

White Paper

# Corporate Tax, Digitalization and Globalization

Platform for Shaping the Future of Trade and Global Economic Interdependence

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World Economic Forum  
91-93 route de la Capite  
CH-1223 Cologny/Geneva  
Switzerland  
Tel.: +41 (0)22 869 1212  
Fax: +41 (0)22 786 2744  
Email: [contact@weforum.org](mailto:contact@weforum.org)  
[www.weforum.org](http://www.weforum.org)

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# Foreword

## Sean Doherty

Head of International Trade and Investment, Member of the Executive Committee, World Economic Forum

## Aditi Sara Verghese

Policy Analyst, International Trade and Investment, World Economic Forum

This paper is intended to support informed debate among non-experts on the reform of international corporate taxation. It has been produced with the input of a diverse group of individuals representing governments, corporations, civil society organizations and academia.

Digitalization enables companies to interact with users and the economy of a country without establishing a physical presence there. Unique, intangible assets make it difficult to apply the arm's length principle in determining how to value transactions between related entities in different countries. Tax competition among countries and remaining opportunities for profit shifting to low tax jurisdictions have raised concerns.

Considering these developments, 135 countries are discussing new rules under the Organisation for Economic Co-operation and Development (OECD) Inclusive Framework:

1. To reflect the ability of businesses to create value in a jurisdiction without physical presence there, by reallocating taxing rights among countries (Pillar 1)
2. To tackle tax competition and remaining tax avoidance concerns through a global minimum tax (Pillar 2).

Important details are yet to be hammered out: which activities and what portion of profits will be subject to the new taxing right, the global minimum tax rate and any carve-outs.

Further analysis on how proposals will affect different economies, tax administrations, taxpayers and individuals is needed for informed, inclusive agreement. Clearly, for government revenues to be most beneficial, spending needs to be allocated and delivered responsibly through accountable institutions.

Corporate tax is only one source of government revenue, though sometimes an important one, particularly for developing countries. While a global minimum tax may help small countries resist pressure to lower rates, they may also need to find alternative ways to attract investment.

At a time when multilateral cooperation in trade is faltering, momentum for international corporate tax reform is promising. However, fundamental questions remain about the proper allocation of taxing rights between source and residence countries, the value of user participation in new business models, tax sovereignty and industrial policy objectives.

Clarity among all parties involved on what ongoing reforms are meant (and able) to deliver will help avoid frustrations over unmet expectations and highlight where further work is needed for tax systems to meet society's expectations.

This paper is a product of the World Economic Forum's Platform for Shaping the Future of Trade and Global Economic Interdependence.

# Corporate tax challenges in a globalized, digitalized economy

Multinational enterprises (MNEs) play an important role in international trade and investment. They account for half of world exports, almost one-third of global production and one-quarter of employment.<sup>1</sup> Economic liberalization and advancements in transport and communications have led to the proliferation of global value chains. Digitalization has enabled new business models. Intangible assets (trademarks, patents and other forms of knowledge-based capital) and (digital) services have become more important.

However, the rules that govern how countries tax the profits of MNEs are largely based on principles established in the early 20th century under the auspices of the League of Nations. Since the late 19th century, countries have entered into double taxation agreements to ensure that MNEs are not being taxed more than once on the same income for the same period by different taxing authorities. Certain fundamental principles underlying these rules are being called into question on the grounds that they are still tailored to a physical, less globalized economy and give rise to the following challenges.

## Remote business models

General tax principles, as enshrined under domestic and treaty law, provide that a source country can only tax business profits of foreign enterprises attributable to a “permanent establishment” through which the enterprise carries on business in the country. A permanent establishment is generally considered to be a fixed place of business, such as a branch, office, factory, etc.<sup>2</sup>

However, digitalization allows businesses to play an active role in the country’s economy without a physical permanent establishment. Digital businesses can achieve “scale without mass”,<sup>3</sup> reaching users and customers in different countries without significant local presence, though there may be significant activity, research and development elsewhere. For instance, social network websites can use data and content generated (“produced”) by users and sell targeted advertisements to other businesses, all without establishing a physical office in the country. Digital stores can access customers in a country without hiring employees there. Traditional businesses can also interact with an economy through digital channels.

## Data and user participation

One of the arguments in favour of reform is the idea that for highly digitalized businesses, the content and/or data generated by users contributes significantly to the value of the business, enabling the sale of targeted advertising products to other businesses, for example. This is sometimes contested on the grounds that raw data derived from user jurisdictions is worthless without analysis. Addressing this question involves

distinguishing between real value creation by users and consumers (taxed through corporate tax) and mere sales in the jurisdiction (taxed through consumption taxes).

## Heavy use of intangible assets

Highly digitalized businesses are also characterized by a heavy reliance on intangible assets. This raises challenges when determining how to allocate profits for tax purposes among companies of the same MNE group operating in different countries. The “arm’s length principle” (ALP) is used to determine how to value transactions between these companies. It sets the amount that related entities in the same MNE group charge each other (the “transfer price”) for inputs, finished products, the use of intellectual property rights, etc. as if they were independent from each other. To assign values to transactions between related entities in different jurisdictions, companies’ tax departments need to consult economic databases to find comparable prices from similar independent transactions.

The ALP works as an anti-avoidance rule that aims to prevent price manipulation. However, where businesses make profits from unique and valuable intangibles such as databases, software and algorithms, as well as marketing activities involving brands and trademarks, often no comparable price can be found, making it difficult to apply the ALP. As a result, this principle may be manipulated in an economy where intangibles play an important role and where commerce is increasingly carried out digitally. This tension has given rise to disputes between taxpayers and tax authorities and is at the centre of current discontent with the rules. Some have advocated for replacement by less complex allocation mechanisms, such as formulary apportionment.

