The **BEPS** Monitoring Group

INTERNATIONAL CORPORATE TAX REFORM AND THE 'NEW TAXING RIGHT'

This Briefing has been prepared by the BEPS Monitoring Group (BMG). The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. This report has not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. It is based on detailed discussions at a workshop on 4-5 July attended by senior officials from the OECD and the UN Tax Committee and from several tax authorities in Africa, as well as twelve BMG members and other researchers. It has been drafted by Sol Picciotto, with contributions and comments from Tatiana Falcao, Jeffery Kadet, Johan Langerock, Lakshmi Narayanan, Mustapha Ndajiwo, Joy Waruguru Ndubai, Annet Oguttu, Jim Stewart, Suranjali Tandon, Attiya Waris and Francis Weyzig.

September 2019

SUMMARY

The OECD secretariat has been working to produce a unified approach as a framework for a proposed 'new taxing right', following its Consultation document of March 2019 and the Work Programme published in June. This report aims to analyse the various proposals involved, putting forward our own suggestions, and also to explore some unilateral measures that may be considered by developing countries. Our aim is to help inform the debates in various forums from September 2019 to January 2020, after which (if the framework is approved) detailed work is expected to take place to produce a solution for approval in 2020.

The ambitious agenda aims to reform the key elements of international tax: (i) the rules for allocation of income and tax paid by multinational enterprises (MNEs), and (ii) the threshold for taxable presence, as well as (iii) devising a template for a global minimum tax. Particularly welcome is that the new approach now aims at a fairer allocation of MNE profits starting from their total global profits, and there is an emphasis on reducing complexity and adopting methods that are easy to administer especially for developing countries.

A major advance is that allocation would start from consolidated profits, and therefore would take a unitary approach to MNEs. However, the attempt at a unified approach seems based on

methods to separate routine from non-routine profits (referred to as residual profits). This is conceptually flawed, since the super-profits or rents of MNEs derive from the synergy due to the combination of their activities in many countries. It would also entail continued use of the current transfer pricing rules based on the arm's length principle which are complex and difficult to administer. We consider that the approach put forward by India and the G24 developing countries for fractional apportionment is superior. This would allocate profits more fairly, by balancing factors reflecting both supply (assets, employees, users) and demand (sales). We outline how a shift to a new approach could be done in an evolutionary way, combining explicit general principles of allocation with a pragmatic process to devise detailed methodologies for identifying, quantifying and weighting apportionment factors, and building on the existing profit split method (Appendix 1).

A new treaty provision on taxable presence should be based mainly on a minimum sales threshold, but this should be proportionate to the size of each country's economy. A quicker way to adopt such changes could be if the UN Tax Committee examined the existing provision in its model convention for taxable presence if services are furnished in a country for over 183 days (article 5.3.b), and developed the Commentary to adapt it to the digitalised economy.

A global minimum tax would help developing countries protect their tax base by curbing tax competition. It should be as broad as possible, with no carve-outs and income blending only at country level. On this basis, the minimum rate should be 15%, rising to 20% after a transition period. The dual system currently proposed would entail complex coordination and application rules. We suggest a combined approach based on single substance test using the same multi-factor allocation of profits as for Pillar 1, based on quantifiable and location-specific factors that reflect where real activities take place, and balancing supply-side factors (labour, capital, and users where relevant) with demand-side factors (sales). This would ensure that the measures are non-discriminatory and make the tax simpler and easier to apply.

Our final section outlines and briefly evaluates some measures that developing countries might consider introducing unilaterally or as groups: indirect taxes on digitalised services and transactions (including reforming VAT); withholding taxes on payments for services or royalties; reconsideration of the taxable presence criterion and attribution of profits to the furnishing of services; and alternative methods for allocation of MNE income, including alternative minimum corporate taxes, a shared net margin method, and a shift towards fractional apportionment.

1. The Current State of the BEPS Project

In 2012 an attempt was begun by the OECD countries to reform international tax rules, described as the project on base erosion and profit shifting (BEPS). This was a recognition that the international tax system had become increasingly dysfunctional due to the pervasive use of often artificial structures enabling multinational enterprises (MNEs) to create income that was 'stateless', i.e. not taxed anywhere. The BEPS project was extended to involve the G20 leading developing countries, which gave their support in the St Petersburg Declaration of 2013.[1] The first phase of the BEPS project concluded in 2015 with a package of recommendations that were extensive, but unfortunately only patched up the existing rules

[1] Available at https://www.oecd.org/g20/summits/saint-petersburg/Tax-Annex-St-Petersburg-G20-Leaders-Declaration.pdf

and made them even more complex.[2] However, the work continued especially on Action 1, which aimed to address the tax challenges of digitalisation of the economy. Since 2016 participation was extended to all countries willing to accept the minimum commitments, under the umbrella of the Inclusive Framework for BEPS (IF-BEPS). This now has 131 members, so it has a numerical majority of developing and emerging countries.

The BEPS project entered a new phase in 2018, for several reasons. First, the US international tax reform of December 2017 has made it possible for the US to initiate and support proposals for a new approach. Secondly, there has been a proliferation of unilateral measures which have put pressure on countries reluctant to accept change, and made it more urgent to find a coordinated approach. Furthermore, this proliferation of measures and proposals has led in-house tax counsel for some leading MNEs to engage more directly in the search for new solutions.[3] Thirdly, developing countries have begun to make an impact in the IF-BEPS,[4] leading to a greater recognition that a solution must take account of their viewpoints. Nevertheless, there remain significant obstacles preventing officials from these countries from being able to make an effective contribution to the process (ATAF 2019a).

Although this work has been done under BEPS project Action 1, *Addressing the Tax Challenges of Digitalisation of the Economy*, the proposals have much wider application. It was agreed, based on the reports under BEPS Action 1 produced in 2015 and 2018, that (i) digitalisation affects the whole economy, and (ii) it exacerbates existing problems. Nevertheless, there are still some pressures to restrict the scope of any changes so that they would affect mainly highly digitalised business models. In July 2018 it was agreed to explore new approaches to both the allocation of income and taxable nexus, on a 'without prejudice'

---

[2] See our submission to the IMF consultation on the Analysis of Corporate Taxation, available at https://www.bepsmonitoringgroup.org/news/2018/12/18/submission-to-the-imf-analysis-of-international-corporate-taxation.

[3] Notably, the 'distributional' approach originated in a submission from Johnson & Johnson in March 2019 in response to the consultation document, which had explicitly pointed to the need to deal with the problem of 'limited risk' distribution; the J&J submission offered a method for allocating more to the market jurisdiction while affirming its strong support for retaining the arm's length principle. More recently, a detailed proposal for a 'modified residual profit split' method has been put forward by Uber's top finance and tax executive (Chadwick 2019), which would also substantially preserve existing transfer pricing rules, while allocating some additional income to the market jurisdiction based on marketing intangibles. The vast bulk of contributions from the business side have generally resisted any significant changes, and have mainly come from or been written by tax advisers from the Big Four and other large professional services and law firms, whose enormous intellectual capital investments in existing rules make it hard for them to envisage new approaches. However, proposals from individual firms so far seem aimed at making sufficient concessions to stave off unilateral measures, and have not yet embraced comprehensive solutions, which business submissions still say are unlikely to be agreed at the political level.

[4] A significant input was the G24 proposal that has now been included in the Work Programme. Further, it has been reported that the African group succeeded in inserting additional text in two of the reports to the IF-BEPS (ATAF 2018). An amendment inserted in the report *Additional Guidance on Attribution of Profits to a Permanent Establishment* (PE) of 2018 (para. 45) acknowledged that that report does not imply acceptance of the new approach to attribution of profits to a PE adopted by the OECD in 2010 (referred to as the authorised OECD approach, or the AOA), which was rejected by the UN Tax Committee. The Indian government's proposal of 2019 to introduce fractional apportionment in attribution of profits to PEs (India 2019) relies in part on this rejection of the AOA. The African group also apparently put forward an example that was included in the report of Working Part 6 to the Inclusive Framework in 2018 *Revised Guidance on the Application of the Transactional Profit Split Method* in which the local entity makes a unique and valuable contribution relating to the exploitation of natural resources, allowing the use of the profit split method. (This seems to be Example 2, regarding Tea). The work of the IF-BEPS is managed and directed by its Steering Group (see Work Programme para.17), currently chaired by Martin Kreienbaum of Germany, the deputy chairs being Jianfang Wang of China and Mathew Olusanya Gbonjubola of Nigeria, who chairs the Technical Committee of the African Tax Administration Forum (ATAF).

basis (indicating that many states had objections and accepted no commitments). A discussion document published in February 2019 (OECD 2019a) was debated in a public consultation in March. Following this, a Work Programme was agreed by the IF-BEPS in May, and published in June (OECD 2019b).[5] The work is now being taken forward through OECD Working Parties, enlarged to include IF members, supervised by the Steering Group of the IF-BEPS.

Negotiations are currently taking place at an unprecedented pace, in an attempt to reach a solution by 2020. The discussions and work on technical details are still very fluid, and the possible outcomes highly uncertain. In this context, this report aims to outline the direction the work seems to be taking, from the information available to us, and to analyse the proposals, particularly from the viewpoint of low-income developing countries. It will then outline and discuss some alternatives such countries themselves could explore, which could be adopted either independently of or in conjunction with any measures that may emerge from this process.

