

## Beyond the Two Pillar Proposals

# A Simplified Approach for Taxing Multinationals

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### Abstract

This paper puts forward an alternative to the proposed multilateral convention under Pillar One of the BEPS project, by building on and going beyond the progress made so far. A new direction was signalled in 2019 by the G-24 paper proposing a taxable nexus based on significant economic presence, combined with fractional apportionment. The resulting measures agreed under the two Pillars entail acceptance in principle of this approach, and also provide detailed technical standards for its implementation. These include: (i) a taxable nexus based on a quantitative threshold of sales revenues; (ii) a methodology for defining the global consolidated profits of MNEs for tax purposes, and (iii) detailed technical standards for defining and quantifying the factors that reflect the real activities of MNEs in a jurisdiction (sales, assets and employees).

The time is now right to take up the roadmap outlined by the G-24. The work done shows that technical obstacles can be overcome, the challenge is essentially political. This paper aims to provide a blueprint for immediate measures that States can take, while engaging in deliberation at national, regional and international levels for a global drive towards practical and equitable reforms. Unitary taxation with formulary apportionment is the only fair and effective way to ensure taxation of MNEs where economic activities occur, as mandated by the G20. It can ensure that MNE profits are taxed once and only once, provide stability and certainty for business, and establish a basis for international tax rules fit for the 21<sup>st</sup> century.

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*Le présent document propose une alternative au projet de convention multilatérale proposé dans le cadre du pilier Un du projet BEPS, en s'appuyant sur les progrès réalisés jusqu'à présent et en allant au-delà. Une nouvelle orientation a été donnée en 2019 par le document du G-24 qui suggère d'établir un nouveau nexus basé sur la présence économique significative et l'allocation des bénéfices par le biais de la répartition fractionnée. Les mesures qui en découlent, convenues dans le cadre des deux piliers, impliquent l'acceptation de principe de cette approche et fournissent également des normes techniques détaillées pour sa mise en œuvre, notamment i) une règle concernant le lien imposable comportant des seuils quantitatifs sur la base du montant du chiffre d'affaires généré ; ii) une méthodologie pour définir les bénéfices mondiaux consolidés des entreprises multinationales à des fins fiscales, et iii) des normes techniques détaillées permettant de déterminer et de mesurer les critères reflétant l'activité réelle des entreprises multinationales dans une juridiction (chiffre d'affaires, actifs et salariés).*

*Le moment est venu de mettre en œuvre la feuille de route définie par le G-24. Les travaux réalisés montrent que les obstacles techniques peuvent être surmontés, le défi étant essentiellement politique. Le présent document vise à fournir un schéma directeur concernant les mesures immédiates que peuvent prendre les États, tout en engageant des discussions aux niveaux national, régional et international en vue de favoriser l'adoption de réformes pratiques et équitables. La taxation unitaire fondée sur une formule de répartition des bénéfices est le seul moyen équitable et efficace de garantir l'imposition des entreprises multinationales là où elles exercent leurs activités, comme l'a demandé le G20. Elle peut permettre de faire en sorte que les bénéfices des entreprises multinationales soient imposés une fois et une seule, apporter stabilité et certitude aux entreprises et jeter les bases de règles fiscales internationales adaptées au XXI<sup>e</sup> siècle.*

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*En este documento se plantea una alternativa a la propuesta de convenio multilateral con arreglo al Pilar 1 del Proyecto sobre la Erosión de la Base Imponible y el Traslado de Beneficios, al basarse en los progresos logrados hasta ahora e ir más allá de estos avances. En 2019, el informe del G24, que proponía un nexo imponible en base a una presencia digital significativa, combinado con el reparto fraccionario, marcó una nueva dirección. Las medidas resultantes acordadas con arreglo a los dos pilares conllevan la aceptación en principio de este enfoque, y también proporcionan normas técnicas detalladas para su implementación. Entre ellas figuran: i) un nexo imponible en base a un umbral cuantitativo de los ingresos por ventas; ii) una metodología para definir las ganancias consolidadas en todo el mundo de las empresas multinacionales a efectos fiscales; y iii) normas técnicas detalladas para definir y cuantificar los factores que reflejan las actividades reales de las multinacionales en una jurisdicción (ventas, activos y empleados).*

*Ahora es el momento adecuado para aceptar la hoja de ruta marcada por el G24. La labor realizada demuestra que los obstáculos técnicos se pueden superar, y el reto es esencialmente político. Este documento pretende proporcionar un plan sobre las medidas inmediatas que los Estados pueden adoptar, al tiempo que participan en deliberaciones a nivel nacional, regional e internacional para impulsar reformas prácticas y equitativas en todo el mundo. El sistema fiscal unitario con fórmula de reparto es la única manera justa y efectiva de garantizar la tributación de las empresas multinacionales donde se produce la actividad económica, tal como prevé el G20. Puede asegurar que las ganancias de las multinacionales tributen una vez solamente, proporcionar estabilidad y certidumbre a las empresas y establecer una base para unas normas fiscales internacionales adaptadas al siglo XXI.*

## A. Introduction

### 1. The Need for A Fresh Initiative

It is now ten years since the Group of Twenty (G20) leaders gave their support to the Organisation for Economic Cooperation and Development (OECD)-initiated project on 'base erosion and profit shifting' (BEPS), and called for reforms to ensure that multinational enterprises (MNEs) could be taxed on their profits "where economic activities occur".<sup>1</sup> The BEPS project may now finally be delivering on the package of proposals presented in October 2021 as the Two Pillar Solution.<sup>2</sup> Some important principles have been established, and assiduous technical work has resulted in agreement on important international standards. However, a closer examination of the actual measures now proposed shows that the four elements of the package fall well short of establishing effective and fair solutions for all, especially for developing countries.<sup>3</sup>

It is now time for a fresh initiative, which could maintain the momentum and build on what has been achieved. A leading role in this should be taken by developing countries, which have succeeded in playing a stronger role in recent years, although their perspective has been eclipsed by that of the larger and more dominant countries. Lower-income countries are more affected by the fundamental flaws and unfairness of the current rules, and more willing to envision a paradigm shift, which in practice would benefit all.