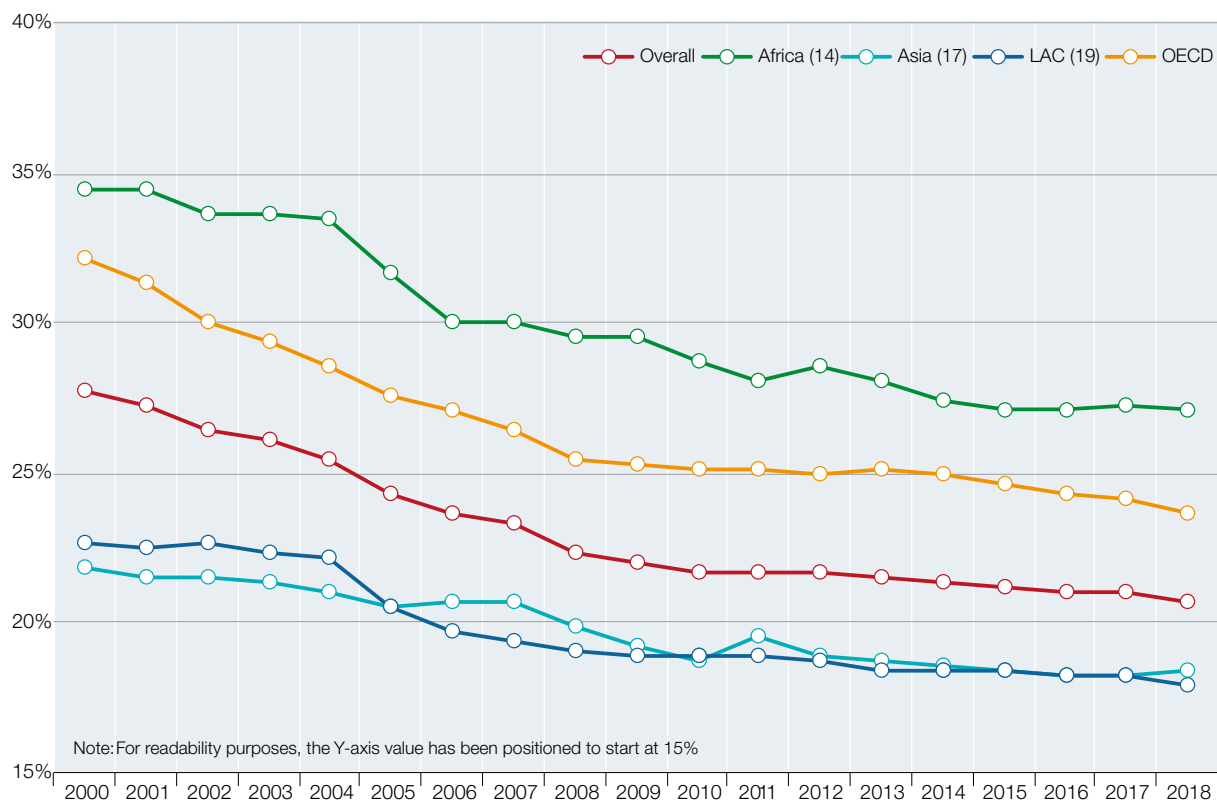
## Tax competition among countries

Tax competition among countries is another source of tension. This involves lowering corporate tax rates or providing tax incentives for specific industries or activities as countries compete for mobile economic activities.<sup>4</sup> This is evidenced by the proliferation of tax regimes that treat income derived from intellectual property in a preferential way<sup>5</sup> and the general downward trend in corporate income tax rates as shown in Figure 1. It should be noted, however, that, lately, corporate tax revenues as a percentage of GDP have increased in many countries.<sup>6</sup> Further, countries have a sovereign right to set their tax rates, and many use them as part of industrial policy.

## Remaining base erosion and profit-shifting issues

In 2013, news media around the world highlighted a steady decrease in contributions to public finances by some high-

**Figure 1: Declining average statutory corporate income tax rates by region (2000–2018)<sup>7</sup>**



Source: OECD Corporate Tax Statistics Database, 2019

profile MNEs. This decrease was associated with the ability of sophisticated taxpayers to shift otherwise taxable income and transactions out of the tax base, in what the OECD labelled “base erosion and profit shifting” or BEPS.

The concern is that some MNEs use complex arrangements to legally pay very low corporate income tax. For instance, within an MNE group, an entity established in a low tax jurisdiction might give loans to other companies in the group and receive interest payments in return or hold valuable patents and license them to other companies in the group for royalty fees. These have the effect of reducing the taxable income of those other companies, typically based in higher tax jurisdictions, and reducing the overall tax liability of the MNE. The result is less tax revenue for countries and a public perception that MNEs do not pay their fair share. The increasing importance in the digital economy of intangible assets, which tend to be more mobile, exacerbates the issue.

In 2013 the OECD/G20 launched the BEPS Project to coordinate international tax rules and tackle tax avoidance strategies that exploit gaps in the rules and artificially shift profits to low tax jurisdictions. Although difficult to calculate in practice, estimates of yearly tax revenue losses due to profit shifting range from \$100 billion to \$650 billion.<sup>8</sup> A full impact assessment of the changes introduced through the BEPS process on these figures has yet to be conducted – partly since implementation is still under way in many countries. Despite progress to date (see Box 1), there are some concerns over remaining BEPS issues.

### Box 1: BEPS 1.0

The initial BEPS Project did not address allocation of taxing rights among jurisdictions. Instead, it provided a set of 15 Actions: four minimum standards, 10 best practices for countries to implement individually and a Multilateral Instrument. The minimum standards are soft law and thus not legally binding, but there is an expectation that they will be implemented into the tax system of the countries participating in the BEPS Inclusive Framework. The Multilateral Instrument, in force since July 2018, was introduced to modify bilateral tax treaties accordingly.

The BEPS Project introduced Action 1 to address the tax challenges of the digital economy. BEPS Action 1, one of the best practices for countries to implement, called for “a realignment of taxation and relevant substance to restore the intended effects and benefits of international standards, which may not have kept pace with changing business models and technological developments”. This also included the allocation of taxing rights where there is not physical presence and the improvement of transfer pricing rules to put more “emphasis on value creation in highly integrated groups, tackling the use of intangibles, risks, capital and other high-risk transactions to shift profits”.<sup>9</sup>

# The opportunity for reform

## Public concern and political impetus

There is considerable political momentum behind international and domestic tax reform. This is a result of broader societal pressure to deliver meaningful reform if support for a globalized economy is to be maintained. In the aftermath of the 2008 financial crisis and the austerity measures that followed, there was public outcry over high-profile instances of tax avoidance and tax evasion. Politicians, particularly in Europe, made tax reform a prominent part of election campaigns. Public and consumer backlashes have also raised the issue as a priority in corporate boardrooms and among tax advisory firms.

The BEPS Project described above was an effort to tackle corporate tax structures that result in artificial profit shifting and to deal with highly digitalized business. Through the Inclusive Framework on BEPS, the OECD/G20 brings together (as of November 2019) 135 jurisdictions, including developing countries, to work towards implementation.<sup>10</sup> More recently, these countries are working towards new rules to tackle the fundamental tax challenges of digitalization. Economic analysis and impact assessments of the proposals are being conducted. The discussions are evolving quickly, with a deadline for reaching agreement on the outlines of a Unified Approach in early 2020 and the aim to deliver a final solution by the end of 2020.

To adapt existing tax rules to the digital economy, the European Commission introduced two legislative proposals in March 2018: one long-term solution to reform corporate tax rules so that profits are registered and taxed where businesses have significant interaction with users through digital channels; and one interim solution to introduce a digital services tax applicable to certain digital activities that generate revenues in the EU. There is no consensus on these two proposals, so the European Council presidency continues to work on the EU position in international discussions on digital tax.<sup>11</sup> Meanwhile, a digital services tax was introduced in France (3% tax on revenues from digital services) and has been proposed in Spain, Austria and other countries.

Other unilateral measures include the equalization levy in India (6% tax on business-to-business transactions in the digital advertising space) and the diverted profit tax in Australia and the United Kingdom. The diverted profit tax aims to tackle corporate tax structures used by MNEs to avoid paying taxes in a specific country by shifting the profit to another country with a lower tax rate.

In the midst of these initiatives, businesses seek certainty, simplicity and coherence in tax rules and, to that end, many MNEs welcome international cooperation over unilateral action.