2. The Emerging Package of Proposals

The objective now is to produce a package of proposals that could go well beyond the outputs of the BEPS project issued in 2015. The current work programme (WP) aims to publish its proposed framework for a unified approach in late September or early October following meetings of the IF Steering Group (5-6 September) and the Task Force on the Digital Economy (which all IF members can attend) on 1 October. It will then be submitted to the G20 Finance Ministers meeting on 17 October, then opened for public consultation, with a revised report submitted for approval by the IF-BEPS in January 2020. If this framework is agreed, further detailed technical work would be done to produce a final report in 2020, presumably in time for the G20 leaders' summit in Riyadh on 21-22 November 2020.[6]

The new proposals would include three elements: (i) new rules for the allocation of income of multinational enterprises (MNEs); (ii) a new definition of taxable presence, going beyond the physical requirements of the concept of a permanent establishment (PE), and (iii) a template for a global anti-base erosion tax (sometimes described as the GLOBE). The first two are Pillar 1 of the package, and recognise that MNEs have become increasingly able to earn substantial revenues, often without a significant physical presence, that under current rules are generally lightly taxed in source countries and are often not fully taxed anywhere. The third is Pillar 2, which aims to provide stronger measures to restrict the competition to offer tax preferences and incentives to MNEs.

2.1 Allocation of MNE Income (Pillar 1)

The March discussion document outlined three proposals, all of which entailed a reallocation of taxing rights departing from current rules. Two put forward different rationales for allocating income to market jurisdictions. The first would recognise the value of 'sustained engagement and active participation of users' (including solicitation of data); this would

---

[5] All the BEPS project reports are available at https://www.oecd.org/tax/beps-reports.htm.

[6] Johnston 2019. The BEPS work is being done by the OECD Secretariat, with multiple formal lines of political accountability: to the OECD Ministerial Meeting, the IF Steering Group and Plenaries, the G7 and G20 Finance Ministers and central bank governors, and G7 and G20 Leaders. Pascal St Amans, the OECD head of tax, has been extremely skilful and active in managing the interaction of technical and political issues, keeping close direct contacts with the key high-level national players and attending most of these meetings, while also engaging with both business representatives and some civil society groups. He and some senior colleagues participated in a workshop co-organised by the BMG to discuss the Work Programme on 4-5 July 2019, which helped inform this report. This was one of a series of events attended by OECD officials, including a meeting organised by ATAF in South Africa also in July.

restrict the changes to highly digitalised business models. The second suggested that a greater allocation to market jurisdictions should be based on the more active engagement by all kinds of businesses with customers, which could be recognised by building on the concept of 'marketing intangibles'. This would not be limited to digitalised businesses, but might still exclude important sectors, such as professional and technical services.[7] The third, put forward by India and the G24 group of developing countries, proposed a more comprehensive approach, combining a new definition of taxable nexus based on significant economic presence with an allocation of income using a fractional apportionment method. This would be based on factors reflecting both supply and demand: assets, employees and sales, and perhaps also users. This apportionment method could in principle replace existing transfer pricing rules. However, in the WP it seems to be under consideration only for attribution of profits to this new concept of significant economic presence.

The WP published in June 2019 identified the commonalities among these proposals, and put forward three possible methods for implementing the new taxing rights. The common elements are: (i) that there should be a taxable nexus even without a physical presence; (ii) a starting point would be the total profit of a business, (iii) simplifying conventions should be used to reduce disputes and increase certainty, and (iv) the new rights would operate alongside existing transfer pricing rules (Work Programme para.23). It suggested three methods to be examined: (i) a modified residual profit split, (ii) distributional approaches, and (iii) fractional apportionment.

We understand that, alongside the exploration of these issues, the work of the OECD Secretariat is now exploring a possible unified approach, focussed on methods of identifying and allocating the 'residual' profits generated by an MNE group as a whole, to be allocated to countries regardless of whether they have a physical presence. This is at an early stage, meaning that the details are still fluid and tentative, so we can only provide a provisional account and evaluation. Another type of Residual Profit Allocation by Income (RPA-I) was discussed in the recent IMF Board paper (IMF 2019, p. 35), and has been advocated by some economists (Devereux et al 2019). The OECD Secretariat take the view that the approach they are exploring has very significant differences from that methodology.

Stated briefly, the version now under consideration would begin by identifying the residual profits of the group as a whole, based on some simplifying convention or proxy (possibly linked to the group's financial accounts). A portion of these global residual profits would then be allocated. Broadly, this amount would be taken from entities with residual profits at the individual level, using some formula to determine how much is taken from each of those entities, and then it would be allocated among market countries by reference to the sales in each (by destination of the sales). Where there are marketing and distribution activities of the MNE group in the market country, the intention is that these would also be allocated some income, using a simplified method. Furthermore, the sales jurisdiction could claim an additional share of the 'routine' profits, but this would be subject to mandatory dispute resolution. The remainder of the Routine profits would be attributed using current methods, which the OECD considers can be done by existing transfer pricing methods.[8]

[7] Developing countries have long argued that income from services should be taxable in the country where they are delivered, but this has been resisted by OECD countries, see further below.

[8] This seems similar to the approach suggested by Devereux et al. 2019. They define the 'routine profit', which could be determined by current transfer pricing rules, as 'the profit a third party would expect to earn for performing a particular set of functions or activities essentially on an outsourcing basis' (p.21), and explain that 'residual profit' is not the same as the concept of 'economic rent', although there is some overlap (pp.22-3). For the application of the Residual Profit method, a new example was included in the OECD Transfer Pricing

In addition to technical issues that would need work, several of the key elements would require a primarily political decision. These include two in particular. First, the scope of the measure, i.e. whether it would apply quite widely to most sectors, including e.g. professional and technical services, telecommunications, travel and tourism, or only to highly digitalised businesses. It is unlikely to be considered appropriate for mining or oil and gas extraction, which are obviously important to many developing countries, since the rent from natural resources should be attributed to the source state, not destination countries. However, many MNEs provide engineering and technical services in these sectors, often with little physical presence, so a carve-out for the entirety of extractive industries could be detrimental to those countries. Another key sector that may be carved out is financial services, although they are becoming increasingly digitalised. However, a distinction could perhaps be made between traditional banking (which is highly regulated) and Fintechs, digital coin and token providers and other financial, blockchain-based businesses that are not currently subjected to extensive national or international regulation.

Secondly, the methodology for dividing the residual from the routine profits, and for allocating the residual, is obviously key. The residual is likely to be a substantial portion of the total profit, especially for many of the MNEs that conduct internet-platform businesses, as well as those that sell both physical and intangible products that involve important and unique trade and/or marketing intangibles.[9]

A merit of this approach, in our view, is that it would start from consolidated profits, and therefore would take a unitary approach to MNEs. The OECD will undertake technical work to propose methods for adjusting financial accounts to something more suitable for tax purposes, e.g. to take account of depreciation, and loss carry-forward.

However, we have major reservations about this approach. Firstly, there is no rationale for separating 'residual' from 'routine' profits. In our view, there is a fundamental flaw in attempting to separate routine and residual profits. Large MNEs generate extraordinary profits that are in effect rents, resulting from the synergy due to the combination of their activities and market presence in many countries. It is not appropriate to distinguish between routine and residual profits, especially based on financial account information on categories of expenses.

The economic estimates that have been done have adopted a pragmatic method, choosing a rate of return that produces results that appear on average in line with expectations, though with some wide variations for individual countries that are not always easy to explain. It seems that the choice of method would be a primarily political decision, based on imperfect or even speculative estimates of outcomes. This does not provide a basis for a solution that can be seen as fair and accepted as legitimate, or provide a sustainable foundation for MNE taxation.

Guidelines 2017 (Annex II to Chapter II) resulting from the work on the Profit Split Method in the BEPS project.

[9] One method that has been publicly proposed, by Francois Chadwick (Uber's head of tax) would attribute as routine profits the higher of 4% of sales or 15% of depreciable and amortizable assets other than goodwill, which assumes that the residual profits are attributable to intangibles. It proposes to divide the residual profits between product-related and marketing-related intangibles, using a ratio based on the proportion of R&D and product-development costs to total costs (i.e. those plus selling, general and administrative expenses) as shown in the firm's financial statements. In this proposal, only the remaining marketing-related residual profits would be allocated to market jurisdictions (in addition to the routine profits), based on net revenues from external sales (Chadwick 2019). This is different from the OECD secretariat's suggested unified approach, which starts by identifying total residual profits at the group level instead of attributing routine profits at the local level.

Secondly, the approach would entail attempting to apply two inconsistent approaches: the identification and allocation of the 'residual' profits of a group as a whole, while attributing 'routine' profits to its various affiliates treated as if they were independent entities, using existing transfer pricing rules. These rules are based on the arm's length principle, which is conceptually unsound and in practice highly complex and difficult to apply, especially for developing countries. Furthermore, the scope of the new taxing right is likely to be significantly reduced by excluding sectors for which it is considered inappropriate. It seems that for sectors that are excluded from the scope of the new taxing right, the existing rules on allocation of income would be unchanged. Hence, tax authorities would be left trying to apply these unsuitable transfer pricing rules in parallel to the new taxing right for large parts of their economy. The resulting system would be both complex and incoherent. Developing countries in particular have stressed the need for the new rules to be simpler and capable of efficient administration (ATAF 2019b, para. 3.13).

