deductions of interest, fees and royalties, and attribution of only 'routine' profits to any resident affiliate. The DMTT has no impact on any of this. The DMTT would benefit countries that have adopted tax incentives to encourage MNEs to declare high profits there (e.g. Ireland, Netherlands, Bermuda, Luxembourg, Cayman Islands, Singapore, Mauritius). These jurisdictions offer zero- or low-tax regimes to attract profits shifted from other countries where MNEs have real activities. The adoption of a DMTT by such conduit countries would ensure that MNEs in-scope of the GloBE pay at least 15% there, pre-empting the application of an IIR by home countries.

However, unlike either the IIR or the UTPR, the DMTT does not apply to profits that have been shifted to jurisdictions where they are undertaxed, but only to profits which which are declared in and could in any case be taxed by the country concerned. Giving the DMTT priority over both the IIR and the UTPR continues to encourage profit-shifting, due to the still significant difference between the 15% minimum ETR and the average headline rate on corporate profits of 25%. Inclusion of the DMTT in the GloBE makes it easier for conduit countries to continue offering preferential tax regimes.[17]

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[14] The 27 EU member states must implement it by the end of 2023, with both the IIR and the UTPR, and most are likely to include a DMTT also; plans of other countries include: Korea (enacted IIR & UTPR, and a power for a DMTT); Japan (IIR, wef April 2024); Malaysia (plans by 2024, including DMTT); Indonesia (considering for 2024); Singapore (plans by 2025, including DMTT); Hong Kong (the same); Australia (consultation); UK (enacting IIR and DMTT in 2023); Canada (plans for IIR & DMTT by 2024, UTPR 2025); Colombia (enacted its own minimum tax, which has a broader scope than the DMTT); New Zealand (Bill published May 2023 to incorporate all GloBE rules into NZ law). There have been no announcements yet from other G20 countries, e.g. Brazil, China, India. Informal working groups are working on outstanding issues (e.g. administrative guidance DMTT).

[15] See Jane A. Gravelle (2023), 'The 15% Corporate Alternative Minimum Tax', Congressional Research Service, p. 6.

[16] See BEPS Monitoring Rules (2022) *Comments on the Model Rules for the GloBE*, 25 January.

[17] M. Devereux, J. Vella and H. Wardell-Burrus (2022) Pillar 2's Impact on Tax Competition. WP 22/11: Oxford University Centre for Business Taxation. There is already evidence that such conduit countries have managed to benefit from the failure of the first phase of BEPS reforms to prevent treaty shopping, see Hohmann

The likelihood that the DMTT will be adopted by conduit jurisdictions strengthens the need for source countries to adopt more appropriate measures to protect their own tax base, rather than adopting a DMTT or relying on the UTPR, which has the lowest priority under the GloBE. Of course, all states have the sovereign right to tax income sourced from their territory, unless such right is ceded by a tax treaty. The logic of the GloBE is that if a country fails to exercise its right to tax income at least at the minimum 15% rate, top-up tax can be applied by others. Hence, countries should ensure that income is taxed appropriately at source, where it derives, by applying suitable measures to prevent profit-shifting.

In our view, participation in the GloBE is not appropriate for most developing countries, due to its design and scope, and the complexities and constraints that the implementation framework would impose. The worst option of all would be to join the GloBE scheme and rely on the QDMTT, without also adopting measures to ensure that MNEs pay a fair level of tax at source. However, the GloBE's adoption could benefit all, by creating an incentive for all countries to raise their effective tax rate to at least the 15% minimum, since any undertaxed profits would likely be taxed at that rate by another country. Hence, countries should review and phase out their tax incentives. Revenue authorities should work with civil society to help politicians to resist the lobbying pressures from MNEs for new subsidies, which have already begun.[18]

All countries should also consider other measures, as alternatives or in addition to the GloBE, that may be more suited to protecting their tax base (discussed in section B below). Such measures should be considered compatible with the GloBE, and hence treated as 'covered taxes', provided they fall within its definition of a tax on income rather than on gross receipts. This would both assert the prior right to tax profits at source, and forestall complaints by MNEs of double taxation.