## Venues for discussion

The OECD has become the primary venue for intergovernmental discussion on international tax reform. Additionally, other organizational structures that facilitate cooperation among developed and developing countries have been established or revitalized in recent years, allowing more consistent dialogue among policy-makers throughout the world. An unprecedented number of jurisdictions have been brought together through the OECD/G20 Inclusive Framework on BEPS. Other fora, such as the Network of Tax Organizations, the Platform for Collaboration on Tax (the International Monetary Fund, the OECD, the United Nations and the World Bank), the International Tax Compact and the UN Committee of Experts on International Cooperation in Tax Matters (“UN Tax Committee”) have emerged or been strengthened. Such enhanced communication increases the likelihood of real agreement among countries.

The UN Subcommittee on Tax Challenges Related to the Digitalization of the Economy (“UN Subcommittee”) was created in 2017 to consider the interests of developing countries in particular. In January 2019, noting the developments at the OECD as well as unilateral measures taken by some countries, the subcommittee decided to undertake work on suggesting measures to tackle the tax challenges raised by digitalization of the economy. The goals are to avoid double taxation and double non-taxation, encourage taxation of income on a net basis and seek simplicity and ease of administration. Accordingly, changes to the UN Model Tax Convention may be suggested, reflecting new nexus and profit allocation rules. However, as of November 2019, no definitive proposals have been released.

With public mobilization, political will and the expertise and capacity of international organizations, conditions for significant reform of the international tax system have rarely been as favourable as they are currently. Various proposals have been presented by international organizations,<sup>12</sup> civil society and researchers. The next section examines the proposals being discussed currently at the multilateral, intergovernmental level in the area of corporate tax reform.



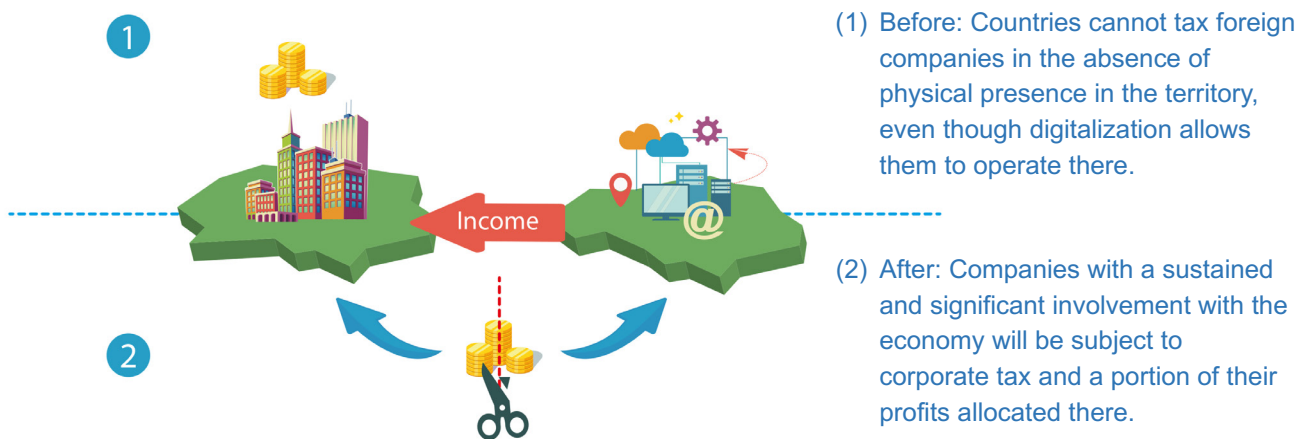
# Proposals for reform

## OECD/G20 Inclusive Framework proposals

In addition to the implementation of the BEPS actions, countries in the Inclusive Framework are working towards agreement on a “consensus solution” to address two main concerns.

The first concern is that current rules that require physical presence to create a “nexus” between the taxing jurisdiction and the firm operating there need to be updated for a digitalized economy. “Revised nexus and profit allocation rules” (Pillar 1) seek to address this issue. The proposal will have the effect of redistributing taxing rights among countries towards market jurisdictions by creating a “new taxing right”. However, the extent of this shift will depend on the form of the final proposal.

**Figure 2:** Pillar 1: An illustration of the situation before and after the adoption of revised nexus and profit allocation rules<sup>13</sup>

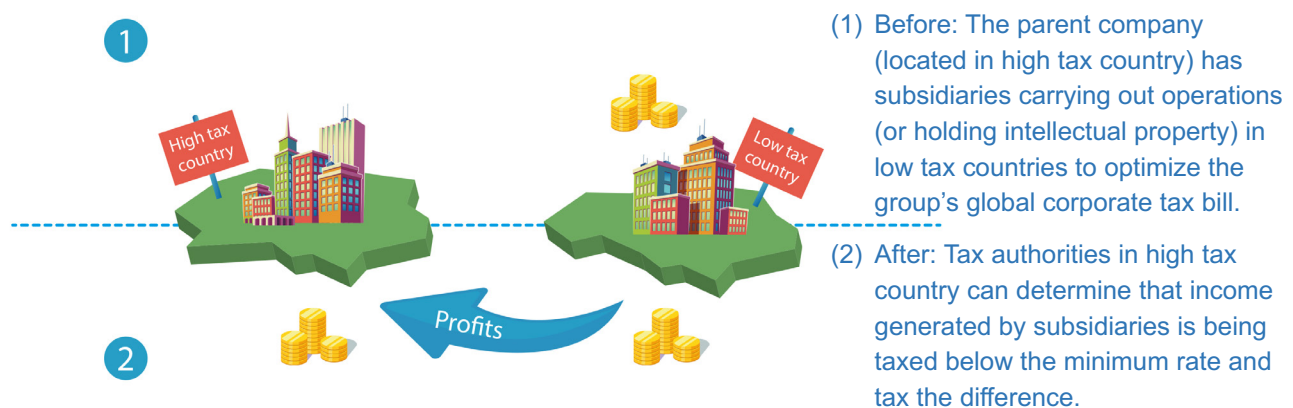


Source: World Economic Forum, adapted from G7 France, 2019.

The second concern is that, despite the progress made so far through the BEPS Project, there are still ways for firms to avoid corporate tax by shifting their profits to low or no-tax jurisdictions – and that jurisdictions are able to effectively

offer such low tax rates with the purpose of attracting business. This is intended to be addressed through the “global anti-base erosion proposal” (Pillar 2), which would introduce a global minimum tax system.

**Figure 3:** Pillar 2: An illustration of the situation before and after the adoption of the global anti-base erosion proposal<sup>14</sup>



Source: World Economic Forum, adapted from G7 France, 2019.



The two pillars are discussed in more detail below.

## **Pillar 1: Revised nexus and profit allocation rules**

Under Pillar 1, there are four technical aspects that need to be determined:

1. Scope: defining which business models are covered
2. New nexus rules: defining the basis of the connection between the taxing jurisdiction and the taxpayer that gives rise to the new taxing right, regardless of physical presence
3. New profit allocation rules: determining the amount of profits that are subject to the new taxing right and how those profits should be allocated among different market jurisdictions
4. Implementation arrangements: considering issues about the implementation and administration of the new taxing right, including measures to avoid double taxation, arrangements for dispute settlement and coordinated risk assessments.<sup>15</sup>

At the beginning of 2019, three alternative proposals on these issues were considered: one by the United Kingdom (“user participation”), one by the United States (“marketing intangibles”) and one by the Group of 24, led by India and Colombia (“significant economic presence”).<sup>16</sup> These were discussed in a public consultation process. Based on these original proposals and contributions from the public, the OECD developed a Programme of Work released in May 2019 containing three distinct technical proposals to allocate profits: the modified residual profit split method, the fractional apportionment method and distribution-based approaches.