Thirdly, this approach would allocate a large share of MNE profits in proportion to where the MNE has final sales to third parties. Allocation by sales does have some advantages, notably it makes it easier for countries to maintain high corporate tax rates without discouraging investment to create jobs. However, it is very unlikely to be considered an acceptable allocation of taxing rights by countries with relatively small domestic markets, or those with substantial exports, of which a large part of the value derives from natural resources, production factors, or other elements that are not related to the market or destination. Attempts are being made to conduct economic impact assessments of this approach. However, these can only produce speculative estimates, due to the non-availability of suitable data, and the unpredictability of the dynamic effects of such a drastic change in the rules. Furthermore, any allocation based on the location of customers or users will face significant barriers of obtaining adequate data on their location. The level of transparency required to effectively apply this approach will go above and beyond the current standards that have yet to be fully operationalised.

Overall, this approach does not seem to satisfy the mandate given by the G20 in 2013 for the BEPS project to ensure that MNEs could be taxed 'where economic activities occur, and value is created'. We strongly believe that allocation factors should reflect both supply (production) and demand (consumption) aspects of economic activity if there is to be any hope of buy-in and compromise by all countries.

In our view, a superior approach is the one put forward by India and the G24 developing countries, for fractional apportionment. This would allocate profits more fairly, by balancing factors reflecting both supply (assets, employees, users) and demand (sales). However, this should begin from the global consolidated profits, and not be applied only for attribution of income to the new concept of significant economic presence. It seems that the proposal was put forward in this way to make it relatively easy to introduce. However, it has now been accepted that the allocation of income should begin from the MNE's total global profits, as is proposed in the RPA method now being developed. Hence, there should be no reason not to use the same starting point for the fractional apportionment method, which would provide a simpler and fairer method of allocation. Objective and concrete fractional apportionment factors will take into account and reflect both routine and residual profits. They would also satisfy the evident need especially for developing countries for simplified methods, evidenced by their adoption of safe harbour and fixed margin methods. By contrast, the RPA approach would be both disruptive and unbalanced, by allocating a significant share of profits by sales only, while retaining much of the complexity of the current system.

In our view there is an urgent need for the new approach to be based on clear principles for the allocation of MNE income, which should balance sales with supply-side factors (including users where relevant). Governments and their technical specialists are, perhaps understandably, reluctant to abandon the arm's length principle, even though they now acknowledge its many flaws and accept that it is time to adopt a new direction. Some countries appear to be resisting the new proposals on the grounds that they are not based on clear principles, but others regard this argument as obstructionism.

We have put forward proposals for how a shift to a new approach could be done in an evolutionary way, combining explicit general principles of allocation with a pragmatic process to devise detailed methodologies for identifying, quantifying and weighting apportionment factors. It would build on the profit split method already accepted for transfer pricing, while recognising the reality that MNEs operate as unitary enterprises (see Appendix 1, and Kadet et al 2018). The weighting of factors would differ among industries/sectors, for example giving larger weight to tangible assets for extractive industries. This would provide a more balanced allocation of taxing rights over MNE income that could be widely accepted as fair, and hence would be sustainable. It would also have considerable advantages for MNEs, notably allowing for fair apportionment of losses as well as profits, and providing much great simplicity and certainty.

2.2 Taxable Nexus (Pillar 1)

The Work Programme is also examining basing the new taxing right on the concept of a 'remote taxable presence'. Two methods are being considered:

> (i) amendment of the definition of a PE in article 5 of model tax treaties, with consequential revisions to article 7; and
>
> (ii) a standalone provision to establish 'a new and separate nexus', which could be based on either (a) a new taxable presence, or (b) a new concept of source.

Option (ii) would involve consideration of the relationship between this new nexus and existing treaty provisions, especially the non-discrimination provisions.

The new taxable nexus rule would be based on indicators of a sustained and significant involvement in the host economy based on (i) 'a sustained local revenue threshold (both monetary and temporal); and (ii) a range of additional indicators which, in combination with sustained local revenues, would be taken to demonstrate a link beyond mere selling between those revenues and the MNE's interaction with the economy' (WP p.19). This is similar to the criteria for significant economic presence enacted by India in 2018, as well as to the proposal from the European Commission.

However, it seems that the new nexus would require both a threshold requirement and other criteria to apply, whereas in both India's legislation and the EU proposal they are alternatives. India's criteria specify *either* the 'systematic and continuous soliciting of business activities or engaging in interaction with such number of users as may be prescribed, in India through digital means', *or* 'payments received for transactions for trade of goods, services and property in India by non-resident exceeding certain prescribed amount'.[10] The EU proposal suggests, in addition to a threshold of €7m of annual sales in a state, *either* 100,000 users accessing digital services in any year, *or* over 3,000 business contracts for digital services per year. Requiring both criteria to apply would obviously create a higher threshold.

[10] A consultation was held on the level for this amount, but no decision has yet been announced.

One issue here is clearly whether these thresholds would be set in absolute terms, or in relation to the size of the domestic economy. It would obviously be unfair to countries with small economies to set them in absolute terms. It would be especially inappropriate for such countries if the revenue threshold is required as well as the other criteria, instead of as an alternative.

Another question is whether the new nexus would be regarded as applying at the group level rather than at the entity level. The allocation options outlined in the WP at some points appear to envisage a transactional approach, for which taxable presence need only exist at the entity level. However, this inevitably causes difficulties if the 'new taxing right' is applied to only one entity in a group, while the other entities are still subject to existing rules and methods. One or more of these other entities may be resident in the country in which the new nexus is found to exist, but the transactional approach adopted in the OECD Transfer Pricing Guidelines requires them to be considered separately. The BMG has previously argued that once a taxable presence is found, the attribution of profits should be done on a holistic basis, taking account of all the related activities carries out by members of an MNE group within a country. Under this approach, once a significant economic presence is found to exist, there is no need to attribute it to any particular entity within the group. If a form of RPA is agreed that begins from the group's global profits, the nexus would presumably have to apply to the group.

Changes to the formal definitions of taxable nexus are clearly desirable, indeed long overdue. Whether this is done by amending the existing model treaty articles or adding a standalone provision, it should not be limited to highly digitalised business models. As we have consistently argued in our previous comments, the threshold should be based on significant and sustained contact with customers, clients and users, proportionate to the size of the country's market, but should not cover small or medium enterprises which may have sales in many countries but without sustained engagement. The WP envisages that these measures would require changes to tax treaties, and we discuss in section 2.3 below the possible options for implementing these.

However, it is important also to consider what could be done under existing treaty rules, perhaps with some changes in their interpretation adopted in the Commentaries. This is likely to be important, since it is very unlikely that there will be a broad consensus on new treaty provisions, and in any case changes to existing treaties would take a long time.

Developing countries are already at an advantage in this respect, because they have long attempted to defend taxation of income in source countries, which is where business activities take place. This pre-dates digitalisation of the economy. A particular concern since the 1970s has been the growing importance of services, which have increasingly been delivered with little or no physical presence in the client's country. Digitalisation has exacerbated this problem, indeed both can be seen as part of the same process of dematerialisation of economic activities. Even where physical products are involved, such as computers, mobile phones or automobiles, suppliers now have a continuous relationship with their customers, who have become more like clients for services than purchasers of a one-off product. Thus, manufacturing is increasingly taking the form of the provision of services. Digital technologies make it possible for these closer interactions with customers to take place on a much wider scale, even globally, as well as deepening them. A notable example is cloud computing, in which clients make a minimal outlay on hardware purchases but pay subscription fees to a remote provider for access to sophisticated computing services. Similarly, a search engine and an online marketplace can bring together producers and

consumers who may be geographically separated, while creating trust through feedback and other quality assurance mechanisms.

The UN Tax Committee has been concerned with the allocation of taxing rights for services since its upgrading from a Group of Experts in 2005. In 2013 it considered a general paper on the issue,[11] which outlined several methods of dealing with the problem. It decided to proceed with drafting a new treaty provision on taxation of fees for technical services and, despite strong opposition from many OECD countries, this was concluded and added (as article 12A) to the UN model convention in the Update of 2017. The Commentaries to Article 12A contain further language extending the application of 12A to all fees for services (technical and other services) provided in a contracting state and also services provided outside that state by a person closely related to the payer of the fee The new U.N. Model recommends this approach for those countries wishing to confer a source taxing right on all fees for services.

The Committee also noted in 2013 that its model includes a 'services PE' provision (article 5.3.b) which provides that an enterprise has a taxable presence if it furnishes services through personnel for an aggregate of over 183 days in a 12-month period. A version of this provision is included in many existing treaties, especially with developing countries. However, there remain significant disagreements on how it should be applied: in particular, whether it requires the actual physical presence of personnel for 183 days.[12] This would make it often ineffective, but the alternative view that the 183-day period refers to the delivery of the services and not the presence of the personnel would make it very relevant.

The position put forward on taxation of services by developing countries, especially leading countries such as China and India, is that income from their delivery should be taxed by the country of residence of the customer. That seems to be, in essence, the 'concept of source', based on sales by destination, which the WP now proposes to investigate as if it were a new concept. We suggest that it could be helpful to examine the existing UN model article 5.3.b, and consider (i) how far it could help resolve the issues posed by digitalisation, and (ii) what changes could be made either to the Commentary or to the article itself to this end. This could form part of the work of the Subcommittee on Taxation Issues Related to the Digitalization of the Economy of the UN Committee, which is expected to operate in parallel with the work being done by the OECD for the IF-BEPS. This issue was perhaps understandably not pursued by the UN Committee while it concentrated on the new article on fees for services, but it is now clearly very important and also urgent.