The only simple and effective way to deliver on the aims of the BEPS project is to tax MNEs in accordance with the economic reality that they operate as unitary enterprises under common ownership and control. This means that they should be taxed in every country where they have a significant economic presence (including sales), based on an apportionment of their total global profits for taxation in proportion to their real activities in that country. This approach has a long history. It has been applied in some federal states (notably the United States of America) for much of the last century; it has been proposed for application with-

in the European Union since 2001, and continues to be part of the EU's agenda. A proposal for its global adoption was most recently put forward in early 2019 by the Group of Twenty-four (G-24) group of developing countries, which pointed the recent negotiations in a more fruitful direction.<sup>4</sup> The recent report on international tax cooperation by the United Nations (UN) Secretary-General also formulates the goal that: "[t]he international tax system ... must ... help ensure that taxes are paid where economic activity occurs, including through relevant market participation".<sup>5</sup>

The current Two Pillar proposals accept the basic principle of unitary taxation of MNEs, with an allocation of taxing rights based on a threshold of sales, and provide detailed technical standards needed for its comprehensive adoption. Unfortunately, however, the measures now proposed for its implementation would be for only part of the profits of a small number of MNEs, while retaining existing rules for all other purposes. Estimates suggest that the likely benefits would at best be very small, particularly for developing countries, while joining the scheme could prevent countries from adopting alternative and more effective approaches.<sup>6</sup>

This paper therefore outlines the elements of a new approach for taxing the profits of MNEs and proposes a feasible pathway for its comprehensive adoption. This could be through a new initiative by willing States, as far as possible in coordination, and could finally establish a basis for international tax rules fit for the 21<sup>st</sup> century.

### 2. Rationale and Principles

MNEs operate in the real world as unitary enterprises under central management and control. This has enabled them to become dominant worldwide by taking advantage of economic globalisation. They are able to derive super-profits due to their ability to locate activities and access markets in countries around the world, while integrating and coordinating these activities to benefit from economies of scale and scope, and the synergy of the group as a whole. Large MNEs consist of often hundreds of companies and other legal entities,<sup>7</sup> and it is inappro-

appropriate and ineffective to attempt to attribute profit to the individual affiliates or business segments of these complex corporate groups, as current rules attempt to do. The whole is much greater than the sum of its parts, and all contribute to the total profits.<sup>8</sup> Hence, each MNE should be taxed on its global profits, with taxing rights allocated to all countries in proportion to that MNE's real activities in each country.

Instead, the approach historically adopted has required tax authorities to tax each individual affiliate within the MNE as if it were an independent entity, dealing 'at arm's length' with others in the same corporate group. This creates an incentive for MNE tax advisers to create complex structures to attribute low levels of profit to affiliates in high-tax countries, while shifting the bulk of their excess profits to entities in tax havens or investment hubs where they are lightly taxed, or not taxed at all. It is this fundamental flaw that is at the heart of the problem of BEPS. The new approach agreed in the second phase of the BEPS project in 2021 now accepts the principle of a unitary taxation, as well as a global minimum tax to limit the competition to offer tax preferences, but the detailed proposals have significant limitations and flaws.

A unitary approach should start from MNEs' consolidated global profits, and apportion them for tax purposes among all the countries where they do business, based on factors that reflect their real activities in each country. This is the only way to ensure that their profits are taxed *at least* once and *only* once. Rules based on this economic reality would be much simpler to administer, and would provide predictability and certainty, for both businesses and tax administrations. This would also greatly help to ensure a level playing field on tax between MNEs and purely national enterprises. It would greatly reduce the costs of compliance with international tax rules, which have continued to become increasingly complex, subjective, hard to enforce, ineffective, and unfair.

Such an approach could be adopted in a coordinated way, that would restore national tax sovereignty, which has been undermined by the power of MNEs and economic globalisation. Coordination would be provided by the adoption of agreed standards to define each MNE's global consolidated profits for tax purposes, as well as for the factors for apportionment and their weighting. Such standards have already been formulated in the detailed technical work done for the two Pillars in the BEPS project. Each country would remain free to decide its own rate of tax on corporate profits, to be applied to its share of each MNE's profits based on that firm's activities in the country. The pressures of competition to offer lower rates on excess profits would be restricted by concerted measures to ensure a global minimum effective tax rate, which are already being implemented under the global anti-base erosion tax (the GloBE) of Pillar 2.<sup>9</sup>

As regards the principles of apportionment, the G-24

in 2019 argued that profits are attributable to both production and sales: essential activities take place in countries where MNEs have physical assets and employees, but equally important to the realisation of profits are countries that provide access to markets and the customers and infrastructure enabling sales. As explained by the G-24:

"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".

Based on these principles, the factors historically proposed and adopted for apportionment are physical assets, employees and sales.<sup>10</sup> These reflect the elements of both supply and demand that are essential in producing profits. They are also physical factors that can be relatively easily measured and geographically located. Digitalisation of the economy raises the additional issue of contributions from users of digital platforms, and the apportionment factors are discussed in more detail in Section B below.

Rules based on these principles would be relatively easy to administer, and hard to 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. Under unitary taxation 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. Some would even consider this type of competition between States to be beneficial. 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.

The adoption of a unitary approach requires (i) a new principle for taxable presence, and (ii) agreement on the methodology for apportionment of profits. This was recognised in the report resulting from the BEPS project Action 1 on *Addressing the Tax Challenges of the Digitalised Economy* in 2018. Since then, the work on Pillar One has resulted in agreement on a formulary method to allocate MNE income based on sales, and the carve-out for the global anti-base erosion tax (GloBE) in Pillar Two defines substance based on physical assets and employee remuneration costs. Hence, the work on the Two Pillars has resulted in agreement on, and detailed specifications for, all the elements for a unitary approach and formulary

apportionment.