In October 2019, the OECD Secretariat released a new document for public consultation, in which a new “Unified Approach” was presented. This new proposal is based on considerations about which elements of the three proposals would most likely lead to a consensus among member states of the Inclusive Framework.<sup>17</sup> The main elements of these proposals are presented below.

### **1. Scope**

The Secretariat’s Unified Approach covers highly digitalized businesses, as well as consumer-facing businesses “that market their products to consumers and may use digital technology to develop a consumer base”.<sup>18</sup> Certain industries (such as extractives, commodities and financial services) may be carved out and a revenue threshold may be introduced so smaller businesses are excluded.

### **2. New nexus rules**

New nexus rules that capture the concept of remote taxable presence are being developed. A set of standards or indicators to determine when a business is said to have a remote taxable presence in a jurisdiction is also required. This may include a measure capturing sustained local revenues, along with other indicators which show that the MNE’s interaction with the economy goes beyond just selling.

In its Unified Approach, the Secretariat proposes that the new nexus rule cover “cases where a business has a sustained and significant involvement in the economy of a market jurisdiction, such as through consumer interaction and engagement, irrespective of its level of physical presence in that jurisdiction”.<sup>19</sup> A revenue threshold may be determined for the market, based on its size, above which there is deemed to be a sustained and significant involvement. It is suggested that this take the form of a self-standing treaty provision, as opposed to a broadening of the definition of “permanent establishment”.

### **3. New profit allocation rules**

New profit allocation rules are likely to involve separating the profits of an MNE into a portion that would be allocable following the current transfer pricing rules and a portion on which new rules would be applied that allow “market jurisdictions” to tax this part of the profits regardless of physical presence – if the business meets the nexus requirements above.

This creates a system in which the current transfer pricing rules are still applied where the system supposedly works well and new rules apply where the case-by-case transfer pricing analysis does not produce results considered as adequate. To this latter part, a simplified distribution of the tax base relying on a formula negotiated between countries would be applied. What exact portion of profits will be allocated to each part still needs to be settled politically.

Three alternative proposals to change profit allocation rules were published in the Programme of Work of May 2019:

#### **A. Modified residual profit split method (MRPS)**

The MRPS method allocates a portion of the non-routine profits of an MNE group to market jurisdictions according to an allocation key. The first step is to determine the total profits of the MNE group and then differentiate its routine profits from its non-routine profits. Routine profit refers to a basic return appropriate for the type of transactions in which the business is engaged. Any profit above that level would be considered to be “non-routine” or “residual”. It would, in particular, cover unique and valuable intangible assets, for which no comparator can be found. Then, the portion of non-routine profits to be allocated to market jurisdictions under the new taxing right needs to be determined. Finally, that portion must be allocated between the different market jurisdictions according to an “allocation key”. For instance, the allocation may be based on revenue.

#### **B. Fractional apportionment method**

In this method, total profits are not separated into routine and non-routine profits. Instead, the overall profits of an MNE group (or business line)<sup>20</sup> are considered. This method involves the following steps:

- a. Compute the profit to be divided: This may be done, for instance, by starting with the profit of the selling entity using current transfer pricing rules or by applying a global profit margin to local sales.

- b. Apply the allocation key/formula to apportion the profit to the relevant market jurisdiction(s): Factors considered in constructing the formula may include employees, assets, sales and users.

It would be necessary to address the interaction between current transfer pricing rules with the rules that implement the fractional apportionment method to avoid double taxation and double non-taxation. Rules are needed to determine how the new tax burden will be borne by the different entities of the MNE.

### C. Distribution-based approaches

The BEPS Inclusive Framework is also considering the possibility of a simplified approach that pursues the aims of allocating more profit to market jurisdictions and reducing controversies concerning the proper pricing of marketing and distribution activities. One possible approach is to develop rules that determine a baseline amount of profit attributable to marketing, distribution and user-related activities in the market jurisdiction. This baseline profit may be increased or decreased, taking into account the MNE group's overall profitability and/or additional variables such as industry and market differences to allocate a proportion of routine and non-routine profits to market jurisdictions.

### OECD Secretariat's Unified Approach

The Secretariat's "Unified Approach", released on 9 October 2019, takes elements from all three proposals mentioned above and suggests a three-tiered approach to calculate income attributable to market jurisdictions. Three different amounts are calculated using different rules, and mandatory binding arbitration is included as a procedural element to avoid overlaps between the tiers and the potentially resulting double taxation.

Amount A: To calculate the first amount (or first part of the tax base), profits would be separated into a routine and a residual part. A fixed percentage of the residual part of the profits would then be allocated to the market jurisdictions based on the amount of sales made in that jurisdiction (see the explanation of the residual profit split above). This rule would apply regardless of whether or not the company has a physical presence in the jurisdiction. As a simplification measure, a fixed ("deemed") percentage of the profits would be used to undertake the split, instead of a case-by-case analysis. The two fixed percentages to be defined have important implications for the impact of the proposal (the higher the amount of routine profits, the lower the impact; the higher the fraction of residual profits to be allocated, the higher the impact) and would therefore be subject to political debate.

Amount B: The routine profits would still be allocated using the current transfer pricing system – with the exception of the second amount. This second amount would be a part of the routine profits, calculated by applying a fixed return (or profitability) to entities of the multinational group that undertake marketing and distribution activities within a market jurisdiction (see in essence the explanation of the

distribution-based approach above). The reason why this part of the routine profits would be taken out of the current transfer pricing system is that many disputes between taxpayers and tax authorities arise when it comes to determining the proper remuneration for these marketing and distribution functions. Importantly, this second amount can be attributed only to jurisdictions where the multinational group has a physical presence.

Amount C: Finally, a tax administration or a taxpayer might argue that more profits than fixed by the second amount should be attributed to the marketing and distribution function mentioned above or that the company performs other business activities in the jurisdiction, apart from marketing and distribution. Hence, a third amount, supported by a proper justification, could be added. Since the determination of this third amount could easily lead to dispute, the OECD Secretariat proposes including mandatory dispute resolution mechanisms.

### 4. Implementation

Once the new nexus and allocation rules have been introduced, rules will be needed to ensure efficient implementation and administration of the new taxing right by developed and developing countries. The Inclusive Framework anticipates that the following issues will need to be addressed:

- Whether existing double taxation relief mechanisms and dispute resolution systems are sufficient
- How to coordinate the application of the new taxing right with other taxing rights, such as withholding taxes
- How to enable the tax authority to enforce and collect the tax where the entity liable to pay it is not resident in the taxing jurisdiction
- How to ensure the data needed to implement the new taxing right is available to tax administrations and taxpayers
- How to establish and report on where final sales and services are deemed to have taken place or been delivered.

A peer review process may be needed to ensure consistent implementation, along with a second Multilateral Instrument to update existing treaties.