2.3 Implementation and Administration

The WP will investigate the methods for ensuring relief from double taxation where necessary, consequent on the new allocation method to be proposed. This would of course have some complexity if, as seems likely, the new taxing right involves reallocation of the global profits of MNEs, rather than adjusting profits on specific related party transactions. However, given that there is experience in some countries for consolidated or combined filings that include foreign tax credit mechanisms, these potential complexities should not be considered in any way insurmountable. In any case, to the extent that it is possible to identify a specific entity in respect of which the income is reallocated, existing relief mechanisms could apply. Otherwise, some form of multilateral coordination would be needed, and the WP mentions multilateral competent authority agreements, and multilaterally coordinated risk assessments. These would be 'informed' by work done by the Forum on Tax Administration.

[11] Document E/C.18/2013/CRP.16 submitted by Tizhong Liao, the member from China.

[12] See Commentary on article 5 of the UN Tax Treaty (2017), para. 10 (p.157), and the Report on the 9th session of the UN Committee (document E/2013/45-E/C.18/2013/6), para.16.

In our view a key necessity for effective implementation of both Pillar 1 and Pillar 2 is improved availability of information on MNE groups to all tax authorities. The most significant achievement of the BEPS project has been the establishment of the system for country-by-country reporting (CbCR), and the OECD should be congratulated on its implementation. However, the CbCR system still has significant limitations, which should be addressed in the review now being undertaken, for report in 2020. In particular, the threshold of 750m euros global turnover is high, particularly for countries with smaller economies. In addition, most developing countries still do not have effective access to the system. The simplest solution would be to ensure publication of CbCRs, with any necessary safeguards for information that may be commercially confidential. This would greatly facilitate effective administration of the proposed new rules, and ensure the accountability needed to reassure the public.

The WP also entails consideration of changes to procedures for both dispute prevention and resolution, including arbitration. Under the unified approach now being explored, it seems that simplified methods would be an important component. If so, there would be fewer disputes. However, acceptance of mandatory dispute resolution is envisaged if a source country claims an additional tranche of the routine profits based on market factors. In our view, it is inappropriate to use arbitration for disputes resulting from the application of ad hoc and subjective rules. This would delegate too much power to arbitrators, who operate in secret and with no accountability. It would be far better to establish transparent and representative procedures, which should aim primarily at preventing disputes by issuing public rulings on the issues of interpretation that will inevitably arise.

The WP will also consider methods for implementing any tax treaty changes that may be needed. This may be done by extending the existing multilateral convention on BEPS measures (the multilateral instrument, or MLI), or by a self-standing convention. In either case, states would necessarily remain free to decide whether to accept new or amended provisions, and in which treaties (as is already the case for the MLI). The MLI is in force in 29 jurisdictions, and has 89 signatories, but this does not include some key states, notably the USA. It might therefore be preferable to keep these two issues distinct, and negotiate a new multilateral convention to introduce tax treaty changes resulting from this second phase of the BEPS project, rather than further complicating the MLI.

2.4 Pillar 2: The Global Anti-Base Erosion Tax

Under this heading two inter-related measures are envisaged, to allow countries that wish to do so to counteract the shifting of profits to jurisdictions where they are subject to low or no taxation. This recognises that existing rules, even after the BEPS project outputs, remain ineffective especially in relation to profits attributed to entities supposedly exercising functions or assuming risks related to intangibles and to intra-group financing. The aim is to facilitate coordinated action by willing states to prevent a race to the bottom because countries are tempted to offer tax incentives and preferences to attract investment by foreign firms. There is considerable evidence that such incentives simply distort the allocation of investment, and are damaging particularly to developing countries. Pillar 2 is not limited to highly digitalised firms, but aims to ensure that all MNEs pay a minimum effective tax rate on their global profits.

The first measure is an income inclusion rule, which would allow the home state of an MNE to tax any income of its resident parent company's foreign group members that is taxed below a minimum effective rate. It would operate as a top-up to bring the tax paid to the minimum. The tax base would be defined under the tax rules of the parent jurisdiction, but simplifications are being studied, to allow use of financial accounts of foreign affiliates

subject to adjustment for tax purposes (e.g. loss carry-forward and timing of receipts). This is similar to existing rules that tax the 'passive' income and some active income of controlled foreign corporations (CFCs), but countries that tax CFCs at their own full rate may continue to apply these rules in addition. A 'switch-over' rule is being considered, to allow use under tax treaties of foreign tax credits instead of the exemption method for profits, e.g. when there is low-taxed income attributable to a PE or derived from immovable property.

The second is a tax on base eroding payments. This would apply to payments which reduce the tax base in a host country (the source) because they are deductible from business profits (e.g. fees, royalties or interest) but are taxed at below the minimum rate in the receiving country. It would allow the source or host state either to deny the deduction, or to tax the payment (e.g. via a withholding tax). There would also be a 'subject to tax' provision to ensure the validity under tax treaties (if necessary) of denial of benefits especially relating to interest and royalties. Design issues to be resolved include clarification of the types of payment covered (including dealing with conduits and other indirect payments), deciding when a payment can be regarded as 'undertaxed', and how to calculate the adjustment.

It has been agreed early in the discussions that the effective tax rate to be applied for both measures would be an agreed numerical rate, but the decision on the actual rate has been left till later. It seems that the same minimum would apply for both elements.

Coordination

A number of issues need to be dealt with regarding the coordination of these proposed new rules both with rules in tax treaties, and especially with each other.

The issue of which rule should apply first is clearly important. Since the primary aim of the changes is to ensure effective taxation at source (where activities take place), the tax on base-eroding payments should have priority over the inclusion rule. This is obviously of great importance to developing countries, which have particular difficulties in countering erosion of their source tax base. A key aim of Pillar 2 is to curb the temptation to reduce taxes to attract inward investment, especially in developing countries. Giving priority to the source country would reduce this motivation.

Giving priority to the tax on base eroding payments would also make it easier to administer the income inclusion rule. Many MNEs have created structures to facilitate base erosion that are not caught by existing counter-measures such as CFC rules, for example through the use of hybrid entities, or by locating their ultimate parent in a country that does not have such rules. Residence-based rules also involve difficulties, such as deciding the priority between regional headquarters and the ultimate parent entity. If income-inclusion rules were given priority, source countries would face enormous administrative problems in determining for every deductible payment whether it has been effectively taxed.

Coordination would also be more effective if the same minimum tax rate applied to the tax on base erosion measures as for the income inclusion rule. However, giving priority to source countries should also mean that they could apply a higher minimum if they wished to do so.

The minimum rate, carve-outs and blending

Obviously, the key issue for Pillar 2 will be the determination of the minimum rate, though this will interact with other aspects, especially blending and carve-outs (Becker and Englisch 2019). Some degree of competition to reduce rates will continue, creating pressure for countries to converge on the minimum rate. Choosing a low minimum rate would exert a sharp downward pull on tax rates that could have very damaging effects on government

revenues, especially in developing countries that are more heavily dependent on corporate taxes.

Analysis for the Tax Foundation (Bunn 2018) shows that the average nominal corporate tax rate worldwide (weighted by GDP) is just over 26%, with some regional variations from 25% for Europe, 28% for Africa and 32% for Latin America. The G7 average is 27% and for OECD countries it is 24%. A dozen countries have no corporate income tax, and the next 20 countries have rates between 7.5% and 12.5%. At the top end of the scale, many countries retain rates around 35%, including some large economies such as Brazil and India.

Pillar 2 would leave countries free to decide their own tax rates. Indeed it should strengthen national tax sovereignty, by reducing the pressures to reduce taxation on more highly mobile tax bases, especially on MNEs, which shifts the tax burden to labour and consumption (OECD 2019 para.90). Its aim is therefore to put a floor under effective tax rates, i.e. the rates actually paid.

Most countries offer lower rates with various policy objectives, such as encouraging innovation (e.g. 'patent boxes'), or special economic zones for regional development. However, it is widely agreed that a proliferation of incentives is undesirable, and that good tax policy should aim at a wide tax base and a corporate tax rate the same or similar to that for unincorporated business and individual income. Incentives too often lack transparency, and may be sweetheart deals for particular investors, or responses to business lobbying. Competition to offer special incentives for investment damages all countries. It is particularly harmful when countries offer low rates or exemptions for entities which exist only on paper, or have few employees.

An attempt has been made to ensure that incentive regimes comply with the BEPS project's aim that tax should be aligned with real activities, through Action 5 on Harmful Tax Practices. However, this has had limited effects, mainly because of the weaknesses of the key standards, those of 'substance' and 'ring-fencing'.[13] It is still possible for countries to offer exemptions or low rates for substantial levels of income attributed to services such as headquarters management, logistics and distribution, treasury and financial functions, or commodity trading, with relatively low substance requirements in terms of operational expenses in the country. In fact, various countries are introducing new regimes that are designed to be BEPS-compliant while aiming to attract tax-driven structures.[14] Such regimes are essentially predatory on other countries' tax base, taking advantage of the arm's length principle and the continuing weaknesses of the transfer pricing rules. They are especially damaging to developing countries, which generally lack the capacity to counter such regimes.