In the next section we will consider these principles in more detail, while Section C discusses how they could be implemented by willing countries, adopting a concerted approach.

### **B. Details of the Approach**

#### **1. Taxable Presence**

The traditional concept of Permanent Establishment (PE) used in tax treaties, which requires a physical presence, is now clearly outdated. The increased importance of services, accelerated by the digitalisation of the economy, has led to proposals that a taxable nexus should be based on a 'significant economic presence'. Some countries have already introduced this concept into their domestic law, using indicia aimed at digitalised activities, sometimes in combination with a monetary threshold.<sup>11</sup> These provisions are generally intended to supplement the PE concept, but should now simply replace it.

The work on BEPS Action 1 showed that digitalisation has affected the whole economy. At the same time, MNEs themselves pointed out the difficulties of disentangling their activities to provide segmented accounts attempting to define the specific profits derived from digitalised activities. Hence, the nexus criterion agreed for Pillar One rightly aims to cover all types of business. The test agreed in the proposed multilateral convention (MLC) under Pillar One for a country to be allocated taxing rights based on sales by an MNE is a quantitative monetary threshold of revenues derived from that country. This should now be adopted as the basic rule for taxable presence.

A nexus based on sales also requires sourcing rules to define which revenues should be considered 'derived from' that country. These have now also been agreed in the rules for Amount A, which provide detailed methodologies to define the source of revenue, generally in terms of the physical place where goods are delivered or where the service is performed. This does not necessarily coincide with the location of the buyer of the goods or services. For example, sales revenues from online advertising are deemed to arise in the jurisdiction where the viewer of the online advertisement is located; revenues from air transport in the jurisdiction where the passengers disembark, and for goods split 50:50 between the jurisdiction of loading and unloading.

A simple monetary threshold is clear and easy to apply, and would provide certainty for businesses and tax administrations alike. In the MLC the threshold has been set at €1 million, or €250 thousand for jurisdictions with an annual gross domestic product (GDP) of less than €40 billion.<sup>12</sup> In our view it is appropriate, and indeed important, to apply this to all MNEs, and not only to the small number of very large and highly profitable ones within the scope of Amount A. The quantitative

threshold for a taxable nexus in a country agreed for Amount A is high enough to screen out those corporations for which it would be disproportionate to create obligations to register for and pay tax on profits. A similar threshold is common in federal states where a formulary system is used, notably the United States.

A right to tax income or profits once there is a significant level of sales in a country is justified because of (i) the necessity of sales for the realisation of profit, (ii) the increasingly close and continuous interaction with customers, especially for services, and (iii) the important contributions from users of digital platforms in the digitalised economy. Sales revenues now require long-term cultivation of customers, and are often through regular payments or subscriptions, or monetisation of user contributions, rather than one-off purchases of goods. Market access in countries around the world is a key factor enabling companies to grow in scale and achieve high rates of profit. Also, an important share of such sales is to businesses, payments for which are deductible from the customers' business income, directly reducing the source country's tax base.

This new taxable presence principle should in due course be included in tax treaties. In fact, this has long been advocated by capital-importing countries, going back to the Mexico draft of the League of Nations model convention.<sup>13</sup> The first UN model convention included a provision that income above an agreed monetary threshold from the furnishing of services in a country by an enterprise should be taxable in that country, as an option in the Commentary. It also allowed taxation of income from independent personal services if the payments derived from residents of the country exceeded an agreed amount. The UN model has a much wider PE definition than that of the OECD, including a provision for a 'services PE' (article 5.3.b) for services furnished in the country through personnel for a minimum of 183 days a year. It also provides an option for profits from the operation of maritime shipping to be taxed in the country where they arise "if such activities are more than casual".<sup>14</sup> In recent years, the UN Tax Committee has understandably concentrated on strengthening withholding taxes, particularly while the BEPS project was considering the PE definition, but it now seems time for a global tax body to tackle the issue of taxable nexus directly.

In the meantime, a simple interim solution is for countries to require enterprises wishing to do significant business in the country to do so through a local entity registered for tax purposes.<sup>15</sup> Such a requirement has long been in force, for example, in Nigeria.<sup>16</sup> A similar mechanism has been introduced by many countries for collection of sales or value added tax as countries have shifted to a destination basis, to apply such taxes to sellers.<sup>17</sup>

#### **2. Allocating Net Taxable Profits**

The issues of taxable presence and attribution of (net) income are linked, although in the traditional model tax treaties they have been dealt with by separate provisions. Both have until now been dealt with by source countries

by applying withholding tax on the gross payment. While this type of tax is easy to administer, it is a blunt instrument, because the tax rate applied to the transaction bears no relation to the actual profitability of that enterprise, leading to possible under- or over-taxation.

The key problem of taxing income derived from a country is how to define the net taxable income to be allocated to each country. This is because costs and revenues will not be correlated by country, due to the highly integrated nature of MNE operations. Much of MNE expenditure is on joint or overhead costs of research and development, financing, and shared services such as advertising, marketing, logistics, supply chain management and communications and information technology, which the firm would prefer to allocate among all its affiliates. Many MNE operations are cross-border: notably for international services, performance entails activities that take place at the location of the supplier as well as of the customer.

These problems can only be adequately dealt with by apportioning tax rights over the MNE's global consolidated net income between the countries where it has a significant economic presence, based on factors reflecting that presence.

The G-24 paper of 2019 pointed out that for apportionment:

“(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.”

Technical standards have now been established in the work on Pillars One and Two for the definition of all these elements. What remains is only the determination of the appropriate factors to be used for apportionment and their weighting, which inevitably involves some political considerations.

#### **a. The Tax Base: Consolidated Profits of the MNE Group**

The proposed MLC under Pillar One defines the tax base to be divided based on the consolidated financial accounts of each MNE corporate group, with specified adjustments for tax purposes. Financial accounting standards provide the basis for the definition of a corporate Group, as well as for its consolidated accounts. These accounts are the means by which MNEs present themselves to outside investors and financial markets, and in the case of quoted companies they are required to be audited. They are clearly a much better starting point for determining the allocation of taxing rights over MNE profits than the individual accounts of separate affiliates of the MNE group that until now have been the focus for tax authorities. Allocating tax rights based on consolidated accounts enables the sharing of losses as well as profits, which benefits MNEs also.