### Pillar 2: Global anti-base erosion (GloBE) proposal

Under Pillar 2, the Inclusive Framework considers rules to prevent global undertaxation of corporate profits and thereby builds on the initial BEPS Project. These were proposed by Germany and France and based on similar rules introduced through US tax reform in 2017.<sup>21</sup> The proposals comprise a combination of the four rules listed below:

**Figure 4:** Summary of rules making up the GloBE proposal

	Proposed rule	Primary concept	Applicable jurisdiction
<b>1</b>	<b>Income inclusion rule</b>	Apply a minimum tax to help prevent tax competition among countries.	Residence
<b>1.1</b>	Inclusion rule	Foreign profits from a foreign company or permanent establishment that belongs to the same group as a resident company would be included in the company's tax base if they have been taxed only at a low rate. (Top-up to ensure minimum tax is paid.)	
<b>1.2</b>	Switch-over rule	For jurisdictions committed through their tax treaties to exempt foreign earned income, introduce an additional rule that would allow applying the credit method (instead of the exemption method) in case the foreign income is taxed at a rate lower than the minimum rate. <sup>22</sup>	
<b>2</b>	<b>Tax on base-eroding payments</b>	Protect the source jurisdiction from base-eroding payments.	Source
<b>2.1</b>	Undertaxed payments rule	Deny deduction or impose a tax (including withholding tax) for payments made to a related party in another jurisdiction, if payment was not subject to the minimum tax.	
<b>2.2</b>	Subject to tax rule	Grant certain benefits only if the particular income was taxed at the minimum rate or above.	

Underlying these rules will be an effective tax-rate test, which could be carried out at either entity, jurisdiction or global level. Conducting such a test at the global level, for example, would mean that the overall effective tax rate of the whole corporate group would be calculated and, if it falls short of a predetermined rate, a jurisdiction would have the right to impose additional tax up to that (minimum) level.

Fundamental questions remain, such as how high the minimum tax should be and whether the source jurisdiction or the residence jurisdiction would have the right to apply their respective rule first (to increase the company's effective tax rate, in case the company is undertaxed). An important political question is the level at which the test should be applied – worldwide, jurisdiction or entity level. The lower the level, the bigger the impact of the minimum tax at a given rate.

Another issue is determining exceptions and carve-outs. Proposed ideas include a carve-out for tax incentives related to research and development (to ensure continuity of preferential regimes for intellectual property),<sup>23</sup> an exception for income that has economic substance in a jurisdiction or limiting minimum taxation profits above a normal rate of return. An additional important concern is the definition of the multinational group. What participation threshold should trigger “belonging to a group”? Political debate about these is likely to influence the ultimate outcome on the global minimum tax approach.

With regards to the impact on developing countries, there are two considerations. On the one hand, if a developing country taxes income at a low rate due to a preferential regime or other rules, the residence country of the MNE (generally a developed country) would tax the income instead, up to the minimum rate. A minimum tax thus reduces the ability of a developing country to compete for foreign direct investment (FDI) through low tax rates and, in addition, the profits realized in source countries would be taxed by the residence country. On the other hand, if developing countries actually wish to adopt higher taxes but are prevented from doing so because of tax competition, a minimum tax would effectively enable them to do so. Finally, the hierarchy of rules mentioned above might have particular implications for developing countries, since it would determine whether source countries (which most developing countries are, to a great extent) or residence countries have priority in applying a minimum tax. Generally, if the source rule (tax on base-eroding payments) becomes the primary rule, and income inclusion only the secondary rule, this would be more beneficial for most developing countries, being capital importing countries.

In November 2019, the OECD Secretariat published a consultation document seeking input from stakeholders on technical issues regarding the GloBE proposal; for example, whether financial statements can be used to undertake the effective tax-rate test and what carve-outs might be appropriate. It also asked for responses on the potential

compliance effects of the different possible policy choices, such as the question of the level at which the effective tax-rate test should take place, while leaving the final decision on the level and the actual minimum tax rate open for political discussion in 2020.<sup>24</sup>

## UN Subcommittee

The UN Subcommittee highlights concerns regarding the value creation-based models discussed under Pillar 1. Such proposals might potentially result in reallocating taxing rights from the supply side, which focuses on production and marketing, to the demand side, where the primary focus is on price, profits and the paying capacity of consumers. While both demand- and supply-side factors create market value, under currently applicable rules, corporate taxation is primarily allocated to supply-side factors contributing to profitability, whereas other indirect taxes such as VAT, excise and sales tax are allocated to demand-side factors, based on consumption.<sup>25</sup>

User-based proposals may shift this existing balance to the detriment of smaller developing economies with limited domestic markets and a greater reliance on exports. Therefore, rules should be determined based on multiple factors from both the demand and supply side and not merely demand-side considerations. The “significant economic proposal” put forward by G24 countries does examine this to an extent by considering factors beyond sale, such as assets

and employees. One factor that is currently usually overlooked is “location savings” – that is, consideration of lower labour and real estate costs in some countries.

The UN Subcommittee also highlights the complexities of the OECD’s MRPS and fractional apportionment proposals. The MRPS method is complex in theory with respect to determining routine and non-routine profits, whereas the fractional apportionment method would be difficult to implement in practice as it would require consensus among all countries on a common tax base, allocation factors and joint auditing and dispute resolution responsibilities.

Therefore, the UN Subcommittee is considering solutions that are easy for taxpayers to comply with and for developing-country authorities to administer, while acknowledging that such solutions will probably involve trade-offs with respect to accuracy, allocation between countries and identifying applicable businesses.

The amendment of Article 5 of the UN Model Tax Convention – the provision defining permanent establishment – is being considered, along with the addition of Article 12B – a new rule to enable source taxation of digital services, on the lines of taxation of passive income (for example, royalties, interest, dividends). Withholding taxes are also being explored as mechanisms to ensure compliance with any new or revised taxation rules. However, as of November 2019, no firm proposals have been shared.

# Stakeholder perspectives

This section provides examples of positions and actions that different stakeholders have taken on these issues. Despite several differences, there are points of convergence among stakeholders. Most see the need for transparency and simplicity in any new rules to minimize the costs and inefficiencies concerning compliance and administration for taxpayers and tax authorities.



**From KPMG’s multistakeholder roundtables, it is clear there are different drivers for change: the outdated global tax accord due to modern business models; a desire to change the current split of taxing rights between countries; concerns about avoidance; complexity; perceptions of fairness; quasi-monopolies. Clarity is needed on which of these issues any solution is designed to address.**

*Chris Morgan, Head of Global Tax Policy, KPMG International*

## Governments

With corporate taxation, governments attempt to strike a balance between two main objectives: (1) raising tax revenue from capital income to finance public expenditures or to redistribute income; and (2) using tax incentives to attract investment in their economies, which may also lead to other sources of tax revenue. How these objectives are weighted depends on the country’s economic structure (size and other factors that influence investment decisions) and political factors (such as preferences of voters, power of other political actors). Differences between countries along these lines make reaching international agreement challenging.

In a system in which many countries have agreed that one unit of income of an MNE should be taxed only once, countries have varying preferences as to how the income should be distributed. Countries with large markets, such as most G7 countries, may prefer to have the location of sales play an important role in the distribution. Developing countries with many factories with low value-added activities and smaller markets, may prefer to have the distribution of the number of employees within an MNE determine how profits are allocated.<sup>26</sup> Some countries with high value-added activities and many headquarters, especially of companies affected under Pillar 1, may prefer more limited changes. For instance, Switzerland has argued along these lines.<sup>27</sup> Smaller developing countries and the UN Subcommittee challenge the validity of the value creation principle as a basis for taxing rights. Many governments work through and with international and regional organizations to develop and express their positions (see Box 2).