The WP mentions the possibility of carve-outs for such regimes, while also rightly pointing out that such carve-outs 'would undermine the policy intent and effectiveness of the proposal'. In our view this is clearly correct, as a primary aim of Pillar 2 is to reinforce the counter-measures against harmful tax practices. Hence, carve-outs should not be permitted. Also under consideration are carve-outs for a return on tangible assets (which is the standard applied by the US GILTI tax), and for entities with intra-group transactions below a defined

[13] Compliance with the Action 5 standards is done through the Forum on Harmful Tax Practices (FHTP) through 'peer review', which is highly opaque. No evaluations of countries or regimes are published, only brief reports of outcomes (OECD 2017, OECD 2019c).

[14] For example, Mauritius amended its Global Business Licence regime in 2018 and was found compliant by the Forum on Harmful Tax Practices, although still offering an effective tax rate of 3% on income from services aimed at firms outside Mauritius (Picciotto 2019, 25-26); and the budget in June 2019 announced a series of incentives including a five-year tax holiday for e-commerce platforms (http://budget.mof.govmu.org/).

threshold. These also seem undesirable, as they would create unnecessary complications and loopholes.

However, it may be desirable to leave policy space for countries to provide incentives for income resulting from real activities, and which are not only aimed at foreign MNEs. This could be done by allowing 'blending' at the jurisdictional level. This would mean that a corporate group benefiting from a low rate must also have sufficient income taxed normally in the jurisdiction to bring its combined effective tax rate above the minimum. In this way, countries could offer tax relief for economic development activities, provided that the benefits do not go to MNEs with no other economic activities in the country. It would also allow other tax and non-tax benefits targeted at specific types of investments by any company, as long as the company's overall effective tax rate is not reduced below the minimum.

On the other hand, it would be completely counter-productive to allow global blending, i.e. to apply the tax only if an MNE's aggregate foreign income falls below the minimum. This would encourage MNEs to continue to devise complex structures seeking to take advantage of preferential tax regimes, and stimulate further tax competition between states. The aim should be to halt the decline of effective tax rates on MNEs, narrow the gap between nominal and effective rates, and promote convergence of effective rates to levels that all taxpayers can accepts as legitimate, and that support adequate and sustainable government revenues.

This suggests effective corporate tax rates in the range 20-25%. To encourage convergence towards this range, a staged process could be agreed, to increase the minimum after a period of perhaps three to five years. If only jurisdictional blending is allowed, and no carve-outs are permitted, a global minimum rate could initially be 15% then raised to 20%. If global blending is allowed, the minimum rate could begin at 20% then raised to 25%. However, even with such a higher minimum rate, global blending would largely defeat the purpose of the minimum tax, because it would not eliminate the incentives for multinationals to locate part of their profits in zero tax jurisdictions, or for them to put pressure on countries to grant tax holidays.

It would be preferable for these key issues to be decided by a group of states actively in favour of them, rather than allow the design to be weakened by attempting to reach consensus within a larger group including doubtful or sceptical countries, which may in any case not adopt the measures. The measures could be designed to be implemented by such a group of like-minded countries, without the need for a broad consensus. If they are well designed, then once adopted by willing states they could create a beneficial 'race to the top' instead of a mutually harmful 'race to the bottom' in corporate taxation.

Other design issues

Much will depend on how the effective rate is calculated. Coordination between states applying the tax would require some standardisation of tax accounting standards. Key issues include the allocation of costs; the treatment of losses and loss carry-over;[15] and whether the calculation should be done for single years or averaged over a period. Work on coordination of tax accounting could be done in conjunction with the work on Pillar 1, for which rules on allocation of combined profits would also require standardisation of the tax accounts.

[15] Estimated effective tax rates will be negative in the accounting period in which the loss is declared and where firms receive tax refunds in a particular period (perhaps due to losses reported in a previous accounting period). Estimated tax rates could also be positive where firms receive tax refunds in an accounting period and also declare losses. A posible solution of omitting all firms which declare losses or receive tax refunds in an accounting period poses additional problems as firms have choices in relation to the recognition of losses.

Also important will be the interaction with CFC rules, as well as tax credits. For example, the US GILTI tax is said to result in a minimum global effective rate of 13.125% (16.4% after 2026) when combined with CFC rules and tax credits apply, but only 10.5% when a CFC in a zero-tax country is used and credits do not apply (OECD 2018 p. 101, and footnote 17). The effective rate may fall further, or even become negative, when the tax benefit of expenses related to foreign operations but incurred within US group members is considered (Driessen 2019).

Perhaps to help deal with such complications, the WP states that the use of a range or corridor of rates is being considered, although it strongly favours a single rate (paras. 64-67).

An alternative approach

In our submission to the consultation in March 2019 we proposed an alternative approach that could combine the two elements. This would have many advantages for both effectiveness and ease of administration. Both the elements in the dual approach are premised on participating states including in their own tax base MNE income that is not effectively taxed in another jurisdiction. The income inclusion rule would do so by including low-taxed income of a foreign branch or subsidiary in the tax base of its parent, while the tax on base eroding payments would deny deductions or treaty relief to achieve the same objective.

What is needed is a common substance test, to identify when the income that has been attributed to an entity is excessive in relation to its real activities. A common substance test could both combine the two Pillar 2 measures and link them to Pillar 1, if it were based on a method of multi-factor allocation of profits and applied to all business sectors. We suggest that this could be based on quantifiable and location-specific factors that reflect where real activities take place. As put forward in the fractional apportionment method for Pillar 1, this should balance supply-side factors (labour, capital, and users where relevant) with demand-side factors (sales). This would have many advantages, including ensuring the measures are non-discriminatory and hence valid under investment treaties and EU rules.

Such a combined approach would also ensure proper coordination between the two elements without the need for complex linking and priority rules, and hence make the tax simpler and easier to apply.

3. Measures for Consideration by Developing Countries

This section will briefly outline and analyse measures that could be considered, especially by developing countries. We will consider their advantages and disadvantages. Since these are measures that can be adopted unilaterally, they do not depend on waiting for the outcomes of the international negotiations discussed in the previous sections. Their evaluation also offers a comparative perspective from which to consider the suitability of the measures now under negotiation.

Such measures should be compatible with each country's international obligations, or achievable by feasible changes to them. They should also be adopted where possible by groups of states in a coordinated manner, or designed to contribute to better international tax coordination.

Adopting such measures could have two objectives. First, they should defend a country's tax base. Secondly, they could put pressure on countries that are offering tax incentives or preferences to support and join in with effective internationally coordinated solutions.

3.1 Indirect Taxes on Digitalised Services and Transactions

Special Taxes

A number of countries have introduced or are considering taxes targeted at various kinds of payments for digitalised services or transactions. In addition to raising revenue, these taxes also have social effects, sometimes intentional. For example, in 2018 the Uganda Government introduced a 1% tax on mobile money transactions (Ferracuti 2018). This was later reduced to 0.5% and applied only to withdrawals, due to opposition (Mulondo et al. 2018). It also enacted a daily levy of 200 shillings on social media platforms (Ratcliffe and Okiror 2019). Kenya has had an excise tax at 10% on mobile phone-based transactions since 2013, increased in 2018 to 12% for money transfer services and to 15% for airtime (SMS, voice and mobile data services).

These are taxes on consumers, and do not impinge on corporate profits, except by restricting market growth. Even if they target services for which demand is considered relatively inelastic, they can have a distortive effect and create unexpected and often undesirable consequences, such as hindering financial inclusion (Ndung'u 2019). In addition, they tend to be regressive, and unpopular. In 2018 both the Benin and Zambian government dropped proposals for a social media tax due to public protests. Before resorting to such special taxes it seems advisable that governments should consider whether they have done all they can to ensure that digitalised transactions are properly subject to existing taxes, notably VAT and customs duties.

VAT on Cross-Border Transactions

Taxation of cross-border services and transactions poses particular problems. As part of the BEPS project the OECD has recommended the reform of VAT rules to ensure that they apply on the destination basis, i.e. to imports. In particular, for business-to-business services the OECD's International VAT/GST Guidelines (OECD 2017) now include provisions to ensure that the right to levy VAT is allocated to the jurisdiction where these services and intangibles are used for business purposes. This entails requiring business customers to self-assess VAT on remotely delivered services or intangibles acquired from offshore suppliers (OECD 2018, p.102). Also, to facilitate collection of VAT on cross-border transactions with consumers, the Guidelines include recommendations for a simplified registration and compliance regime for offshore suppliers. South Africa has introduced amended registration rules for VAT with effect from April 2019 to cover foreign suppliers of electronic services, subject to a threshold of 1 million ZAR, which treats the platform provider as the supplier if it facilitates the transactions. The Kenya Finance Bill of 2019 extends VAT to 'supplies made through a digital market place'.

Ensuring effective compliance by foreign suppliers also depends on mutual assistance and exchange of information. There is a legal basis for this in tax treaties, since the exchange of information provision is not limited to direct taxes. However, since most developing countries do not have an extensive network of bilateral treaties, those which have not done so should consider joining the OECD/Council of Europe Multilateral Convention on Mutual Administrative Assistance in Tax Matters.

However, ensuring a legal basis is only a minimal starting-point. Much more could and should be done to ensure that developing countries can effectively apply VAT to foreign suppliers of goods and services. The OECD submitted a report on *The Role of Digital Platforms in the Collection of VAT/GST on Online Sales* to a meeting of the Global Forum on VAT in March 2019 attended by representatives from around 100 countries. The participants

highlighted the particular challenges faced by developing countries, and the OECD undertook to work with them and with other organisations to develop practical guidance tailored to the specific needs and circumstances of developing economies. This issue should be taken into account when countries consider whether to approve payment by cryptocurrencies, such as the Libra led by Facebook.