This would strengthen the paradigm shift that was begun with the establishment of a system for country-

by-country reports (CbCR), which was the most important advance in the first phase of the BEPS project. These have been a game-changer, as for the first time they give a global overview for tax purposes of the activities of the largest MNEs in all countries where they have a taxable presence. However, so far these reports are only available to tax authorities, and are still not shared with the vast majority of developing countries, due to the difficulty and cost of compliance with strict rules on legislation and data confidentiality. The specifications for the data they require also need continuous evaluation and improvement.

Consolidated financial accounts are only the starting point for defining the tax base, since investors evaluate companies for their future earnings potential, whereas tax is applied on actual accrued profits. This is dealt with by the MLC, which now provides detailed rules for adjustments necessary for tax purposes, including a methodology for carrying forward losses.

However, the MLC apportions only part of this tax base, and only in relation to sales, while the remainder would continue to be determined under existing rules on ‘transfer pricing’. This makes its rules extraordinarily complex, since it attempts to combine two contradictory principles for attributing MNE profits for tax purposes. Formulary apportionment of the total profits would be much simpler to apply. There is also a sound rationale for apportioning the total consolidated profits of each MNE, rather than the ‘residual’, as done for Amount A. As outlined in section A.2 above, the extraordinary or excess profits of MNEs are due to the size and synergy of their global activities as a whole, hence it is the total profits that should be apportioned.

#### **b. Apportionment Factors and the Formula**

Ease of administration suggests that as far as possible a single general formula should be used, since applying different formulas to all the different types of business would inevitably lead to complexity. This suggests basing the apportionment factors on clear, high level general principles.

The factors usually applied or proposed for formulary apportionment (FA) are assets, employees and sales, because they are considered to be the drivers of profit. From the economic perspective, FA acts on firms as a tax on the formula factors. Hence, emphasising the capital and labour factors discourages the use of those factors in that State. This also means that apportionment based on sales greatly reduces the pressure on States to lower the tax rate, since a country increasing its tax rate on MNEs based on its sales in that country does not deter them from investing to create jobs there. Thus, the investment incentive effects support apportionment based on the destination of sales.

Partly for this reason, some have argued for a destination-based cash-flow tax as an alternative to FA. This would be a dramatic change, highly disruptive to international trade and currencies, and it was rejected mainly for that reason, after some debate, in the US in 2017.<sup>18</sup> How-

ever, the BEPS project has shown considerable support by States for a greater allocation of rights to tax in countries where sales are made. The proposed 'new taxing right' in Pillar 1 would limit this to 25% of only the 'residual' profit. This was regarded as low by many, and African countries called for 35%.<sup>19</sup> The new article 12B in the UN model tax treaty providing for taxation of income from automated digital services includes a net income option, which would allow the country of sales to tax 30% of the 'qualifying income'. This suggests that there is support from States for at least a 30-35% weighting for sales, but not 100%.

Taking into consideration both tax revenues and investment effects could produce a convergence towards a formula that balances demand and supply-side factors, as proposed by the G-24 in 2019. In fact, the history of FA demonstrates such a convergence. This has occurred in federal systems in which states can tax corporate profits, notably the US and Canada. In the US, by the 1930s states had converged on the 'Massachusetts' formula of three equally weighted factors: property, payroll and gross sales receipts. This is one of the methods currently accepted for the apportionment of profits from international air transport where countries have not agreed reciprocal exemptions by treaty.<sup>20</sup> In Canada, since the 1960s the provinces have used a 50:50 weighting of payroll and gross receipts.<sup>21</sup> The 3-factor formula was also adopted by the European Commission in its proposals for a Common Consolidated Corporate Tax Base (CCCTB), first put forward in 2011, and renewed in 2016.<sup>22</sup>

It is true that in the US there has been a shift to greater use of the sales factor: in 1986 80% of states used the 3-factor formula, but by 2012 this had fallen to 17%, with 30% of states using only the sales factor. However, evidence suggests that it was only in the short run that it had the desired effect of attracting job-creating investment; over a longer period it ceased to have a significant effect on levels of economic activity, while states using the single-sales factor lost revenue.<sup>23</sup> This experience should reinforce resistance to giving too great a weight to sales. The use of a sales factor also requires a 'throwback rule' so that when the sales factor attributes the income to a State where it is not taxed, sales income is attributed to the last State of production, or sales are thrown out from the formula entirely. The sourcing rules for sales developed for Amount A attribute the revenue from sales of components within an MNE group to the country of sale of the finished item, which would deter the location of assembly in low-tax countries. If a balanced formula is used, countries where assembly takes place could be apportioned profit based on production factors.

Another key issue is the definition of the employment factor. The US and Canadian systems, as well as the GloBE substance-based carve-out, use payroll expenditures (total compensation expenses, including bonuses, health insurance and pension contributions).

This seems inappropriate for application among countries with wide disparities in wage rates; but using only a headcount of employees would undervalue skilled workers. For this reason, the EU's CCCTB proposed a 50:50 split of the employment factor between number of employees and payroll. The same principle was also recommended in India's consultation paper in 2019. Estimates that have been done of the distributional effects of FA confirm that the employment factor is very important for the revenue allocation under FA to low-income countries: as the International Monetary Fund (IMF) has noted "developing countries gain mostly if employment receives a large weight in the formula".<sup>24</sup> However, low-wage countries also need to bear in mind that an allocation based on headcount would reduce their attractiveness for investment in labour-intensive activities. The 50:50 split proposed by the EU and India seems a plausible compromise.

