Sitting between two stools?

Christian Valenduc considers the agreement to reform taxation of multinational companies and asks if the resulting tax system will be stable?

Last July, an important agreement was concluded under the auspices of the OECD and the G20 to reform international corporate taxation. The rules for international taxation have been considered, since a long time, as out of date. This enables multinational companies to reduce their tax bill, what is largely considered as unfair and inefficient from an economic point of view.

Following the agreement on measures to counteract base erosion and profit shifting (BEPS) in the autumn 2015, the taxation of digital economy has been put on the agenda. The recent agreement has however a broader coverage.

It consists in two pillars. The first one is on the allocation of taxing right and will partly redistribute the tax base to 'market countries' what will reduce tax planning and move the tax base out of low tax jurisdictions. The second one is on a minimum level of effective taxation.

Lines have been shifted. From a political point of view, the changes are significant. But the international tax system seems now to be seated between two seats. The prevailing rules have been adjusted at the margin.

Consolidation and formulary apportionment have been introduced, but to a limited extend, and coexist with the basic rules of tax treaties and transfer pricing. Is it the achievement of BEPS? Or the first stage of new era, with more radical changes in the future? The debate is far from over.

On 5 June 2021, the G7 reached agreement on a minimum taxation rate for multinational companies. The second stage took place on 1 July 2021, 130 (Now 134) of the 139 (Now 140) members of the 'inclusive framework'[2] approved the agreement.

Among these 140 members are 66 developing countries and most tax havens. This was described by the press as historic. A few weeks earlier, on 18 May, the European Commission had published a Communication on business taxation for the 21st century, which also supports fairer taxation and a reduction in tax competition.

Are the lines definitely shifting? In a G20 meeting at the heart of the economic and financial crisis, President Sarkozy, commenting on the decisions of the Head of State, stated *"It is the end for tax havens."* Despite that, Panama papers and Dubai papers shed the light on large tax evasion practices later on.

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But the 163 members of the Global Forum on Transparency and Exchange of Information for Tax Purposes - another body working under the auspice of the OECD and G20 – have committed to automatic exchange of information and have engaged in a per review process to check the compliance of its members.

Regarding corporate income tax, it is worth mentioning that, at the start of this century, the European Commission confined its comments on taxation to stigmatising 'tax obstacles', such as barriers to the internal market while the policy stance is now on fair taxation.

Background

International taxation is based on very old rules, some of which date back 100 years. These rules come from a time when the proportion of goods traded within multinational companies was low and trade was a matter of clearly identifiable intermediate goods or finished products. It was easy to establish where a product was manufactured, where an economic activity gave rise to a profit and the residence of a shareholder.

A company established itself physically in a country in order to sell and make profits there. These days, a company can make profit in a country without being established there. A given final product incorporates parts that may be manufactured in different places. Intangibles have become significant, in terms of both company assets and in the design and manufacturing processes of a good.

A large proportion of trade takes place between companies in the same group and applying the market price to them – the basic rule for transfer pricing – has become a challenge, when the main point is the singularity of a particular part of the product.

In this context, it is an economic fiction to regard the various companies within a multinational group as separate entities, even if this is still in line with the legal reality: they are parts of a whole.

Tax avoidance has swept into the gaps in the current system. By exploiting transfer prices, the location of intangible assets and their income stream, and the financing structures of the group's businesses, multinational companies shift the tax bases to low-tax jurisdictions and/or take advantage of preferential regimes established in countries with 'normal' tax regimes, primarily patent boxes.

In this way they can significantly reduce their effective taxation. This leads to downward pressure on corporation tax revenue and unfair taxation. Beyond these strictly tax aspects, their dominant position may be economically ineffective (Sorbe and Johansson, 2017).

From the BEPS plan to minimum and destination-based taxation

In 2013, the OECD and the G20 countries took stock of the situation and adopted an action plan against Base Erosion and Profit Shifting known as the BEPS plan.

This plan was based on 15 actions, intended to address the various aspects of the problem: taxation of the digital economy, transfer pricing rules, preferential regimes, the improper use of bilateral agreements to secure zero taxation, excessive interest deductions and hybrid arrangements. The action plan also provided for an economic evaluation of the extent of tax avoidance and its impact.

In 2015, an agreement was reached comprising three decision-making levels, four binding minimum standards, an upgrading of the transfer pricing rules and basic rules for international agreements and recommendations for best practices, in particular to neutralise the effect of hybrid arrangements and counter excessive interest deductions.

The European Commission took this up and, soon afterwards, put forward a proposal for an Anti-Tax Avoidance Directive (ATAD), which went further in some areas, including as regards interest deductions. The proposal for a Directive was adopted within just a few months, which is an extremely rare event in tax matters.

At the OECD/G20 level, the 2015 agreement left the issue of the digital economy unresolved. Work on this subject resumed, and an interim report was published which, among other things, included a very interesting economic analysis of business models.