Customs Duties on Imports of Digitalised Products

Another issue is the loss to developing countries of customs duties due to the digitalisation of products. A moratorium was agreed in the WTO in 1998 on the application of customs duties on electronic transmissions. This was supposed to be temporary, and aimed at assisting a then-nascent economic sector, but it has been continually renewed. The issue has now been taken up by India and South Africa at the WTO (WTO 2019), based on evidence from a study by UNCTAD (Banga 2019). This estimates the potential tariff revenue loss to developing countries as $10 billion, to the least developed country members of the WTO at $1.5 billion, and to African countries around $ 2.6 billion. These losses are far higher than those for developed countries (estimated at $212 million), partly because developing countries' tariffs on digitisable products are higher. At the same time, the benefits have accrued to enterprises in only a few countries: developed countries account for 76% of exports of digitizable products; while China has 18%, it is also a substantial imports so suffers revenue losses (Banga 2019, p.14). The moratorium is again being reviewed by the WTO in December 2019.

3.2 Withholding Taxes and the 'Equalisation Levy'

A practical alternative that many developing countries have long used to ensure taxation of services delivered by foreign service suppliers is the use of withholding taxes on payments such as fees or royalties. These are relatively easy to apply, and hence quite effective.

The basis for such taxes is the view that income from providing services to residents in a country can be treated as sourced in that country, and hence taxable there, even if the service provider is a non-resident and does not have a PE. Countries do not need authority under tax treaties to impose such taxes. However, tax treaties may restrict their right to apply such taxes. In particular, treaty articles may limit the withholding taxes that can be applied on royalties, or fees for professional or technical services. If the income can be considered to fall outside the categories covered by treaty provisions, the host country's right to tax it may be protected by the savings provision in the Other Income article (21.3 of the model convention).

Unfortunately, many bilateral tax treaties contain neither a separate article allowing source country taxation of professional or technical services nor a savings provision in the Other Income article. Such treaties prevent developing countries from applying withholding taxes on relevant payments to the treaty partner. Moreover, some treaties limit the withholding tax on royalties to a low rate, such as 5 percent, or even zero. Even if a country has few or even only one bilateral tax treaties with other countries that disallow withholding taxes on fees or royalties, this can be a major impediment if MNEs can route payments through those other countries. Addressing such treaty shopping practices requires anti-abuse clauses in the treaties, plus effective information exchange to enable their application.

If developing countries wish to use withholding taxes to tax services provided to their residents from abroad, they should therefore consider whether they need to amend existing tax treaties to enable this. At the very least, they should limit any existing leaks through anti-treaty shopping provisions. A stronger option would be to (also) amend existing treaties so that they allow source taxation of payments for services to any country at a sufficient level.

The highly digitalised business models developed by MNEs such as Amazon, Airbnb, and Uber are based on using advanced software to provide services in a country, or to facilitate the provision of services by others. This raises issues regarding the categorisation of the payments. They could be treated as royalties for the use of the software, or fees for technical services.

India's experience is relevant here (Tandon 2018). A large number of Indian tax treaties include an article permitting taxation of fees for technical services (FTS), which could permit a withholding tax on services rendered by non-residents within India. However, applying a Supreme Court ruling that provision of technical services requires human intervention (CIT v. Bharti 2010), a Tribunal held that payments made to Google Ireland and Yahoo U.S. for sponsored search results and online advertising could not be treated as FTS. Hence, they must be regarded as the business income of the non-resident supplier, but since the Tribunal also held that a website does not constitute a PE, the remote non-resident service providing businesses were in practice non-taxable (*Right Florist* 2013). However, a later Tribunal decision found that the Google Adwords program enables the provision of advertising services, hence payments for such services do constitute a royalty (*Google India* 2017, esp. paras. 52, 55).

In the meantime, however, India had enacted the equalisation levy covering delivery of electronic advertising services by a non-resident. Other countries have now introduced or are proposing similar taxes on the provision of digital services, notably France. Such taxes side-step the problem of categorisation, and hence are arguably not contrary to tax treaties. Nevertheless they may be challenged as discriminatory against foreign suppliers of services, perhaps under the WTO's General Agreement on Trade in Services (GATS). The US administration has denounced the French tax as discriminatory, and opened an investigation under s. 301 of its Trade Act.[16]

These taxes are gross levies on payments, and not taxes on net profits. Hence, they have a number of disadvantages. First, they are likely to be passed on to the client or consumer. The experience in India was that the non-resident providers generally entered into contractual obligations to ensure that the payment they receive is net of such a withholding tax. Hence, the burden of such taxes is directly passed on to the service recipients rather than non-resident service providers. This may nevertheless affect the service suppliers' profit margins, and their market penetration. Secondly, they apply regardless of profitability, so the rate must be carefully calculated. Thirdly, the difficulty of calculating an appropriate rate in effect gives the foreign service supplier the option of accepting the WT (and passing it to clients), or establishing a PE or affiliate and attributing some profit to it. This calculation also depends on whether the tax is eligible for a foreign tax credit in the country of residence.

3.3. Taxing Income or Profits from Services

The digitalised economy has accelerated the shift to business models based on delivery of services, even if physical products may also be involved. Many developing countries already have domestic tax rules that treat income from services delivered to their residents as taxable at source. This should apply also to services delivered by digital means, and countries should review their legislation to ensure that it is sufficiently broad. For example, the Kenya Finance

[16] The first hearing was held on 19 August, see https://ustr.gov/about-us/policy-offices/press-office/press-releases/2019/august/public-hearing-section-301. Following the G7 summit in Biarritz, France announced an agreement under which if a measure is internationally agreed, payments of this tax would be refunded or credited against tax due once such a measure is introduced.

Bill 2019 extends the definition of income chargeable to tax to 'income accruing through a digital marketplace'.

Tax treaties limit taxation of net profits to the income attributable to a PE. This is very restrictive in relation to services, which can easily be delivered without the need for a physical base in the country, or even on a remote basis. For this reason, developing countries have often resorted to withholding taxes on gross payments, as discussed in the previous section.

However, as pointed out in section 2.2 above, a wider scope for taxation of the net profits from services is available under the UN model convention's provision for a 'services PE' (article 5.3.b). This provides that an enterprise has a taxable presence if it furnishes services through personnel for an aggregate of over 183 days in a 12-month period. In some cases this model has been modified. For example, some treaties negotiated by Mauritius limit this to services 'furnished through employees or personnel engaged in' the state. Countries should review their treaties to ensure both that this article is included and that it is sufficiently broad, and consider renegotiation if this is not so.

It is now generally accepted that the physical presence requirement for a PE is now outdated, as developing countries have long argued in relation to services generally.[17] Hence, the work on Pillar 1 aims to agree a new definition of taxable presence. Even if such a new provision can be agreed, its implementation in actual treaties will take considerable time.

We suggest that an initiative could be taken by developing countries on this issue. This could focus on a reconsideration of the existing article 5.3.b by the UN Tax Committee. Such a reconsideration could entail a revision of both the Commentary and of the article itself. The Commentary at present provides little clarification of what is meant by the furnishing of services by personnel or employees. It is widely assumed that this requires physical presence of those personnel in the place where the services are delivered, and for the whole of the 183-day period. However, this need not be the case. A view has been expressed in the UN Tax Committee that the provision refers to the period over which the services are delivered, and not the period of physical presence of personnel. This seems to be the interpretation favoured by the Saudi Arabia Department of Zakat and Income Tax (DZIT), on the basis of which they introduced the concept of a *Virtual Service PE,* although the interpretation may be contested.[18]

The scope of application of the existing provision is potentially quite broad, and this could be clarified by changes to the Commentary. Of course, the scope would be far broader if the 183-day period were eliminated, as developing countries have previously argued. It now seems urgent that the UN Tax Committee should return to reconsideration of this provision. Another merit of article 5.3.b, especially if interpreted without the physical presence requirement, is its applicability to services in the extractive sector. Many developing countries, especially in Africa and Latin America, have important extractive industries, to which services are often provided by non-resident companies. This can constitute a major source of erosion of their tax base in this key sector. The UN Handbook on Taxation of the Extractive Industries mentions the importance of article 5.3.b (UN 2018, p. 117) but does not discuss it in any detail, and does not refer to the interpretation of the physical presence requirement. This strengthens the case for re-examination of this important issue by the UN Committee.

[17] See para. 10 of the Commentary on article 5 of the UN model.
[18] See EY Global Tax Alert 30 July 2015, available here.

Perhaps even more important than the taxable presence threshold is the method for attribution of profits to a PE under article 7. Here also the UN Model Convention includes a method that is very appropriate, the 'fractional apportionment' provision in article 7(4). Developing countries could review both their domestic law and their tax treaties to consider the feasibility of adopting this method of income allocation, as India is doing.[19] Here also there seems to be an important role for the UN Tax Committee, in developing a more coordinated approach building on article 7(4).

3.4 Alternative Minimum Corporate Taxes (AMCTs)

Various developing countries currently apply alternative minimum taxes. An AMCT acts as a backstop for a corporate tax on profits by using an alternative base that is less susceptible to base erosion and easier to verify than for the corporate income tax (CIT). The simplest and most common base for the minimum tax is revenue or turnover. For example, the AMCT rate might be 1% of turnover rather than a CIT rate of 30% of profits. If a company with a turnover of say $10m has deductions for interest, royalties or fees to show a net profit of $200,000, it would pay AMCT of $100,000 rather than CIT of $60,000 (Durst 2019: 96).