4. The Subject to Tax Rule

The Subject to Tax Rule (STTR) was introduced into Pillar Two at the initiative of lower-income countries, which were dissatisfied with the GloBE rules' bias towards MNE home jurisdictions. It will require amendments to existing tax treaties, which will be a non-trivial task, even though Inclusive Framework members have accepted a political obligation to agree to its inclusion in treaties with lower-income countries.[19]

However, the principles for the STTR announced in 2021 mean that it would be weak, since the rate is capped at 9%, and has a limited scope – it is proposed to apply only to interest, royalties and 'a defined set of other payments'. It would ensure that payments between affiliates of MNE groups in two tax treaty partners are taxed at the minimum rate of 9%, so that if the payment is taxed in the recipient country below the 9% minimum, a top-up withholding tax can be applied by the country of the payer to make up the difference. Hence, if the country of the recipient taxes its income at less than 9%, the STTR will have priority over the GloBE top-up taxes. Taxes collected under the STTR will be 'covered taxes' under the GloBE and included in the computation of the ETR.

A, Merlo V and Riedel N (2022) Multilateral Tax Treaty Revision to Combat Tax Avoidance: On the Merits and Limits of BEPS's Multilateral Instrument, https://drive.google.com/file/d/18nwqszywqbeIDFqLY4lnIQXFDWq34x14/view

[18] See e.g. Guarascio, F. & Vu, K., 2023, 'Exclusive: Vietnam eyes multi-million-dollar handouts to Samsung, others to offset global tax', Reuters 30 May: https://www.reuters.com/world/asia-pacific/vietnam-eyes-multi-million-dollar-handouts-samsung-others-offset-global-tax-2023-05-30/

[19] Defined as those with a GNI per capita, calculated using the World Bank Atlas method, of $12,535 or less in 2019, to be regularly updated.

However, the minimum rate of 15% under the GloBE is higher than that of the STTR, so the IIR and QDMTT could still also apply. The rationale suggested for the lower rate is that the STTR applies to the gross payment rather than net profits, but it seems that the rate to be applied will take account of tax paid in the receiving country, hence it is a cap on the rate applied to net profits, so may be less than 9% on the gross payment. Hence, capping the withholding tax under the STTR at a lower minimum rate than for the GloBE means that the STTR will have only limited priority, home and conduit countries could apply a DMTT or an IIR at 6% to ensure the minimum of 15% under the GloBE is reached. This again shows the bias of Pillar Two against source countries.

The STTR should also apply to all services (including automated digital services) even between unrelated entities, as well as to capital gains, but this is unlikely to be accepted by OECD countries. As currently proposed it would cover only 101 existing treaties for 32 lower-income countries with 13 other countries.[20] Even if implemented in all these treaties the IMF estimates the additional revenue as varying from near zero to 0.14% of current CIT revenue.[21] These increased revenues would go to the recipient country if it raises its rate to at least 9%.

An alternative provision has been agreed in the United Nations Tax Committee for an STTR for inclusion in the UN Model Tax Convention. This would have a much broader scope, covering all payments that are undertaxed in the recipient country. In the meantime, lower-income countries should ensure that their domestic tax rules properly tax payments to non-residents of fees, royalties and interest, which reduce the domestic tax base, and review any treaties that allow such payments to be made to entities in countries where such income is taxed at low or zero rates. They should deny deductions for such payments under domestic anti-abuse rules, in conjunction with the general anti-abuse principle (the principal purpose test, PPT), that should now be included in all treaties following the recommendations of Action 6 in the first phase of the BEPS process.[22] Specific anti-abuse provisions could also be introduced: for example, Australia's measures tabled in June 2023 to deny deductions for payments attributable to an intangible asset made by 'significant global entities' to an associated entity if the income is subject to a low tax rate.[23]