The content of the asset factor is also debatable. Although some, particularly business representatives, argue that it should include intangible assets, this is rejected by all serious proposals for FA. The practical reason for this is that the formula factors should be location-specific, to prevent avoidance. Physical assets, employees and sales are all relatively easy to define by geographical location, and indeed technical standards for this have been developed in the BEPS Pillars, as mentioned above. The location of intangibles is defined by ownership, which can easily be located anywhere, and indeed attributing intangibles to entities in low-tax countries is a major technique for avoidance. More fundamentally, intangible assets result from research and development, which is reflected in expenditures on skilled employees. This strengthens the argument that the employment factor should be based at least partly on expenditure on remuneration.

The importance of simplicity also suggests minimising the factors used for apportionment. In particular, there are significant variations between businesses in their need for physical assets (fixed capital). Economists have argued that including assets in the formula would particularly deter capital investment in assets. The growth of services and the increased importance of skilled and intellectual work in many sectors have widened the gap between these and businesses still highly invested in physical assets. In some sectors even expensive physical assets are mobile, for example transportation and construction, which would make it difficult to tie such investments to specific geographical locations. There are also significant difficulties in valuing fixed assets. These considerations, together with the need for simplicity, support the argument for a two-factor formula based on employees and sales, as in Canada.

This would greatly reduce the need for different formulas, which might otherwise be needed for businesses such as transportation and construction. If the assets factor is retained, these sectoral differences would need to be dealt with, e.g. by rules to allocate the value of moveable assets according to the times they are located in different countries. Similarly, if an assets factor is used, specific rules

may be needed for financial services. For example, in the EU's CCCTB, for financial institutions the assets factor was defined as 10% of the value of financial assets except for own shares, and specific rules were applied for different types of sales revenues, and to attribute their location (article 40).

Thus, differences in the nature of some types of business can be dealt with by specifications of the factors, or sourcing rules. In particular, suggestions have been made that a specific factor may be needed for digitalised activities to take account of the importance of users, both for their contributions of content and the value of data on users.<sup>25</sup> However, users essentially constitute intangible assets, which must be monetised through sales to those users of advertising or goods and services. User contributions and data derived from them are monetised through digital platforms, and have now been addressed in the sourcing rules in the MLC for Amount A for revenues from digitalised activities. These divide the revenues from intermediation through digital platforms 50:50 between the locations of the customer (generally the platform user) and the seller of goods or services, and attribute revenues from the sale or licensing of user data to the location of the subject of the data. This strengthens the argument for a significant weighting to be attributed to sales, perhaps a simple 50:50 formula of sales and employees.

A specific rule is essential for revenues from the sale of primary products, which should be attributed to the countries of origin, not the sales destination. Income from extraction of natural resources is in the nature of rent, while the countries where the processed primary products are sold generally apply often high consumption taxes. Attribution of sales of oil and gas was attributed to the country of origin in the EU's CCCTB (article 42).

A formulary apportionment system would of course not provide a panacea, but it would be much more objective, fairer and easier to apply than the current approach based on transfer pricing rules. These are highly subjective, requiring an individual analysis of the facts and circumstances of each individual entity within an MNE corporate group. Large MNEs are able to employ teams of specialists to justify their chosen methodology, which is hard for even well resourced tax authorities to challenge, while attempting to do so inevitably generates time-consuming and resource-intensive conflicts.<sup>26</sup>

### C. The Transition from Current Rules

A comprehensive adoption of this new approach should be based on new treaty provisions to be developed and adopted in due course, most appropriately through a global tax body. In the meantime, however, willing countries can take action, preferably acting in concert, to begin to apply this approach. This can be done in domestic law, while seeking conformity with tax treaty rules, if necessary through the adoption of suitable interpretations, or renegotiation of treaties.

Tax treaties only provide protection for genuine residents of a treaty partner jurisdiction, and national tax policy should take precedence over treaty rules. Developing countries have fewer tax treaties, and those they have are generally based on the UN model, which provides greater scope for both source taxation and fractional apportionment. Treaty shopping can and should be prevented by stricter application of anti-abuse rules, supported by the Principal Purpose Test that has now been included in the vast majority of treaties following the first phase of the BEPS project. Convergence on a common approach can be greatly facilitated by the adoption of the standards and rules now agreed in the technical work for the two Pillars.

#### 1. Taxable Nexus

Countries should now enact a taxable nexus provision in their domestic law based on the concept of Significant Economic Presence (SEP). Several countries have already done so, notably Colombia, India and Nigeria, sometimes in addition to the standard criterion of Permanent Establishment (PE). We suggest that the SEP concept should now replace that of a PE, and that countries should base it on the simple quantitative monetary threshold agreed for Amount A of Pillar One. This would ensure convergence on a common position.

Comprehensive replacement will require negotiations, preferably through a global tax body. In the meantime, treaties based on the UN model generally provide a greater scope for source taxation, as outlined in section B.1 above. We also suggest, as outlined in section B.1 above, that a simple interim solution is to require that non-residents with income from sales above the SEP threshold must do business through a locally incorporated affiliate, as is the case in Nigeria. Both MNEs and reluctant countries may accept that taxation of a formulary share of net income is a preferable alternative to the application of withholding taxes, or taxes on payments for digital services (as provided in article 12B of the UN model).

#### 2. Attribution of Net Income by Formulary Apportionment

Willing countries should also now adopt measures in domestic law for attribution of net income to MNEs with a taxable nexus through a SEP in the country. Compatibility with tax treaties can be ensured, based on the applicability of article 7(4) in model treaties, which allows 'fractional apportionment', coupled with the concept of an 'agency PE'.