Minimum tax systems have been used, especially in low and middle-income countries, to prevent the erosion of the corporate tax base. In Pakistan, for instance, all corporations are required to calculate their tax liability based on profits (at the normal tax rate, previously 35%, now 29%), and also by applying a much smaller percentage on sales (previously 0.5%, now 1.5%). For certain sectors, a reduced percentage applies (e.g. now 0.25% for distributors of consumer goods, medicines and fertilisers), thus accommodating differences in profitability.[20] In addition, an alternative corporate tax charge is calculated at a rate of 17% on accounting income. Firms are then required to pay whichever is higher. An analysis of its operation found that over half of firms were liable for the AMCT, and that it accounted for more than half of corporate tax receipts and estimated that it reduced avoidance and evasion by about 70%.[21] An IMF country study of Mali reported that a 1% turnover-based AMCT was paid by 36 per cent of corporate taxpayers in 2013, and accounted for 11.8% of corporate tax revenue (cited by Durst 2019: 98).

Some countries have chosen alternative tax bases other than sales, for instance fixed assets, to counteract possible evasion by under-reporting of sales. The alternative tax in Ecuador is particularly sophisticated, being constituted of the sum of 0.4% of assets, 0.2% of wealth, 0.4% of taxable profits and 0.2% of deductible costs. In some countries, including Ecuador, the minimum tax is not an alternative tax but rather an advance payment that is creditable against the corporate tax liability calculated at the end of the fiscal period. If the advance tax payment is higher than the final corporate tax liability, the taxpayer can request a refund of the difference. If requesting a refund generates significant inconvenience for the taxpayer, or a perception that it would increase the probability of audit, refund requests might be rare, and the minimum tax can effectively increase tax payments.

AMCTs are a blunt measure, perhaps even more so than withholding taxes. They are not targeted only at international profit shifting, as they can apply to all companies, even those with no international transactions. Moreover, they do not fully take into account the variability of profits between sectors and companies (even without profit shifting). Yet due to

[19] Our comments on the Indian proposal are available here.
[20] Any minimum tax paid in excess of the normal corporate income tax can be carried forward for five years to be offset against higher normal tax liabilities, thus accommodating variability in a company's profits over time.
[21] Best et al. 2015: 1331-1332; for more details, see also the Microeconomic Insights Blog by these authors, at http://microeconomicinsights.org/designing-tax-policy-high-evasion-economies/ .

the low rate, alternative minimum taxes will be less distortive in extreme situations than withholding taxes.

The strong advantages of AMCTs is that they are simple and very easy to apply, and provide certainty. A tax authority does not require any information about foreign taxpayers to implement them. Furthermore, they are rather robust and therefore very effective. Although turnover, assets and modified income can all be manipulated, it is impossible to avoid alternative minimum taxes completely. They can work against many forms of profit shifting, including forms that cannot be addressed by withholding taxes, for example involving intra-group trade in goods or inappropriate use of losses carried forward. Moreover, in general, AMCTs can be regarded as compatible with tax treaties. This is because they are levied on all resident entities, and as an alternative to the normal corporate income tax. Thus, they can be considered compatible with the independent entity criterion of article 9, and as an anti-avoidance measure.

The trade-off between this simplicity and the introduction of refinements such as those in Ecuador is one for each country to decide. These features of alternative minimum taxes put the bar for a new tax on base eroding payments rather high. Whereas more targeted and less distortive rules would be highly desirable, developing countries with limited capacity should weigh the advantages of such rules against the simplicity, effectiveness and compatibility with existing international treaties of AMCTs.

3.5. Formulaic Allocation Methods

A Shared Net Margin Method

A different approach has been put forward by Michael Durst (Durst 2016). Although presented as a modified version of the existing transactional net margin method (TNMM), it would avoid the need for a detailed audit based on functional analysis and attempting to identify comparable independent firms, by simply establishing a benchmark for the local affiliate's profitability. The proposal would require the local affiliate to earn a profit margin in proportion to that of the corporate group as a whole. The benchmark he suggests is 25 per cent of the group's before-tax net operating margin (Durst 2016), based on experience of attempting to apply the TNMM to a wide range of distributors, manufacturers and service providers. The fraction is chosen to arrive at a profit allocation which could be acceptable to both the revenue authority and the taxpayer.

This suggested method would require a minimum level of income, consistent with group-wide profitability, disregarding all intra-firm related party payments such as interest, royalties and fees, which are a major cause of base erosion. It would generally prevent the very low requirements of income that under current practice tend to be ascribed to 'risk-stripped' subsidiaries. This is put forward as a pragmatic solution, aimed mainly to provide developing countries with a method which is easy to administer and could adequately protect their tax base.

Durst leaves open the key question of whether such a provision would be applied as a safe harbour, in the form acceptable under the OECD transfer pricing guidelines, i.e. optional for taxpayers. However, the experience of safe harbours compatible with the OECD guidelines in countries such as India is that a purely optional safe harbour is unlikely to be effective (Picciotto 2018). The SNMM is likely to be more suitable if treated as a benchmark, or a backstop, like the alternative minimum tax.

A merit of this method is that it focuses on the actual profits, or indeed losses, of the specific firm concerned. In this respect it is very different from the Brazilian fixed margin method,

which applies a single yardstick to all firms, on a broad sectoral basis. The SNMM is therefore based on the ability to pay principle which many consider foundational. However, its focus is on the profitability of the MNE as a whole, and it does not factor in the contribution of the specific local entity. For that reason, as mentioned above, the proposal suggests applying a relatively small fraction of the firm's global profit rate in calculating the local entity's benchmark profit margin (Durst suggests 25%). This is not simply pragmatism but flows from the underlying principle that in an integrated firm profits derive from the synergy of the activities as a whole. A national tax authority might nevertheless find it difficult in some circumstances to accept this method, for example if the MNE as a whole is experiencing difficulties while the local entity seems to be doing well.

A Shift Towards Fractional Apportionment

An extension of this approach would be to establish a benchmark on a formulary basis, by allocating a proportion of the MNE's global income to the local entity, based on factors reflecting its presence in the jurisdiction, such employees, assets and sales. This would revert back to the fractional method that has a long history and continues to be permitted for attribution of profits to PEs in most existing tax treaties. Indeed, the Indian government is proposing to introduce domestic rules for the application of fractional apportionment in the attribution of profits to PEs. To be fully effective, this needs to be combined with applying a similar approach to allocation of profits to associated enterprises under article 9 of tax treaties. This could be done by building on the profit split method already accepted by the OECD.[22]

Such a method may be regarded as counter to the transactional approach now deeply entrenched in the OECD Transfer Pricing Guidelines, which explicitly reject formulary apportionment. However, it could be applied in a way which is compatible with the TPGs, using the framework of an advance pricing arrangement (APA), preferably on a sectoral basis to achieve the aim of simplicity.

3.6 Withholding Taxes to Protect the Source Tax Base

Besides securing taxing rights on services delivered to residents, developing countries can also use withholding taxes as a generic measure against several forms of profit shifting. Withholding taxes levied on outgoing payments of interest, royalties and service fees effectively impose a minimum tax on such payments. The advantage of withholding taxes, compared to more targeted anti-abuse measures such as interest deduction limitations or transfer pricing audits, is that they are simple and relatively easy to apply. This is important for developing countries with limited administrative capacity. Their disadvantages are that withholding taxes are a relatively blunt instrument against profit shifting, and the tax paid can be grossed up onto the payment so that it is passed on directly to the payer. Moreover, they cannot address profit shifting through intra-group trade in goods (and royalty costs could be embedded in the price of purchased goods).

As noted in section 3.2, to be able to apply withholding taxes effectively, a developing country may need to amend existing tax treaties.

Like any minimum tax, the effects of a withholding tax depend on the rate. A low rate, such a 5%, would not take away the incentive to shift profits to zero tax jurisdictions, because the difference between the normal corporate tax and the withholding tax would remain large. Still, it allows the source country to collect at least a minimum tax and thus reduce the revenue losses from profit shifting.

[22] See Appendix 1, and our submission on the Indian proposal available here.

A higher withholding tax, such as 20%, strongly reduces the incentive for multinationals to shift profits out of the country. This limits revenue losses in a more effective way, by protecting the corporate tax base. Hence, the additional corporate tax revenues may be larger than revenues from the withholding tax itself. The disadvantage of higher withholding taxes is a higher risk of over-taxation. This is because withholding taxes apply on gross income, which can be several times higher than the associated profits before tax. The foreign recipients of interest, royalties or service fees can usually get a tax credit for the withholding taxes charged by the source country. Some recipients in high-tax countries will therefore be able to credit the withholding tax against profits from domestic operations; in that case there is no over-taxation. However, recipients with low profit margins on their international financing, licensing or service providing activities, and without substantial profits from domestic operations, may be unable to fully use the tax credit. In that case the effective tax rate on their profits can become unreasonably high.

Note that a tax on base-eroding payments under Pillar 2 could take the form of a modified withholding tax that is more targeted without generating a much larger administrative burden for tax authorities. This could be achieved by making the withholding tax conditional on the rebuttable presumption that the recipient is subject to an effective tax rate below the (globally agreed) minimum. Recipients in high-tax jurisdictions that cannot fully credit the withholding tax could then claim it back, by proving that their profits are taxed at or above the minimum rate and that they did not claim a tax credit abroad for the withholding tax.