B. OTHER MEASURES FOR CONSIDERATION

It is clear that the implementation of Pillar Two will do little or nothing to stop base erosion at source, and hence will not benefit lower-income countries, which are mainly host countries for MNEs. Those countries could nevertheless indirectly benefit from the adoption of the GloBE by others, since it would reduce the pressure on them to offer tax advantages to foreign MNEs. They should therefore review their tax incentives, to ensure that they do not result in an effective tax rate on MNE affiliates in the country below 15%. They may wish to take into account the exclusion under the GloBE rules of income based on economic substance (assets and payroll). However, it should be borne in mind that such expenses are already taken into account in determining the net taxable profits, and adding this income

[20] See IMF (2023) p. 42, which assumes it will include royalties, and charges for financing and insurance, and for professional and technical services, but not digitalised services or capital gains. Note also that the OECD interpretation of royalties excludes income from the licensing of software.

[21] IMF (2023), IMF (2023), *International Corporate Tax Reform*, p. 14.

[22] The PPT can be used to deny deductions of payments to a conduit which is not genuinely carrying out the relevant activities: see example G in Paragraph 182 of the Commentary to article 29 in both the OECD and UN models.

[23] Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Deductions for payments relating to intangible assets connected with low corporate tax jurisdictions, available at https://treasury.gov.au/consultation/c2023-382169

exclusion increases complexity and greatly reduces the revenue potential. For the global minimum tax to create an effective floor and stop the race to the bottom on tax rates, the minimum of 15% is essential.

The GloBE is also an opportunity for countries to strengthen taxation at source. This is in line with the principle of the GloBE, that countries can apply top-up tax to profits which have been shifted to jurisdictions where they are undertaxed. For example, countries should adopt policies, and where necessary introduce specific measures, to deny deductions for payments made to associated enterprises that are subject to low tax rates in the receiving country, as mentioned in section A.4 above. It should be noted that some OECD countries are already protecting their source tax base. Notably, the UK is retaining its Diverted Profits Tax (DPT),[24] aimed at arrangements avoiding tax on income earned in the UK by foreign MNEs. This is an addition to implementing the GloBE, which will also benefit the UK as the home or conduit country of many MNEs. The US has opted for its CAMT as an alternative to the GloBE.

Hence, measures to protect taxation at source may be additional to the GloBE for participating countries, or an alternative to it for countries that do not participate. In the next section we discuss two key general considerations of design, and then we outline and evaluate some measures that countries have adopted or that have been proposed.

1. Design Considerations

Compatibility with the GloBE, Trade Rules and Tax Treaties

Any suitable tax on income at source that falls within the definition of a 'covered tax' under the GloBE rules would take precedence over GloBE taxes (the IIR and QDMTT) when calculating the ETR under GloBE rules. Covered taxes are defined in article 4.2 of the GloBE Model Rules as taxes on income, or 'in lieu of a generally applicable income tax'. The Commentary explains that taxes on income are generally applied to net profits; although that can include a 'simplified estimate of net profit', but not if done by reference to a gross amount 'without any deductions (i.e. a tax on turnover)' (para. 27). The 'in lieu of' test also allows 'taxes that are not described in the generally applicable income tax definition but which operate as substitutes for such taxes.' Explaining this criterion, the Commentary states that it 'would generally include withholding taxes on interest, rents and royalties, and other taxes on other categories of gross payments such as insurance premiums, provided such taxes are imposed in substitution for a generally applicable income tax' (para. 31). This does not specifically refer to withholding taxes on fees for services, so their treatment remains uncertain.

However, the Commentary does specifically state that digital services taxes (DSTs) will generally not fall within the definition of covered taxes. This is because (i) they apply to gross and not net income, and (ii) they are 'generally designed to apply in addition to, and not as substitutes for, a generally applicable income tax under the laws of a jurisdiction' (para. 36). This is likely to apply to all taxes on digitalised transactions, not just the DSTs that would need to be withdrawn under the MLC.[25] However, it is possible to design a tax on

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[24] An announcement on 19th June 2023 stated that consideration is being given to integrating the DPT into transfer pricing rules, while maintaining its key advantages, which are estimated to have resulted in £8b of tax revenue between 2015-2022.