Fractional apportionment has long been an accepted method for the attribution of profits of MNEs in tax treaties, dating back to the League of Nations model. The first OECD model of 1963 in article 7(4) permitted attribution of profits to a PE "on the basis of an apportionment of the total profits of the enterprise to its various parts", in so far as such a method had been customary in a State. The UN model of 1980 followed suit. This provision was omitted from the OECD model in 2010, with corresponding changes to the Commentary. However, these changes were rejected by some OECD members, and also by the UN Tax

Committee, which has retained article 7(4) in its model. In fact, around two-thirds of tax treaties in force retain article 7(4), especially those with developing countries.<sup>27</sup>

The term 'enterprise' refers to a business activity, and not to a legal entity.<sup>28</sup> Hence, it can apply to the total profits of the business of the corporate group as a whole in applying article 7(4). The majority of OECD countries moved away from this with the changes to the OECD model in 2010, and adopted the 'authorised OECD approach' to attribution of profits to a PE. This was rejected by the UN Committee and developing countries, which have continued to maintain their right under tax treaties to apply fractional apportionment under article 7(4).

Under existing treaties also, a subsidiary can be treated as an 'agency' PE of its parent.<sup>29</sup> In many cases MNEs do have subsidiaries within a country, but under existing transfer pricing rules these can claim to be taxed only on 'routine' profits, applying a 'one-sided' transfer pricing method; meanwhile substantial revenues derived from that country are attributed to other affiliates resident elsewhere, usually in a low-tax jurisdiction. For example, a subsidiary may be said to carry out functions such as marketing or customer support, while sales revenues are channelled elsewhere.<sup>30</sup> However, in such circumstances a marketing affiliate, for example, can be treated as a PE of the affiliate formally responsible for sales. If the MNE conducts substantial business within a country without having any local incorporated affiliate, it could be required to do so, applying a monetary threshold, and this affiliate treated as a PE of its parent.

Hence, article 7(4) can be understood to allow the attribution of profits to any taxable entity based on an apportionment of the total business profits of the MNE corporate group to which it belongs. This was explicitly rejected when the OECD adopted its Transfer Pricing Guidelines in 1995, which elaborated the so-called 'arm's length principle', that aims to treat members of MNE corporate groups on the basis of the fiction that they are totally independent of each other. These Guidelines are not legally binding, but only aids to the interpretation of article 9 in tax treaties. They have become increasingly dysfunctional due to the inappropriate and untenable nature of the fiction that MNEs should be treated as a collection of independent entities dealing with each other at arm's length. In our view, they should in due course be completely rewritten, or abandoned. In the meantime, interim measures can be adopted, in the ways we have proposed.

The application of formulary apportionment has now been enabled by the elaboration of standards and detailed technical rules for all its elements in the BEPS Two Pillars, as outlined in section B.2 above. This removes the major practical objection expressed by the OECD, particularly in the Guidelines of 1995, which stressed the 'intolerable compliance costs and data re-

quirements' involved.<sup>31</sup> A possible transition to formulary apportionment was considered in more detail a decade later, in the context of the first emergence of digitalised business models, through 'electronic commerce', which also emphasised the major practical and administrative difficulties.<sup>32</sup>

Formulary apportionment has now been shown to be technically feasible and indeed essential to the effective reform of international tax rules to enable MNEs to be taxed where their activities occur. Any remaining obstacles are essentially political. Negotiations will be needed in particular to enable a consensus on the factors in the apportionment formula and their appropriate weighting, and the appropriate treatment of losses. Even on this there seems to have been substantial convergence, as outlined in section B.2 above.

The transition to the new approach that we propose would clearly be greatly facilitated by the creation of a new global tax body, which is now under examination by the United Nations. However, countries should not delay the process of transition by waiting until such a body comes into existence. It should be recognised that the embryo of a new approach is already well developed, in the detailed technical standards already formulated and available. Willing countries can and should take active steps now to assist its emergence, providing immediate protection for tax bases, while ensuring it is ready to be implemented internationally through the new global institutional framework.

### D. Conclusion

This paper aimed to combine a roadmap for a comprehensive reform of international rules for taxation of MNEs, with practical proposals that could be taken by willing States towards this goal. The aim should be to align tax payable with where real activities occur, as mandated by the G20 for the BEPS project. In our view, the only effective and fair way to achieve this is by treating MNEs in accordance with the economic reality that they operate as unitary enterprises under central direction and control, and that their global profits result from the synergy of their combined activities. Hence, the allocation of rights to tax them should start from the consolidated global profits of each MNE corporate group, adjusted for tax purposes, and apportion them using factors reflecting the real profit-generating activities in each country (employees, assets and sales). The work done in the BEPS project entails an acceptance of this approach in principle, with an allocation based on sales (Pillar One, Amount A), as well as providing detailed technical standards for all the elements of its operationalisation (methodologies for defining total profits for tax purposes, a taxable nexus threshold, and the scope and quantification of employees, assets and sales revenues by destination).

For a comprehensive transition to this new approach changes to tax treaties would be needed. However, significant progress can be made even under existing rules, if countries adopt concerted measures towards this goal.



The UN Model Convention, on which most developing country treaties are based, provides a wider definition of taxable presence, and some States have gone further and introduced in domestic law a nexus based on significant economic presence, which could now be conveniently aligned to the Pillar One standard. Nonresident entities wishing to do significant business in a country can, as an interim measure, be required to do so through a locally incorporated company. The UN model also allows fractional apportionment of the profits of an enterprise, which can refer to the entire business of a corporate group, to determine the net income of a permanent establishment, and this can also be applied to a subsidiary acting as agent.

We hope that this proposal can provide a basis for both actions by States to adopt this approach, and continuing deliberation in relevant forums, national, regional and global, to achieve its comprehensive implementation.

#### Endnotes:

<sup>1</sup> Tax Annex to the St. Petersburg Declaration, September 2013.

<sup>2</sup> OECD, Statement on a Two Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, October 2021.