This report raised some important points regarding taxation in the digital economy, in particular the role of the market in value creation and the economic rent received by the sector but did not draw any conclusions about reforms.

The discussions stalled but later resumed, structured around two pillars: Pillar One on profit allocation to the country of the market and Pillar Two on minimum taxation for multinational companies.

Pillar One is designed to address the problem of the digital economy. One of the latter's characteristics, highlighted in OECD is the capacity to generate profits in a given country without the company having a physical presence there, in particular by creating value from the user data that it collects.

Despite basic rules for allocating taxing rights that are based on the concept of 'permanent establishment', the fundamental principle of the BEPS project is that, to counter profit-shifting, the tax must be levied where value is created. The role of the market in value creation provides a policy rationale for destination-based taxation when there is no physical presence.

But how is this to be determined? The basic idea is to tax part of the 'non-routine profit' in the country of the market. Discussions on Pillar One swing between two models: building on the transfer pricing rules or opting for the unitary taxation model and fixed apportionment of profits (formulary apportionment). Behind this seemingly highly technical alternative lies a fundamental choice that we will briefly discuss later in this article.

Regarding scope, the debate was between targeting the GAFA (Google, Apple, Facebook, Amazon) companies or having a broader scope, with no distinction regarding the economic activity. The debate on the scope is inevitably connected to the policy rationale for a destination-based taxation.

In a conservative view - limiting departures for current rules - destination based taxation should be limited to the case in which there is value creation but no physical presence. Those who promote destination-based taxation as such would call for a larger scope.

Pillar Two is intended to establish a minimum taxation level without removing the right for each country to determine its tax rate. The basic idea is as follows: if, in a given country, the effective taxation of a subsidiary of a multinational group is below a critical threshold (say 15%), the country of the parent company may tax these profits up to the level of the difference between the effective rate and the 15% threshold, even if the profits have not been distributed to the parent company.

There are two rules to achieve this: an 'income inclusion rule' and a 'denying payment rule', according to which payments from a high-taxation country to a lower-taxation country can be denied. The income inclusion rule gives taxing right and allocates tax revenue to the residence country while the *"denying payment rules"* does it for source country.

Discussions stalled in late 2020 because of the position of the Trump Administration, but the change of presidency opened up the way again. The Biden Administration was very quick to table new proposals. Under the final agreement, Pillar One will apply to 100 largest multinationals, irrespective of the nature of the economic activity, with a threshold of US$2 billion of consolidated turnover and a profitability threshold of 10% to determine the excess profit partially attributable to the country of the market.

For Pillar Two, the agreement reached within the inclusive framework refers to a rate of 'at least 15%', to accommodate with the intention of the US to increase the CIT rate to 21%.

Discussion and assessment

A key characteristic of the agreement is that it departs from current rules in significant ways while not fully implementing reforms suggested by tax economists, such as destination-based taxation, cash flow taxation, formulary apportionment, or coordination instead of competition in tax policy setting.

Taxing in the country of the market had already been proposed by economists under the name 'destination-based cash-flow tax'. It was also part of the Trump Administration's initial tax reform proposal, but was later abandoned[3].

A destination-based cash flow tax would incorporate two fundamental changes compared to an usual corporate income tax: taxation of cash flow rather than profits and taxation in the country of destination rather than in the country of production. Both elements are partially to be found in the Pillar One proposal and agreement.

In the case of the former, we are not talking about cash flow taxation as such, but a mechanism that ends up with a partly similar result. A cash-flow tax has the effect of exempting the normal return on capital[4] and limiting taxation to the part of the return constituted by the economic rent ('excess return').

Pillar One simply separates the return into two components with a part of the 'rent' allocated to the country of the market. The agreement builds on transfer pricing concepts, that make a distinction between 'routine' and 'non-routine' profit.

Those concepts belong in the taxation specialist's toolbox (Devereux *et al* 2019) and applied on a case-by-case basis. It is certainly difficult, if not impossible, to translate into the basis for a new taxation system.

An economist tends rather to speak of the normal return on capital (the long-term risk-free interest rate plus the risk premium) and 'excess return' (remaining component of the rate of return). The agreement still uses the terminology of the transfer pricing glossary but operates in a different way by fixing the profitability threshold that determines non-routine profit.

As regards the second aspect, taxation in the country of destination recognises the principle of value creation independently of a physical presence of an economic entity in the country of destination. This point is particularly welcome for taxation of the digital economy.

From an economic point of view, this kind of taxation formula is superior to sales taxation which is independent of profitability. The other advantage is the lower mobility of this tax base: sales to final consumers are less relocatable than production, which, for its part, is less relocatable than the location of the intangible assets, currently a determining factor for the taxation of companies in the digital economy.

A too small step towards unitary taxation?

By defining the rate of return separating 'routine profit' from 'non-routine profit' and the proportion allocated to the country of destination on a fixed basis, Pillar One is taking a step towards unitary taxation.