[25] Many countries have introduced such taxes: see the surveys by KPMG, most recently Taxation of the Digitalized Economy: Developments Summary 9 March 2023; this reports measures which it categorises as direct taxes have been enacted in 31 countries, while 9 more have made announcements or proposals; in addition, 100 have extended indirect taxes, mostly VAT, to digitalised transactions, some at subnational level.

income from digitalised services which is more clearly part of a generally applicable income tax (see below).

DSTs would also be required to be withdrawn by countries participating in the MLC for Amount A. Even for countries that decide not to do so, there may be retaliatory action against DSTs under trade rules, particularly by the US.[26] Kenya recently announced that it will modify its DST to align it with both the Pillar One and Pillar Two rules, in the light of its negotiations for a trade and investment agreement with the US.[27] To align with those rules, such taxes should be designed as far as possible (i) as direct taxes on income, rather than indirect transactions taxes, and (ii) to be broadly applicable rather than targeted in a way that could be considered discriminatory.

It may also be important that such taxes can be considered compatible with tax treaties or international tax rules more generally. There would only be a direct conflict if such a tax is applied in relation to an entity that is resident in a country with which a tax treaty is in force. The provisions in tax treaties can vary considerably, and there are significant divergences between those based on the OECD and the UN models, particularly in relation to tax on income from services.[28] (See further below).

More widely, however, compatibility with international tax rules would mean that such taxes could be taken into account for foreign tax credits. This may depend not only on international tax or treaty rules, but on the domestic tax rules of the country granting the credits. The US in particular has refused credits for some alternative minimum taxes (discussed below),[29] and has amended its rules to disallow credit for any 'extraterritorial' taxation. These require the source rules for income from services to be 'reasonably similar' to those of the US, and to attribute income from services based on the place of performance and not the location of the customer.[30] However, the MLC for Amount A will now include detailed source rules for sales income, including from services, which now establish an internationally agreed standard.[31] If countries adopt this as the basis for defining the source of sales income, it would be hard to justify denial of tax credits on these grounds. It should also be noted that these rules resolve problems such as determining the source of income from digital platforms for the sale of offline services (e.g. for accommodation), by splitting it between the country of residence of the purchaser and the place of performance of the service.

This listing does not include taxes such as Ghana's levy on electronic transactions introduced in 2022, or similar taxes on mobile money transactions in Kenya, Tanzania and Uganda. However, a tax designed to apply to income or profits, even if derived from digitalised transactions, should be treated as a covered tax under the GloBE.

[26] Sanctions under the US Trade Act s.301 are determined by the US Trade Representative, and directed by the executive, and have often been used as a weapon in international negotiations; adjudication under WTO rules, which could counteract them, is currently not possible due to US blocking of its procedures.

[27] A more broadly based tax is likely to produce greater revenues, as well as aligning with Amount A: see D. Akure (2023) 'New digital tax mechanism promises Kenya windfall.' *Business Daily*, 3 April.

[28] For further detail see S. Picciotto (2021) The Contested Shaping of International Tax Rules: The Growth of Services and the Revival of Fractional Apportionment. ICTD Working Paper 124.

[29] Aslam and Coelho, p. 13.

[30] See Internal Revenue Service, Guidance Related to the Foreign Tax Credit; Clarification of Foreign-Derived Intangible Income, 26 CFR Part 1, Federal Register, Vol. 87, No. 2, Tuesday, January 4, 2022. Some countries, e.g. India, apply a withholding tax on payments made by customers resident in the country for services, regardless of where the services are performed, and this is allowed under articles 12A and 12B of the UN model convention.

[31] OECD, 2022, *Progress Report on Amount A of Pillar One*; Schedule E Revenue Sourcing rules.

Data availability and access

Data availability is also set to improve substantially. The system for country by country reporting has been established, but now clearly needs significant improvement. First, the design introduced needless flaws including in the measure of profit, which allows divergences in the accounting methods, and does not require reporting of, or reconciliation with, a group's consolidated profits. Second, it provides for home country filing only, with a complex and costly system for exchange of information. Most non-OECD members are still not participating, and countries face tight limitations on their use of the data, with the threat of being excluded again.[32]

Growing momentum for public country by country reporting is now bringing change, supported by evidence that it can result in more effective taxation.[33] The leading international sustainability standards setter, the Global Reporting Initiative (GRI), developed an improved standard, based on technical work and consultation involving representatives of major reporting companies, the big four accounting firms, academics, investors, labour and civil society. This has been receiving increasing support, including from investors with trillions of dollars of assets under management. The OECD has still not released any report of its public consultation on CbCR conducted in 2020, when many called for it to align with the GRI, including requiring publication.