APPENDIX 1

A new approach is needed for a long-term solution fit for the 21st century.

We propose a combination of principles and pragmatism that will provide (i) results that are fair to both taxpayers and tax authorities, and (ii) true simplicity of application.

- First, a **single enterprise principle** should be adopted, to replace the inappropriate fiction that affiliates of a multinational corporate group are independent of each other.
- Secondly, the aim should be to allocate income and taxes according to the fundamental factors that generate profits: **labour, capital and sales**. This would provide a balance between operational factors (employees, physical assets and users where appropriate) and sales to third-parties (without which profits cannot be realised).
- Thirdly, based on closer analysis of different industries/sectors and their commonly-used business models, the Inclusive Framework, along with other relevant organisations, would develop detailed definitions of these broad factors and their quantification and appropriate weightings. This work would pragmatically develop standardised allocation keys and weightings that would mandatorily apply to taxpayers using these industry/sector common business models. A rebuttable presumption would apply for appropriate flexibility.
- Lastly and importantly, the quantification (i.e. the allocation keys) must be **objectively measurable and location-specific**, using only physical factors reflecting the actual assets, activities, and sales in the countries concerned.

The use of standardised keys and weightings eliminates any need for the resource-consuming functional analyses and other extensive work required for a taxpayer to support its transfer pricing, or for the tax authorities to evaluate and, as necessary, adjust that transfer pricing. This would create greatly simplified international tax rules that would reduce the administrative burdens especially for poor countries, reduce compliance costs and provide greater certainty for business, and improve competitive equality between multinationals and domestic firms. They should be underpinned by an institutional framework to resolve issues and conflicts as well as to formulate appropriate changes to the detailed methodologies as technology and business practices evolve.

This approach is in our view compatible with existing tax treaty rules but would be a sharp departure from the present OECD guidelines on transfer pricing. These have become impossibly complex and difficult to apply, generating continuing conflicts and disputes.

In a more general system, revised OECD guidelines would reflect the proposals outlined in the discussion draft, which have some commonalities, indicating the possibility of convergence. None of these proposals would be adequate or appropriate alone, but they could all be subsumed into the approach we outline. The ‘user contributions’ and ‘marketing intangibles’ proposals entail some allocation of tax to market jurisdictions but not a completely sales-based formula, and the ‘significant economic presence’ proposal explicitly suggests a balanced formula.

See our submission to the public consultation in March 2019 for a fuller explanation.

APPENDIX 2

Three Approaches to Calculating the MNE's Effective Tax Rate

An example may be useful to illustrate the effects of blending, at either jurisdictional or global level.

Say that the minimum effective tax rate is set at 20%. Say further that an MNE has only the following four foreign group members:

Entity 1: 100 profit in Country A; Country A Tax 26 (ETR 26%)

Entity 2: 100 profit in Country B; Country B Tax 0 (ETR 0%)

Entity 3: 600 profit in Country B; Country B Tax 150 (ETR 25%)

Entity 4: 200 profit in Country C; Country C Tax 25 (ETR 12.5%)

No Blending: Entities 2 and 4 have effective tax rates less than 20%, so both would be subject to the Pillar 2 measures.

Jurisdictional blending: the taxes paid by Entities 2 and 3, both in Country B, are combined so that there is total Country B tax of 150 on 700 of profit, a 'blended' rate of 21.4%, exceeding the 20% minimum rate. Consequently, Entity 2 is not subject to the Pillar 2 measures while Entity 4 continues to be subject to them. Jurisdictional blending would allow jurisdictions like Country B to offer targeted incentives that do not run afoul of Pillar 2, provided that the MNE also has sufficient income from other operations there that pay a higher rate, so that the overall effective tax rate for all its operations within that jurisdiction is at least 20%.

Global blending: the MNE's total foreign tax paid totals 201 (26 + 0 + 150 + 25), just above 20% of the 1000 of global profits, so both Entities 2 and 4 will escape the Pillar 2 measures.

References

ATAF (2018). 'Resolving African Challenges in Transfer Pricing ATAF makes critical contribution to affect global tax standards.' *Medium*, 6 April, available at https://medium.com/african-tax-administration-forum/resolving-african-challenges-in-transfer-pricing-44868cfacb64 .

ATAF 2019a. *The place of Africa in the shift towards Global Tax Governance: Can the taxation of the digitalised economy be an opportunity for more inclusiveness.* Available at https://events.ataftax.org/index.php?page=documents&func=view&document_id=35

ATAF. 2019b. *The tax challenges arising in Africa from the digitalisation of the economy.* Available at https://irp-cdn.multiscreensite.com/a521d626/files/uploaded/Tech%20Note%2017012019.pdf

Banga, R. (2019). 'Growing Trade in Electronic Transmissions: Implications for the South', UNCTAD, Research Paper No. 29, UNCTAD/SER.RP/2019/1

Best M. C., Brockmeyer A., Kleven H. J., et al. (2015) Production versus Revenue Efficiency with Limited Tax Capacity: Theory and Evidence from Pakistan. *Journal of Political Economy* 123: 1311-1355.

Bunn, Daniel. 2018. *Corporate Income Tax Rates Around the World, 2018*. The Tax Foundation, Washington DC. Available at https://taxfoundation.org/corporate-tax-rates-around-world-2018/

Chadwick, Francois. 2019. 'International Tax Rules for the Digital Era', *Tax Notes International*, 95: 709-22.

CIT v Bharti (2010). *CIT (Delhi) v. Bharti Cellular Ltd*. Supreme Court of India, Civil Appeal 6691/2010.

Devereux, M. P., A. J. Auerbach, M. Keen, P. Oosterhuis, W. Schön and J. Vella (2019). *Residual profit allocation by income*. OUCBT Working Paper 19/01.

Durst, M. C. (2016). Developing Country Revenue Mobilisation: A Proposal to Modify the 'Transactional Net Margin' Transfer Pricing Method. ICTD Working Paper 44.

Durst, Michael C. 2019. *Taxing Multinational Business in Lower-Income Countries: Economics, Politics and Social Responsibility.* ICTD.

IMF (2019). *Corporate Taxation in the Global Economy*. Policy Paper No. 19/007.

Ferracuti, A. (2018). Understanding the Consequences of Mobile Money Taxes in Uganda. UNCDF, 29 August. https://www.uncdf.org/article/3892/understanding-the-consequences-of-mobile-money-taxes-in-uganda

Google India (2017). *Google India Private Ltd vs. ACIT*, Income Tax Appellate Tribunal 'C' Bench, Bengaluru, IT(TP)A.1511 to 1516/Bang/2013.

India (2019). Proposal for amendment of the rules for profit attribution to a permanent establishment, Ministry of Finance, Department of Revenue, Central Board of Direct Taxes (Foreign Tax and Tax Research - I). Available at https://www.incometaxindia.gov.in/news/public_consultation_notice_18_4_19.pdf

Johnston, Stephanie Soong. 2019. 'U.S. and France Strike Compromise Over Digital Services Tax', *Tax Notes,* 27 August.

Kadet, J., T. Faccio, and S. Picciotto, Profit Split Method: Time for Countries to Apply a Standardized Approach, *Tax Notes International* 91: 359 (23 July 2018). Available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3235487

Mulondo, M., N. Wassajja and M. Karugaba (2018). Mobile money tax reduced to 0.5%. *New Vision,* 2nd October, ttps://www.newvision.co.ug/new_vision/news/1486921/mobile-money-tax-reduced-05

Ndung'u, N. (2019). "Could taxation of mobile banking in Africa stall financial inclusion?" Brookings Blog, 21 February. https://www.brookings.edu/blog/africa-in-focus/2019/02/21/could-taxation-of-mobile-banking-in-africa-stall-financial-inclusion/.

OECD. 2017. *Harmful Tax Practices 2017 Progress Report on Preferential Regimes*. Available from http://www.oecd.org/tax/beps/harmful-tax-practices-2017-progress-report-on-preferential-regimes-9789264283954-en.htm

OECD (2018) *Tax Challenges Arising from Digitalisation - Interim Report*.

OECD (2019a). *Addressing the Tax Challenges of the Digitalisation of the Economy. Public Consultation Document*.

OECD (2019b). *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from Digitalisation of the Economy*.

OECD (2019c). *Harmful Tax Practices - 2018 Progress Report on Preferential Regimes.* Available at http://www.oecd.org/tax/beps/harmful-tax-practices-2018-progress-report-on-preferential-regimes-9789264311480-en.htm

Picciotto, Sol (2019). 'The Interactions of National and International Tax Law and the Kenya-Mauritius Tax Treaty', *Journal on Financing for Development*, 1. Available at http://uonjournals.uonbi.ac.ke/ojs/index.php/ffd/article/view/251

Ratcliffe, R. and S. Okiror (2019). 'Millions of Ugandans quit internet services as social media tax takes effect'. *The Guardian,* London 27 February.

Right Florist (2013). *Income Tax Officer v. Right Florist PVT Ltd*, Income Tax Appellate Tribunal, Kolkata B Bench, ITA 1336/Kol./ 2011.

Tandon, Suranjali (2018). 'Tax Challenges Arising from Digitalization', *Asia-Pacific Tax Bulletin*, 24.

UN (2018) *United Nations Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries*.

WTO (2019). 'The E-Commerce Moratorium and Implications for Developing Countries'. Document WT/GC/W/774, 4 June.