This comes down, in actual fact, to a formula separating profitability into two components, allocating the first on the basis of the transfer pricing rules and the second on a fixed basis according to sales by destination.

There is no denying the conceptual leap: Pillar One introduces a fundamental innovation, in that it proposes to apply the principles of consolidation and fixed apportionment to some of the profit of a multinational group at a broader level than a federal (or confederal) state or than a supranational body such as the EU.

Its excessively limited scope, with very high consolidated turnover and profitability thresholds, is regrettable, but the reform's supporters will respond that the main thing is to take the conceptual leap and, once this has been done, the scope could be extended.

In any event, it marks the end of the absolute reign of separate taxation of the entities of a multinational group and the establishment of their profits by the rules on transfer prices.

Is the minimum tax set too low?

In the context of tax competition that has prevailed over the past few decades, the introduction of a minimum tax by Pillar Two is for sure a significant change. Proposals for a minimum taxation on profits has up to now been disregarded while others forms of minimum taxation are more widespread.

These authors also notes that minimum taxation based on sales or assets has been effective in increasing average tax rate and corporate income tax revenue for governments. Will the Pillar Two agreement have the same consequence? and will this reduce tax competition?

Details – that are still to be negotiated - will of course matter. A much-discussed question is the possibility of leaving certain preferential regimes out of scope.

Patent boxes, which are still compatible with the nexus rules of the BEPS agreement, were safeguarded in this way for a long time. The safeguarding of patent boxes was abandoned in favour of a formula making it possible to leave regimes granting a low rate for real economic activities out of minimum taxation. This option is less detrimental, but it can be argued that it leaves the way open to tax competition.

Pillar Two requires also a common definition of effective taxation requires a common definition of the denominator of the fraction giving the effective tax rate, and hence the profit.

One of the objections of the opponents of unitary taxation was the impossibility of securing a sufficiently broad agreement (in terms of the number of countries) on the definition of the tax base. On this point, the technical discussions on Pillar Two might pave the way for further steps in formulary apportionment.

The effect on tax revenue could be significant, according to the assessment. OECD indicates, for the proposal that was on the table at that time[5], revenue gains around 2% of CIT revenue and from 1.8 to 3.2% including estimated pockets of low taxed profits in high tax jurisdictions[6].

Simulations including dynamic effects (reduction in profit shifting, interactions with Pillar one and increase in nominal rates) concludes in effects of the same magnitude but with a different distribution across jurisdictions. The effect of the minimum rate on tax competition is a disputed question. OECD indicates that the result is theoretically ambiguous, based on a recent literature survey. In the post-COVID context, fiscal space for cutting CIT rates will however be limited in a significant number of countries.

Tax competition not only occur through nominal rates but also through preferential tax regimes. The minimum rate will put a limit, as those who result in an effective tax rate lower than the threshold will be neutralised. There will be no interest for multinationals to lobby for the introduction of such regimes and no interest for countries to compete in this way.

So, Pillar Two could make CIT more uniform and less distortive, within and between various jurisdictions.

The debate is far from over

The recent agreement on taxation of multinational companies is for sure innovative and indicates a new tax policy stance favouring fair taxation and putting at least limits to tax competition. Details have still to be negotiated, that could have a significant effect on the outcome.

In terms of principles, it is the first time that a formulary apportionment approach will, albeit partially, replace transfer prices in the determination of taxable profits at the international level.

The tax system that will result from the implementation of the agreement could look as sitting between two seats, what is typically unstable. For the first time, MNE's are considered as a single entity for tax purposes.

Formula apportionment is introduced, but at the margin. Concept of permanent establishment and transfer pricing rules still operate: the agreement only departs from them in limited circumstances.

The debate on the common consolidated corporate tax base in the EU indicates how it is politically difficult to go beyond that. The optimistic view is that the first step is the more difficult and that the agreement might open the door to more radical changes in the future. More radical, proposals have been made, such as those of Barake, Zucman, Cobham. ■

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Endnotes

1. Christian Valenduc was also Head of the Tax Policy Directorate at the Federal Ministry of Finance, Belgium, until the end of 2020.

2. The 'inclusive framework' was established in 2016, on the initiative of the OECD (Organisation for Economic Co-operation and Development) and the G20, to lead the discussion on reforming the taxation of companies at international level. The remaining 6 jurisdictions that – this stage- did not approve are Estonia, Hungary, Ireland, Kenya, Nigeria and Sri Lanka.

3. OECD, 2007, pp. 93 et seqq., and Auerbach et al 2017.

4. The same result can be achieved by an allowance for corporate equity, as implemented in Belgium in 2005 (and recently reformed) and by Italy later (Valenduc, 2008). The 2016 proposal of the European Commission on a common consolidated tax base included a similar provision and it is still included in its recent proposal as a "Debt-Equity Bias Reduction Allowance" (DEBRA). (European Commission ,2021).

5. Excluding multinationals headquartered in the US but with a lower turnover threshold.

6. OECD (2020), page 87 and more broadly chapter 3.

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