The European Union has agreed to require publication of OECD standard data from 2024, although with one important limitation: country-level data will only be required for EU member states and the small number of jurisdictions on the EU's 'non-cooperative' list (which are mainly irrelevant to international profit shifting). The Australian government continues to consider legislation which is expected to go significantly further and to require publication of GRI standard data for all MNEs operating in the country (likely to cover more than a quarter of those currently reporting under the OECD standard). This would provide many tax authorities with direct access, and further normalise proposals for all countries to require publication of this data by all MNEs with a significant economic presence in their jurisdiction.

2. Alternative Minimum Taxes (AMTs)

Many countries have in place AMTs, designed in various ways, depending on their aim. They can apply only to local affiliates of foreign MNEs, to reinforce territorial taxation, or also to foreign affiliates of locally resident parents (like CFC rules). For most lower-income countries the former are more relevant.

These can be designed either as a substitute for a regular income tax or, more commonly as creditable against any liability for income or profits tax. Carry-forward rules may also be needed, to deal with variations in profitability. However, since they are designed to restrict profit-shifting, companies should eventually pay the higher of AMT or regular CIT taxes due.

[32] Fewer than half of UN members have any access, and progress is negligible even compared to other OECD-led instruments: see Table III.A.2 of IATF, 2023, *Financing Sustainable Development Report 2023*, New York: Inter-Agency Task Force on Financing for Development. In addition, the exchange protocol prohibits use of the data for tax assessment.

[33] Overesch, M. & Wolff, H., 2021, 'Financial transparency to the rescue: Effects of public country-by-country reporting in the European Union banking sector on tax avoidance', Contemporary Accounting Research 38(3), 1616-1642.

(i) Based on Financial Accounts (Book Income)

These aim to limit the benefits for taxable entities from tax incentives, such as generous investment allowances or nonrefundable tax credits, by ensuring that they pay at least a minimum rate on profits calculated by reference to financial accounting rules, in the country concerned. This is the approach adopted by the US for its CAMT as an alternative to the GloBE rules.

This type of tax is far more suitable for developing countries than the DMTT, for several reasons. The top-up tax applicable under the DMTT is limited to what would otherwise be payable under an IIR, and would require complex calculations which would be a heavy burden for small jurisdictions. For an AMT, the country can specify adjustments to the financial accounting measure of profit to suit its own circumstances. It can also determine the scope of application, particularly the size threshold. Overall, such a tailored minimum tax would be far easier to administer, and less restrictive, than adopting a DMTT and joining the GloBE implementation framework. Colombia has introduced such a minimum tax, at the rate of 15%, based on modified book income, as an alternative to a DMTT.[34]

(ii) Based on Modified Income

Here the tax base is the same as the income tax, but the deductions are limited, hence the term modified income. India is one country that follows this approach applying a minimum rate of 18.5% to a tax base which is the normal tax base but with a limited number of allowable deductions.[35] Like the minimum tax on book income, this aims to limit the benefits that a company can obtain from the often large variety of tax incentives enacted by legislatures over time.

(iii) Based on Turnover and/or Assets

AMTs can also be designed as an alternative way of attributing profits to MNE affiliates to restrict base erosion and profit shifting. These are also much easier to apply than the complex transfer pricing rules, so they can be more suitable than the proposed Amount B.

Many low- and middle-income countries have adopted minimum taxes based on gross revenues. According to IMF data, in 2018, 31 countries applied such taxes, at rates between 0.2% and 3.0%, with an average of 1.2%.[36] These have the advantage of being easy to administer, particularly compared to the complex rules on transfer pricing. However, they take no account of differences in profit margins between different sectors or firms, and may hit hard on small and medium firms.