<sup>3</sup> Pillar One consists of a proposed multilateral convention (MLC) to introduce a new right for countries where sales are made to tax a share of the profits of around 100 of the largest and most profitable MNEs, leaving existing rules in place for all other purposes (Amount A); plus a proposed new simplified transfer pricing method for wholesale distributors (Amount B); Pillar Two has a global minimum tax of 15% that can be applied by willing countries on MNEs with over €750 turnover (the GloBE – global anti-base erosion tax), plus a new tax treaty provision to allow a withholding tax by source states on payments taxed below a specified minimum rate (9%) in the destination country (the STTR – subject to tax rule). For a more detailed analysis see BEPS Monitoring Group, “Taxing Multinationals: The BEPS Proposals and Alternatives” (2023). At the time of writing no final versions have been released for any of these except the GloBE, which is being implemented, so far by over 40 countries. For a critique of the GloBE see E. Eze *et al.*, “The GloBE Rules: Challenges for Developing Countries and Smart Policy Options to Protect their Tax Base”, South Centre Tax Cooperation Policy Brief No. 35, 18 August 2023.

<sup>4</sup> G-24, Proposal for Addressing Tax Challenges Arising from Digitalisation, 17 January 2019. This was tabled at a meeting of the plenary of the Inclusive Framework on BEPS in December 2018, although some opposed its consideration, on various grounds.

<sup>5</sup> UN, Promotion of Inclusive and Effective Tax Cooperation at the United Nations, Report of the Secretary General, A/78/235, 26 July 2023, para. 12.

<sup>6</sup> The International Monetary Fund (IMF) estimates that Pillar One’s Amount A would reallocate about 2% of the total profits of MNEs, some \$12 billion based on data from 2019; OECD estimates suggest a somewhat higher range: an average of \$12–25b per year over the period 2017–2021. Both agree that most countries would gain around 0.5–1.5% of their corporate income tax (CIT) revenues; for low-income countries the IMF

estimates an increase of 0.0–0.7% while the OECD suggests 0.7–1.7% of their CIT revenues. See IMF, “International Corporate Tax Reform”, Executive Board Briefing Paper, 20 January 2023; OECD, Webinar: Economic impact assessment of the Two-Pillar Solution, 18 January 2023. Countries participating in this scheme would be required to give up digital services taxes in exchange.

<sup>7</sup> Analysis by the United Nations Conference on Trade and Development (UNCTAD) shows that although only 1% of MNEs have over 100 affiliates, these MNEs account for over 60% of value added by MNEs, and that the largest 100 have some 55,000 affiliates between them: UNCTAD, *World Investment Report – Investor Nationality: Policy Challenges* (Geneva, United Nations, 2016), pp. 134–5.

<sup>8</sup> This understanding comes from the institutional economics of the firm, see R. H. Coase (1937), “The Nature of the Firm”, *Economica* 4 (16): 386–405; O. E. Williamson (1988), “The Logic of Economic Organization”, *Journal of Law, Economics and Organization* 4 (1): 65–93; S. Picciotto and J. Kadet (2022), “The Transition to Unitary Taxation”, *Tax Notes International*, 108 (4): 453–61, at p. 455, available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4281528](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4281528).

<sup>9</sup> In our view, the design of the GloBE is unnecessarily complex, and unfair to developing countries, mainly due to its priority rules. An alternative, much fairer and more effective approach, based on a formulaic allocation of rights to apply a top-up tax, was proposed in A. Cobham *et al.* (2021), “A practical proposal to end corporate tax abuse: METR, a minimum effective tax rate for multinationals”, *Global Policy* 13 (1): 18–33, available at <https://doi.org/10.1111/1758-5899.13029>. Although we consider the GloBE itself inappropriate for most developing countries, so they should not join the scheme, its introduction by others will provide the policy space for a more comprehensive solution, so they can and should adopt complementary measures more suited to their circumstances, which can be compatible with the GloBE (see BEPS Monitoring Group (2023) cited above).

<sup>10</sup> This is seen in systems of formulary apportionment that have long been used in federal states, notably the USA, although there has been a shift in recent years to giving a greater weight to the sales factor. A similar formula was proposed by the European Commission in its proposal for a Common Consolidated Tax Base of 2011, renewed in 2016, and now relaunched as Business in Europe: Framework for Income Taxation (BEFIT). This proposes the adoption in the EU of common rules to define MNEs’ aggregate profits (starting from financial accounting rules, like Amount A), with a simplified methodology for their allocation within the EU for a transition period, and a requirement for the Commission to produce a study within three years of its implementation on the factors and weighting for a possible adoption of formulary apportionment (article 45.9). See EU Commission, Business in Europe: Framework for Income Taxation (BEFIT), COM(2023)532 (2023) available at [https://taxation-customs.ec.europa.eu/taxation-1/corporate-taxation/business-europe-framework-income-taxation-befit\\_en](https://taxation-customs.ec.europa.eu/taxation-1/corporate-taxation/business-europe-framework-income-taxation-befit_en).

<sup>11</sup> For example Nigeria Companies Income Tax (Significant Economic Presence) Order 2020, and India Finance Act 2018, adding Explanation 2A to section 9(1)(i) of the Income Tax Act’s definition of a ‘business connection’ in India. Similar rules were included in the EU Commission’s proposal for a significant digital presence Directive (EU Commission, Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence, 21 March 2018, COM(2018) 147 final). Colombia’s tax reform law enacted in December 2022 provides that non-residents can be taxed on income from the sale of goods or provision of services in the country if they have a significant

economic presence, defined as deliberate systematic interactions with clients or users with gross revenues above a specified threshold, and additional detailed specifications for digital services (Law 2277 of 2022, article 57).

<sup>12</sup> OECD, “Progress Report on Amount A of Pillar One” (2022), Title 3 and Schedule A.

<sup>13</sup> This included a provision that income from any business or gainful activity “shall be taxable only in the State where the business or activity is carried out” unless there were only “isolated or occasional transactions”. This was omitted from the London draft (League of Nations, London and Mexico Model Tax Conventions Commentary and Text, Doc. C.88.M.88.1946.II.A. (1946), pp. 13-14; 60. Available from <https://archives.ungeneva.org/>)

<sup>14</sup> Article 8 (alternative B) of the UN Model suggests a formula approach for taxing profits from international shipping: “on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations”. Several developing countries have successfully adopted source taxation of shipping profits in their tax treaties. However, instead of following the UN Model’s suggestion for net taxation, they generally apply a withholding tax on gross receipts (B. Michel and T. Falcao, “Taxing Profits from International Maritime Shipping in Africa: Past, Present and Future of UN Model Article 8 (Alternative B)”, ICTD Working Paper 133 (2021), p. 44.).