## Box 2: International and regional organizations

The OECD Centre for Tax Policy and Administration organizes meetings of the BEPS Inclusive Framework and of the policy-oriented working parties in which representatives of member states take part. It drafts technical reports that serve as a basis for reaching agreement and undertakes economic impact assessments.

The IMF provides reports and economic analysis of tax policies, gives technical advice to 100 members and covers international tax issues in its surveillance work. It engages in important debates on reforms broader than those discussed within the OECD Inclusive Framework; for instance, in its 2019 report *Corporate Taxation in the Global Economy*.<sup>28</sup> The IMF research has led to growing interest in destination-based approaches, such as Destination-Based Cash Flow Taxation.<sup>29</sup>

The UN Tax Committee strives to include developing countries in the debates on international tax and develops alternative standards to those developed in the working parties of the OECD, such as the UN Model Tax Convention and the UN Transfer Pricing Guidelines.

In addition to the participation in the Platform for Collaboration on Tax created in 2016 to intensify cooperation and to support developing countries, the IMF, the World Bank and the UN also provide technical assistance and advice to member countries.

The G24 is an international organization of developing countries that attempts to coordinate their positions on issues of international economic policy.<sup>30</sup> It has brought countries together to put forward one specific proposal on the allocation of taxing rights, the “significant economic presence” proposal.<sup>31</sup>

The EU Commission strives for harmonization of tax policy at the EU level and promotes “good tax governance” (transparency, exchange of information and fair taxation) through its trade and investment agreements.

Regional tax organizations such as the Inter-American Center of Tax Administrations (CIAT),<sup>32</sup> the African Tax Administration Forum (ATAF) and the Cercle de Reflexion et D’Échange des Dirigeants des Administrations Fiscales (CREDAF) play a role in knowledge dissemination and the formation of policy positions among their member countries. ATAF, for example, released several technical notes on the discussions carried out at the Inclusive Framework, expressing clear policy preferences.<sup>33</sup>



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**ATAF is working for a fairer allocation of taxing rights and to stem the erosion of African tax bases due to profit shifting. Regarding digitalization, new taxing rights for market jurisdictions would address the existing imbalance between source and residence jurisdictions. A minimum rate of taxation for MNEs, if properly designed and implemented, would address base-eroding payments and illicit financial flows out of Africa. ATAF advocates for African policy-makers' involvement in this process**

*The African Tax Administration Forum Secretariat, Pretoria, South Africa*

## Businesses

The most common request from MNEs is for a principle-based, multilateral solution that provides certainty, fairness and coherence and is simple to comply with.<sup>34</sup> Tax certainty implies that the tax burden a company will face when carrying out certain investments and transactions can be calculated in advance with a minimal degree of uncertainty as to whether or not the involved tax administration(s) will agree with the calculation. The issue of certainty is distinct from the issue of the overall level of taxation.<sup>35</sup>

Additionally, MNEs emphasize the need to avoid double taxation and argue for the worldwide establishment of mandatory arbitration to resolve disputes over the allocation of taxing rights between countries. Start-ups that are born global, due to their digital business models, face concerns about compliance if rules are complicated.

Many businesses have engaged constructively in the OECD's public consultation, with proposals submitted by Uber, Johnson & Johnson and others.<sup>36</sup>

Some companies have made use of aggressive tax planning techniques, but not all. A number of them voluntarily publish more information than legally required or adopt explicit strategies to refrain from aggressive tax planning.<sup>37</sup> Due to the growth of the responsible business movement, more and more businesses are concerned with broader issues such as the UN Sustainable Development Goals (SDGs) and have an interest in supporting them through their contribution to public budgets.<sup>38</sup> Businesses profit from a general environment of trust among stakeholders.<sup>39</sup> To address these concerns, various initiatives have been created by businesses<sup>40</sup> and tax advisory firms to engage stakeholders,<sup>41</sup> promote sustainable business,<sup>42</sup> enhance transparency and build trust and reputation.<sup>43</sup>

“

**We at IBM believe that global tax changes should target areas where current rules come up short – we think the long-standing arm's length principle should remain the point of departure. The OECD is the appropriate forum for compromise solutions that target abuse and avoid adverse effects on foreign direct investment.**

*Linda Evans, Director, Global Tax Policy and Government Affairs, IBM*

## Civil society organizations and academics

NGOs and trade unions<sup>44</sup> emphasize the importance of greater transparency on the part of both companies and governments towards the public; for example, through public country-by-country reporting. They also stress the need to raise more tax revenue from corporate income globally to reach the SDGs, safeguard economic human rights and tackle inequality; and they propose allocating a higher share of taxing rights to developing countries. They further argue that aggressive tax planning by companies and tax advisers is unacceptable. Where this entails “aggressive social planning”, there is a negative impact on employment and workers' rights. Tax Justice Network and many trade unions have therefore favoured a unitary taxation approach.<sup>45</sup>

“

**Tax abuse by multinational companies costs \$500 billion annually. Lower-income countries lose the largest share of their revenues. The OECD reforms have, valuably, gone beyond the obsolete arm's length principle, normalizing unitary and formulary approaches. But the present proposal redistributes little profit from tax havens, and barely anything to lower-income countries.**

*Alex Cobham, Chief Executive, Tax Justice Network*

With regards to the GloBE proposal, civil society organizations have argued for setting the global minimum tax rate close to the current average statutory tax rate and raised concerns that a minimum tax rate set at a low level might create a downward trend in countries that currently apply higher tax rates.<sup>46</sup>



**Because of current tax rules, multinationals adopt complex corporate structures to shift profits around. This fails fair taxation; it also has a dire impact on workers. Aggressive tax planning entails aggressive social planning, undermining employment responsibilities and the financial health of normally profitable companies. Trade unions call for more unitary taxation.**

*Séverine Picard, Senior Policy Adviser, Trade Union Advisory Committee (TUAC)*

Some academics have criticized the fast pace of the BEPS Project and argued that it created deficits in input legitimacy (lack of participation in the agenda setting) and output legitimacy (the search for collective solutions and the mechanisms to achieve these solutions) vis-à-vis developing countries.<sup>47</sup> Some issues arising from the implementation of the BEPS Project for developing countries include increased complexity in tax legislation and the diversion of resources from other challenges, such as tackling the informal economy, preventing corruption, improving taxpayer services and tax collection.