Indeed, in 2021 the Kenya High Court suspended the introduction of an AMT that would have obliged all businesses to pay a minimum of 1% on gross turnover as against the normal rate of 30% of net income or profits. It found that the petitioners, an association of bar owners, had made an arguable case that this would violate the constitutional requirement of equality in the application of law, and that businesses such as theirs in the consumer sector

[34] Ley 2277 de 2022, article 10, para. 6.

[35] Chapter VI-A heading C, Section 35AD and Section 10AA of the Indian Income Tax Act (https://cleartax.in/s/amt-alternative-minimum-tax).

[36] Aslam A and Coelho MD (2021) 'A Firm Lower Bound: Characteristics and Impact of Corporate Minimum Taxation.' Working Paper No. 2021/161 IMF. See also Best MC, Brockmeyer A, Kleven HJ, et al. (2015) 'Production versus Revenue Efficiency with Limited Tax Capacity: Theory and Evidence from Pakistan.' *Journal of Political Economy* 123(6): 1311-1355.

would be annihilated, since they could not achieve the implied net profit rate of 3.33%, particularly in the post-pandemic economic conditions.[37]

In Nigeria, the Companies Income Tax Act (Section 30) allows the Federal Inland Revenue Services (FIRS) to assess profits tax on a 'fair and reasonable percentage' of turnover. This is done by charging the standard corporate income tax rate of 30% on a 'deemed profit' of 20% of the turnover, an effective tax rate of 6% of the turnover. The method applies essentially as an anti-abuse rule and is triggered by some prescribed conditions including 'where the true amount of the assessable profits of the company cannot be ascertained'. Probably for this reason, it does not appear to have been challenged in the courts. This has now been applied also to income from digital services. However, it falls outside the definition of a DST under the proposed MLC for Amount A. It would also be hard to treat as a violation of trade rules, since it is a tax on income under domestic law, and not a transaction tax.

Others, particularly in Latin America, have used an assets basis. Such taxes were in effect in 10 countries in 2018, at rates between 0.4 and 2.0%. These can be effective particularly in a context of high inflation, since companies can declare tax losses (e.g. due to interest deductions) which can be carried forward (often indexed to inflation) avoiding tax for many years.[38] Generally, only fixed or tangible assets are used, which increases incentives for their efficient use. This disadvantages capital-intensive firms, but can encourage employment.

It is likely to be contentious whether taxes of this type would be treated as 'covered' under the GloBE rules, or eligible for tax credit under treaties. Such treatment would be more likely if they are formulated as a method of calculating the net income or profit. It should be noted that even the supposedly 'transactional' methods in the OECD Transfer Pricing Guidelines include the 'cost-plus' and 'retail-minus' methods, which apply a profit margin to the gross revenues, although this is determined by reference to supposedly similar transactions between independent parties. An alternative method could be justified as needed because it's not otherwise possible to ascertain the true profits, as under Nigeria's law. Another possibility is to treat the tax as an option in lieu of the regular tax, or an advance payment against it.

3. Fractional Apportionment

The fundamental issue remains that digitalisation has exacerbated the longer-term shift to the intangible and services-based economy, revealing the fundamental flaws of the tax rules devised by the OECD, which prioritised the country of residence and entrenched the independent entity or arm's length principle. As made clear in the 2018 report under Action 1 of the BEPS project, this requires a rethinking of the basic principles of international tax: the definition of taxable presence, and the attribution of profits. The solution, as pointed out by the G-24 in 2018, is to base the tax nexus on significant economic presence, and to attribute profits by fractional apportionment.

Among the many advantages of this approach is that it taxes the net income or profits of the MNE concerned. Hence, it is superior to the AMTs discussed in the previous section, which are mainly a fall-back, simplified mechanism to ensure a minimal level of taxation. Taxation of an appropriate share of each MNE's actual global profit reflects the ability to pay of that MNE, so is much more justifiable in economic terms than a tax on revenues such as a DST.