<sup>15</sup> To forestall possible challenges under international commitments the country may have made under trade and investment agreements, particularly in respect of national treatment for cross-border provision of services (e.g. under the General Agreement on Trade in Services), the legislation should make clear that its purpose is to ensure parity in tax matters with local suppliers (or avoid making such commitments). It should be noted that newer-generation investment agreements protect only investments made through an enterprise in the host State, see Danish, H. El-Kady, M. M. Mbengue, S. H. Nikiéma and D. Uribe, “The Protocol on Investment to the Agreement Establishing the African Continental Free Trade Area: What’s in it and what’s next for the Continent?”, *Investment Treaty News*, 1 July 2023.

<sup>16</sup> Companies and Allied Matters Act s. 54, dating back to the Companies Act 1968 s. 370.

<sup>17</sup> See OECD, *Mechanisms for the Effective Collection of VAT/GST Where the Supplier is not located in the Jurisdiction of Taxation* (2017), and OECD, *International VAT/GST Guidelines* (2017), section C.3.2.

<sup>18</sup> Daniel N. Shaviro, “Goodbye to All That?: A Requiem for the Destination-Based Cash Flow Tax”, *Bulletin for International Taxation*, vol. 72 (2018), pp. 248-58.

<sup>19</sup> African Tax Administration Forum (ATAF), “The Inclusive Framework’s Two-Pillar Solution to Addressing the Tax Challenges Arising from the Digitalisation of the Economy”, 8<sup>th</sup> Technical Note (2021).

<sup>20</sup> See International Air Transport Association (IATA), *Guidelines for Taxation of International Air Transport Profits* (2018), p. 16, available at [https://www.iata.org/contentassets/a72d8d3cfaf84529bcdef6b2dc59f224/taxation\\_intl\\_air\\_transport20profits\\_final.pdf](https://www.iata.org/contentassets/a72d8d3cfaf84529bcdef6b2dc59f224/taxation_intl_air_transport20profits_final.pdf).

<sup>21</sup> Joann Martens Weiner, “Formulary Apportionment and Group Taxation in the European Union: Insights from the

United States and Canada”, European Commission: Taxation Papers, Working Paper 8 (2005), pp. 11-15.

<sup>22</sup> European Commission, Proposal for a Council Directive on a Common Consolidated Tax Base (CCCTB), COM(2016) 683 final (2016).

<sup>23</sup> Kimberly Clausing, “Lessons for International Tax Reform from the US State Experience under Formulary Apportionment”, in *Taxing Multinational Enterprises as Unitary Firms*, Sol Picciotto, ed. (Brighton, UK, International Centre for Tax and Development (ICTD), 2017), p. 96.

<sup>24</sup> See pp. 27-28 of IMF Working Paper available at <https://www.imf.org/en/Publications/WP/Issues/2019/10/11/An-Assessment-of-Global-Formula-Apportionment-48718>; see also Alex Cobham, Petr Janský and Simon Loretz, “Key Findings from Global Analyses of Multinational Profit Misalignment”, in *Taxing MNEs as Unitary Firms*, S. Picciotto, ed., ch. 7.; IMF, “Corporate Taxation in the Global Economy”, Policy Paper (2019), pp. 33-34.

<sup>25</sup> See India’s consultation paper of 2019, especially paras. 197-8, and the European Commission’s 2018 proposal on significant digital presence, pp. 3-4.

<sup>26</sup> For example, in India a Digest of 4000 important tax decisions in tribunals and courts in one year alone (2018) reported 1150 on transfer pricing, and only 130 on other international tax matters (available at [https://itatonline.org/articles\\_new/digest-of-4000-important-judgments-on-transfer-pricing-international-tax-and-domestic-tax-jan-to-dec-2018/](https://itatonline.org/articles_new/digest-of-4000-important-judgments-on-transfer-pricing-international-tax-and-domestic-tax-jan-to-dec-2018/)).

<sup>27</sup> An analysis conducted in 2020 found that of 3181 bilateral tax treaties available in English, 2161 contained article 7(4): see S. Picciotto, “The Contested Shaping of International Tax Rules: The Growth of Services and the Revival of Fractional Apportionment”, International Centre for Tax and Development (ICTD) Working Paper 124 (2021), p. 17.

<sup>28</sup> In both the OECD and UN models the term ‘enterprise of a Contracting State’ is defined as “an enterprise carried on by a resident of a Contracting State”; since 2000 the OECD model has also stated that “the term ‘enterprise’ refers to the carrying on of any business”.

<sup>29</sup> See J. P. Le Gall, “The David R. Tillinghast Lecture: Can a Subsidiary Be a Permanent Establishment of its Foreign Parent? Commentary on Article 5, par. 7 of the OECD Model Tax Convention”, *Tax Law Review*, vol. 60, pp. 179-214; R. S. Avi-Yonah and Z. P. Tinhaga, “Unitary Taxation and International Tax Rules”, International Centre for Tax and Development (ICTD) Working Paper 26 (2014).

<sup>30</sup> See, for example, UK House of Commons, Public Accounts Committee (2012), *Report on HMRC’s 2011-2012 Accounts and Minutes of Evidence: Starbucks, Amazon & Google*; and N. Cicin-Sain, “Taxing Uber”, in *Uber – Brave New Service or Unfair Competition Legal Analysis of the Nature of Uber Services*, J. Marin et al., eds. (Springer, 2020), pp.181-198.

<sup>31</sup> OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2022), para. 1.27, p. 37.

<sup>32</sup> OECD, “E-commerce: Transfer Pricing and Business Profits Taxation”, *Tax Policy Studies* 10 (2005). This includes the report of a Technical Advisory Group which included business representatives.

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