With respect to the GloBE proposal, some have expressed that an international effective minimum tax “still permits countries to vie for foreign investments through low levels of effective taxation but establishes a lower floor for this competition and thereby protects high-tax countries from having to completely abandon their own, diverging tax policy preferences”.<sup>48</sup>

The proposed minimum tax raises several questions in global tax governance, as developing countries will have to reconsider their tax incentives. What will developing countries get in return? How will they attract the FDI necessary to achieve economic growth and reach the SDGs?<sup>49</sup> In particular, “minimum taxation of affiliates in LDCs could be limited to profits that exceed a normal return on eventual investments in this country (similar to the current US tax on GILTI)”.<sup>50</sup>

Developing country and civil society organization respondents to an IMF consultation highlighted the following flaws of the BEPS Project: (1) the continued reliance on the ALP, seen as complex, unsuited to modern economic realities and based on the fiction of separate entities; and (2) the lack of balance in source and residence taxation, seen as unresponsive to developing-country needs.<sup>51</sup>



# Broader considerations

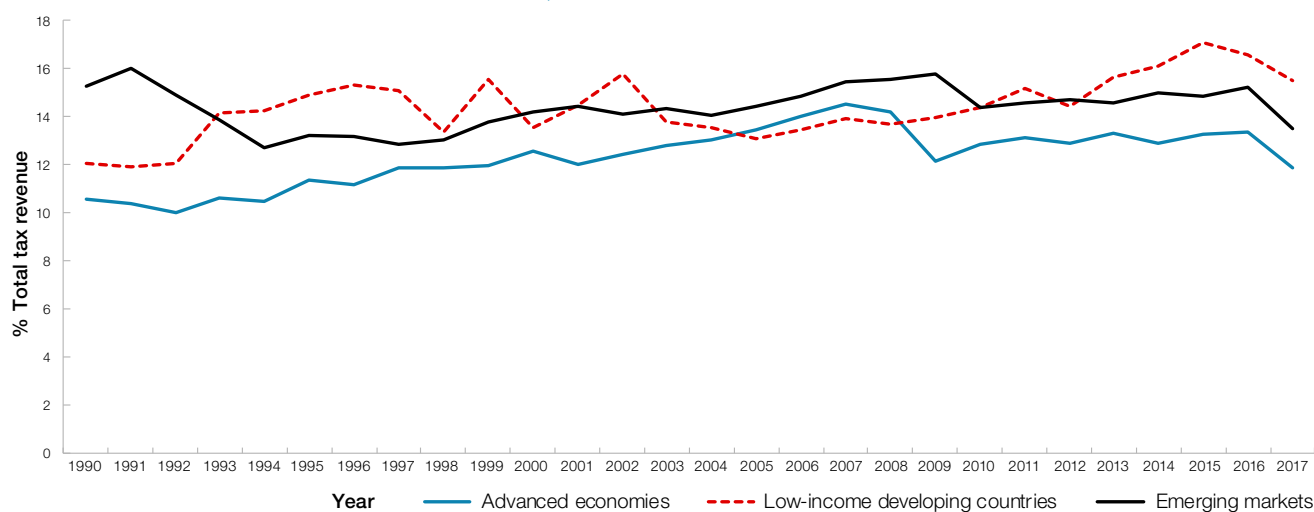
In these discussions and in designing tax policy, governments must consider several factors. The first is the incidence of the tax – that is, who actually bears the economic burden of the tax (as opposed to who makes the payment to the tax administration). If a country increases its corporate tax rate, one or a combination of several things can happen.

1. The after-tax profits of a given company are reduced, the company distributes lower dividends and shareholders are economically affected by the increase.
2. The company pays its workers or suppliers less to keep the same level of dividends, and the incidence lies on workers and suppliers.
3. The company increases the prices of its goods to maintain the level of profits, and the burden is passed on to customers.

Empirically, the incidence of corporate taxation is an important issue in tax policy debates.<sup>52</sup> The economic burden might vary significantly between sectors, depending on consumer and labour market structures, as well as on institutions that influence those markets (competition law, trade law, labour law, etc.).

The second is the tax mix – that is, the relative importance of different sources of government revenue. Relevant considerations are the incidence, administrability and efficiency of different taxes. Corporate taxation plays an important role in the tax mix of developing countries, since it is comparatively easy to levy and administer (see Figure 5). However, other taxes are quantitatively more significant in many countries.

**Figure 5:** Revenue from corporate income tax as a percentage of total tax revenue (1990–2017)<sup>53</sup>



Source: IMF World Revenue Longitudinal Data (WoRLD).

Note: IMF World Economic Outlook (WEO) Income Groups; and excluding resource-rich countries.

Third, tax competition is only one form of “territorial competition”. To avoid a shift to a race-to-the-bottom in other areas, it is necessary to consider international cooperation in tax matters in conjunction with cooperation in other areas, such as labour, environmental and climate policy.

Fourth, taxation is only one side of public finance. A high level of transfers to the government is beneficial if the resources are spent and redistributed in a responsible way. This depends on the existence of accountable institutions and processes that determine how revenues should be allocated.

Finally, the tax challenges of digitalization extend beyond the currently debated issues of allocation of income. Any

future replacement of human labour by artificial intelligence, the growth of the “gig economy” and the ensuing levels of unemployment might necessitate far greater levels of redistribution than currently carried out through tax systems. Some experts have proposed taxing robots or artificial intelligence as part of the solution.<sup>54</sup> Others have emphasized the importance of reskilling the workforce.

These considerations should not, however, be seen as arguments against measures that potentially increase the corporate tax revenue available to governments. They should merely remind us that taxation is one important institution that is and can only be part of a larger environment, in which the quality of one institution affects the quality of others.

# The way forward

Discussions on the reform of international tax rules advance at a pace possibly never witnessed before. Nevertheless, the exact nature and direction of the changes are still uncertain and will be subject to political negotiation.

Whether a stable consensus on a harmonized way to tax income from digital business will emerge in 2020 is still uncertain, and there are developments pointing in the opposite direction. For example, the number of countries that have proposed or have already introduced a digital service tax is rising.

A consensus-based solution with the active and meaningful engagement of all governments and stakeholders can contribute to the long-term stability of the international tax system. At the same time, the material implications of changes are still under-researched. If consensus is reached, the solution will shape the international tax landscape for many years to come. It would therefore be wise to dedicate more resources to investigating the implications.

Such assessments should take into account the effects on overall tax revenue generation and tax competition, but also global investment, trade and innovation. They should evaluate how changes to global tax rules affect the distribution of economic resources between countries, how they affect employment and public resource provision within countries and the feasibility of reporting requirements, implementation, administration and enforcement. In that sense, given that the aims are to be global and inclusive, solutions must be practicable for tax administrations with few resources, such as those one may encounter in developing countries.

Globalization signifies a drastic intensification of relations among countries and between the individuals inhabiting them. Attempts to regulate these relations should aim for fairness and equity and pay particular attention to the least favoured, embodying the spirit of the SDGs.