Apportionment based on factors reflecting the MNE's real presence in each jurisdiction (physical assets, employees and sales) would also be relatively easy to administer, and hard to

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[37] *Waweru - Chairman & 3 others (Suing as Officials of Kitengela Bar Owners Association) v National Assembly & 2 others* [2021] KEHC 455 (KLR).

[38] Aslam and Coelho (2021), p. 10.

avoid. MNEs could of course respond by moving production to lower-tax jurisdictions, but this would be deterred by the inclusion of sales in the formula. Such strategies would also depend greatly on the suitability of a country for the location of such real investments: availability of a workforce with relevant skills, adequate infrastructure, etc. Thus, countries would no longer be able to compete by offering tax breaks to attract paper profits, but would also need to offer an attractive location for real activities. This approach would finally achieve the objective set for the BEPS project of aligning rights to tax MNE profits with their substantive presence in each country.

A comprehensive shift towards unitary taxation with formulary apportionment would require broader international agreement. However, significant shifts in this direction can be made by willing states, learning from each other to enable convergence and collaboration.

Taxable Presence

A taxable presence may be found to exist even under current rules. For example:

> (i) a 'services PE' under treaties based on article 5.3.b of the UN model;
>
> (ii) an 'agency PE', where the MNE has a local subsidiary which may be considered to be also a PE of a related non-resident subsidiary (e.g. a local affiliate dealing with marketing or customer support may be treated as a PE of a non-resident affiliate to which sales revenue has been attributed);[39]
>
> (iii) by requiring a non-resident wishing to do business to do so through a locally incorporated company (e.g. in Nigeria, under the Companies and Allied Matters Act: s.54).

Several countries have also gone further and introduced a new taxable nexus based on 'significant economic presence' (SEP), as proposed by the G-24, notably India, Nigeria and Colombia. These have various definitions, usually aimed at digitalised services. Notably, Nigeria defined a SEP by a combination of user-based criteria and a sales threshold, requiring affected MNEs to register and comply with their tax obligations in Nigeria.[40]

However, the proposals for a new taxing right, Amount A, provide for a taxable nexus based on a simple quantitative threshold of sales revenues.[41] This seems to be both practical and

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[39] Treaties that include the new language resulting from BEPS Action 7 extending the PE definition to an entity 'habitually playing the principal role leading to the conclusion of contracts', could make it easier to treat a subsidiary as also constituting an agency PE.

[40] Finance Act 2019 s.4 extended taxation of income derived by a non-Nigerian company from a trade or business in Nigeria to (i) various kinds of digital activities, including e-commerce, online advertising, and a participative network platform, and (ii) furnishing technical, management, consultancy or professional services outside Nigeria, in each case 'to the extent that the company has significant economic presence in Nigeria'. The Companies Income Tax (Significant Economic Presence) Order 2020 defined the term SEP in relation to (i) as a minimum of 25 million Naira (equivalent to USD 40,000, the de minimis threshold for corporate income tax) derived from a range of digitalised activities, and for (ii) where any payment or income for services is derived from a Nigerian resident or a fixed base or agent in Nigeria of a non-Nigerian company. The Companies Income Tax Act s.30 allows income to be attributed based on a 'fair and reasonable percentage' of turnover if 'the true amount of the assessable profits of the company cannot be readily ascertained', and this was fixed at 6% for income from digitalised activities. Nigeria does not regard this as a DST; but under the 2020 Order it would cease to apply to any company that becomes subject to tax under a multilateral agreement or consensus arrangement addressing the tax challenges arising from digitalisation of the economy to which Nigeria is a party.

[41] €1m revenues from sales in a country, €250k for countries with a GDP below €40b. At time of writing, the latest published draft of the MLC is in OECD, 2022, *Progress Report on Amount A of Pillar One*; the Nexus rule is article 3; article 4 and Schedule E deal with the Revenue Sourcing rules, and article 5 is the Determination of the Adjusted Profit Before Tax of a Group.

effective. It reflects a wide consensus that now accepts that a significant level of sales demonstrates a close interaction with customers and the benefits of access to a market, which are essential to profitability. There seems to be little reason for limiting this to only a few large and particularly profitable MNEs.

There is a strong economic rationale for taxing non-residents when they derive significant levels of income from accessing a country's market without any significant physical presence. The failure to do so gives non-residents tax advantages over local entrepreneurs and hinders the growth of jobs and the local economy. This runs counter to the justification usually argued for tax treaties, that they stimulate inward investment. Furthermore, payments to non-residents, particularly for business-to-business services, are deductible from the customer's business income, hence undermining the source country's tax base.

Attribution of Profit

If the MNE has little or no physical presence in a jurisdiction, it will also have few direct expenditures there. Mismatches between the location of revenues and expenditures are inherent in the modern type of highly-integrated MNEs, and mean that a tax on net income or profits in each country must be based on apportionment. This was recognised from the earliest beginnings of negotiations on international tax standards, resulting in a provision in the model treaty which continues to this day in the UN model treaty's article 7.4. Even the OECD's Transfer Pricing Guidelines include a profit-split method.[42] Various methods of applying apportionment are possible.

India in 2019 published a discussion draft on the for public comment, proposing a formulary method to define profits derived from India when an MNE has a taxable presence, and explaining how this could be valid under tax treaties. The proposal would multiply the revenues from sales in India by the global operational profit margin of the TNC and then attribute the taxable profits using an apportionment method applying a 3-factor formula of sales, employees and assets. The use of local revenues as a base was mainly to make the method easy to apply, in the absence of a suitable standard for global consolidated profits. Such a standard has now been agreed, for the proposed MLC to introduce Amount A.

The OECD Transfer Pricing Guidelines reject global formulary apportionment, defined as the allocation of an MNE's global consolidated profits based on 'a predetermined and mechanistic formula'. Many of the reasons given for this rejection are based on administrative concerns, most of which have now been resolved in the rules for the two pillars. Pillar One establishes agreed rules for defining the MNE's total consolidated profits for tax purposes, as well as for determining the source of sales revenue (including for digital services), for allocating a share of profits based on sales. Rules have also been agreed under the GloBE's substance-based carve-out for defining and quantifying physical assets and employees. Hence, we now have detailed technical standards agreed internationally that could be used to define total global profits for tax purposes, and for all three factors put forward by the G24 for formulary apportionment.

The principled defence of the arm's-length principle in the Guidelines, as based on 'the normal operation of the market', now looks even more shaky, given that the BEPS proposals have accepted the unitary principle, as well as establishing technical standards that would

[42] It is noteworthy that MNEs and their home countries more readily support the apportionment of expenses, particularly for central services, as seen in the first phase of the BEPS project; indeed, the work done by the OECD on limitation of deductions showed that the only effective way to prevent excessive deduction of interest is apportionment of the costs of servicing the MNE's total debts to third parties, and this method was accepted, although only as a backstop in conjunction with a fixed cap.

greatly facilitate coordinated implementation. The OECD guidelines are not binding international law, but at most aids to interpretation of the treaty articles. Tax treaty rules provide considerable leeway in determining the appropriate approach for allocating MNE income, as can be seen by the acceptance of the profit-split method, and the provision for fractional apportionment in article 7(4). The provisions in articles 7 and 9 for attributing profits for taxable purposes to affiliates of MNEs, which have been used to justify the arm's length principle and the OECD Guidelines, are essentially anti-abuse rules. Tax treaties can be reinterpreted or revised, the main obstacles to adopting formulary apportionment are now political.

CONCLUSION: TOWARDS A PRACTICAL CONSENSUS

The central question remaining after the second BEPS phase is this: how will countries, individually or in groupings, take steps now to protect their tax bases by reducing the misalignment between where MNEs carry out their real economic activity and where they declare profits?

The discussion above points to a clear direction of travel. By careful design, it should be possible to elaborate measures for a new approach to allocating MNE income, based on the SEP and formulary apportionment, which are both compatible with other instruments and feasible given the constraints, including data access, that face tax authorities around the world.

We note that there are now multiple fora and processes where such approaches can be taken forward. The time now seems right for a coalition of countries to develop more detailed proposals for the adoption of a new approach to allocating MNE income, based on SEP and formulary apportionment.