# Appendices

## Timeline of events

### OECD/G20 Inclusive Framework: Timeline of events

- 2013  
**OECD/G20 BEPS Project launched**  
Established to create international framework to tackle tax avoidance.
- 5 October 2015  
**BEPS Action 1 report Tax Challenges of the Digital Economy, released (as part of the 15 Action Plan, called “BEPS Package”)**  
Identified tax challenges relating distinctly to digitalization – nexus, data and characterization.
- April 2016  
**Platform for Collaboration on Tax (PCT) launched by the IMF, OECD, UN and World Bank**  
Designed to intensify cooperation between the four organizations on international tax.
- 2016  
**OECD/G20 Inclusive Framework on BEPS established**  
Involves developing economies in the implementation, review and monitoring of the BEPS Package.
- March 2017  
**G20 finance ministers’ mandate to the Inclusive Framework (working through the Task Force on the Digital Economy or TFDE)**  
Tasked to work on implications of digitalization for taxation. Commitment to deliver interim report in 2018 and final report in 2020.
- 16 March 2018  
**OECD interim report, Tax Challenges Arising from Digitalisation, released following mandate from G20**  
Analysis of value creation through digital business models and related tax challenges.
- February 2019  
**OECD public consultation document released seeking comments on proposals**  
Outlines three alternative proposals being considered under Pillar 1: revised profit allocation and nexus rules (user participation; marketing intangibles; and significant economic presence proposals) and Pillar 2: global anti-base erosion proposal.
- 13–14 March 2019  
**OECD Task Force on the Digital Economy holds public consultation meeting**  
Large response with many written submissions.
- May 2019  
**OECD Inclusive Framework’s Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy released**  
Describes three alternative approaches for profit allocation (MRPS, fractional apportionment, and distribution-based approaches) and nexus rules under Pillar 1 and GloBE proposal under Pillar 2; sets out agenda for the work programme; endorsed by G20 finance ministers in June 2019.<sup>55</sup>
- 9 October – 12 November 2019  
**OECD Secretariat proposal for a “Unified Approach” under Pillar 1 and public consultation**  
Combines different elements of earlier proposals, with scope restricted to consumer-facing businesses, nexus based on a sustained, significant involvement and a three-tier mechanism for profit allocation.
- 8 November – 2 December 2019  
**OECD Secretariat document and public consultation on Pillar 2**  
Seeks input on specific technical issues.

### UN Subcommittee: Timeline of events

- 2004  
**UN Committee of Experts on International Cooperation in Tax Matters (“UN Tax Committee”) established**  
Mandate to provide practical guidance for international tax cooperation, to prevent both double taxation and non-taxation, and seeking simplicity and administrability.
- 20 October 2017  
**UN Subcommittee on Tax Challenges Related to the Digitalization of the Economy (“UN Subcommittee”) established under the UN Tax Committee**  
Primary focus on developing countries.
- 16–18 January 2019  
**UN Subcommittee Meeting decision to adopt approach independent of similar work in other fora**  
Work to propose guidance on (1) tax treaty issues; (2) domestic law issues; and (3) VAT issues.
- 5 April 2019  
**UN Subcommittee report Tax Issues Related to the Digitalization of the Economy released**  
Lists possible frameworks for changes to UN Model Convention and provides guidance on VAT and indirect tax issues.

## Glossary of terms

**Arm's length principle:** an arm's length transaction is one in which the parties to the transaction each act individually and in their own respective interests. The actual prices paid for goods, services or intangibles between related parties may vary from those paid in an arm's length transaction. The arm's length principle is an international standard that allows MNE groups and tax administrations to use, for tax purposes, an arm's length price instead of the actual price paid between related parties. Profits that would have accrued to one of the parties had the transaction been at arm's length are included, for tax purposes, in that party's profits and taxed accordingly.<sup>56</sup>

**Corporate income tax:** tax on the income of companies, with the tax base being corporate profits.<sup>57</sup>

**Market jurisdiction:** jurisdiction in which users, customers or consumers of a business are located.

**Residence country:** country in which an entity is liable to be taxed because of domicile, residence, place of management or another similar criterion, and not by reason of income or capital situated within the country. The domestic law of the residence country determines whether the entity is resident there for tax purposes.<sup>58</sup>

**Routine and residual profits:** under the profit split method, the combined profit from controlled transactions is divided into two stages. In the first stage, each party is allocated sufficient profit to provide it with a basic or normal return, determined based on returns achieved for similar transactions by independent parties under market conditions. These are considered routine profits. In the second stage, any residual profit is allocated among the parties based on an analysis of how this residual profit would have been divided between independent enterprises. These residual or non-routine profits may arise from intangibles, for instance.<sup>59</sup>

**Source country:** country in which a particular item of income is deemed to originate or be generated.<sup>60</sup>

**Transfer price:** price charged by a company for goods, services or intangible property to a subsidiary or other related company.<sup>61</sup>

**Withholding tax:** tax on income imposed at source, in which a third party (generally, the payer of the income) is required to deduct the tax from certain kinds of payments and remit it to the government. These taxes are commonly used in relation to dividends, interest, royalties and other similar payments.<sup>62</sup>

# Contributors

## Authors

### Irma Mosquera Valderrama

Associate Professor Tax Law, Lead Researcher, GLOBTAXGOV ERC Project,<sup>63</sup> Leiden Law School, Leiden University, The Netherlands

### Frederik Heitmüller

PhD candidate, GLOBTAXGOV, Leiden Law School, Leiden University, The Netherlands

## World Economic Forum

Platform for Shaping the Future of Trade and Global Economic Interdependence

### Aditi Sara Verghese

Policy Analyst, International Trade and Investment, Switzerland

### Nivedita Sen

Intern, Digital Trade, Tax and Competition, Switzerland

### Sean Doherty

Head of International Trade and Investment, Member of the Executive Committee, Switzerland

## Reviewers

### Alex Cobham

Chief Executive, Tax Justice Network

### Barbara Angus

Global Tax Policy Leader, Ernst & Young

### Chris Morgan

Head of Global Tax Policy, KPMG International

### Christoph Wissmann

Tax Policy Consultant, Business at OECD (BIAC)

### Christian von Haldenwang

Senior Researcher, German Development Institute (DIE)

### Eselien Zelle

Senior Tax Manager, Booking.com

### Ewan Livingston

Cause Strategist, The B Team

### Jaime Salmerón Molina

Tax Manager, Repsol

### Jeffrey Owens

Professor, Vienna University of Economics and Business Administration

### Julien Chaisse

Professor, School of Law, City University of Hong Kong

### Linda Evans

Director, Global Tax Policy and Government Affairs, IBM

### Matthias Bauer

Senior Economist, ECIPE

### Mia d'Adhemar

Manager, Standards Division, Global Reporting Initiative

### Márcio Ferreira Verdi

Executive Secretary, Inter-American Center of Tax Administrations (CIAT)

### Michael Keen

Deputy Director, Fiscal Affairs Department, International Monetary Fund

### Oliver Pearce

Policy Manager – Tax and Inequality, Oxfam

### Robert Phillips

Co-Founder, Jericho Chambers

### Santiago Díaz de Sarralde

Tax Studies and Research Director, CIAT

### Sathi Meyer-Nandi

Adviser, Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ)

### Séverine Picard

Senior Policy Adviser, Trade Union Advisory Committee (TUAC) to the OECD

### Silvia Merler

Head of Research, Algebris Investments

### Stef van Weeghel

Global Tax Policy Leader, PricewaterhouseCoopers; Professor of International Tax Law, University of Amsterdam

### Tommaso Faccio

Head of Secretariat, Independent Commission for the Reform of International Corporate Taxation (ICRICT)

### Tony Merlo

Head of Global Tax Policy and Controversy, Huawei

### Yuliya Logunova

Head of Tax Europe, Rakuten

# Endnotes

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World Economic Forum  
91–93 route de la Capite  
CH-1223 Cologny/Geneva  
Switzerland

Tel.: +41 (0) 22 869 1212  
Fax: +41 (0) 22 786 2744

[contact@weforum.org](mailto:contact@weforum.org)  
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