T20 Policy Brief

Task Force 03

REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

Building on Pillar One's Amount a to Reform Taxation of Multinational Enterprises

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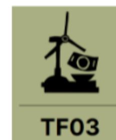


Abstract

Tax avoidance by multinational enterprises (MNEs) has severely hit tax revenues, particularly for developing countries which greatly rely on corporate taxation. In 2013 the G20 called for reforms to ensure that MNEs could be taxed in line with where their real economic activities occur. In 2019 the G-24 developing countries proposed that MNEs should be taxable wherever they have a significant economic presence by apportioning their global profits using factors reflecting both supply and demand. Much progress has been made with the Two-Pillar proposals, which now accept the principle that multinationals should be taxed as unitary firms by apportioning a share of their global profits according to where they have sales, combined with a global minimum corporate tax that could restrict competition between states to reduce corporate tax rates, but these fall short of an effective solution.

The G20 should now support an initiative for states to adopt concerted measures building on Amount A of Pillar One, but with a more comprehensive scope, and that can be compatible with the Multilateral Convention (MLC) for Amount A.

In lieu of digital services taxes and other withholding taxes on payments, MNEs with revenues from sales above a specified threshold should be required to do business through a locally formed affiliate, to which net income could be attributed on a formulary basis. This could be either by applying the MNE's global profit rate to its local revenues, or by adjusting its global consolidated financial profits for tax purposes, and apportioning them based on factors reflecting its real activities in each country (assets, employees and sales). Coherence could be ensured by applying the detailed technical standards developed for the two Pillars: the threshold for tax nexus, the adjustments for tax purposes of consolidated accounts, the sourcing rules for sales revenues, and the definitions for quantifying employee remuneration and physical assets. This would finally achieve the effective and comprehensive reform called for by the G20 in 2013.

Diagnosis of the Issue

The international tax system is in the throes of major transformations. In 2013, the G20 supported the OECD-led project on base erosion and profit shifting (BEPS). The measures produced in 2015 only patched up the system, and in 2016 participation was widened through the Inclusive Framework on BEPS, which in 2021 announced a package captioned as the Two Pillar Solution. It's now clear that these fall short of a fair and comprehensive solution. A new initiative is needed, which could build on the principles and detailed technical standards that have been agreed.

The G20 called for reform of international tax rules so that MNEs could be taxed on their profits "where economic activities occur, and value is created" (G20 2013). This can only be effectively achieved by recognising that MNEs are unitary enterprises under common ownership and control, and apportioning their total global profits by a formula based on factors reflecting their real presence in each country. This could finally ensure that MNEs are taxed at least once, and only once, and provide stability and certainty for both MNEs and tax administrations.

The formulary apportionment method (FAM) was applied and widely accepted when tax treaty principles were first developed a century ago (Picciotto 2021). It has long been used in federal states (notably the USA), has been proposed for implementation within the EU since 2001, and continues to be on EU's agenda. Internationally it has been more difficult to operationalise, since national authorities have focused on the accounts of affiliates of MNEs resident or doing business in their jurisdiction. However, they asserted their right to scrutinise and adjust these accounts to prevent "diversion" of profits, which was confirmed in tax treaties.

The standard was that profits should be in line with those of similar independent firms, and this remains the basic principle in tax treaties. Regrettably, the OECD's Transfer Pricing Guidelines of 1995 adopted an extreme version of the principle, interpreting it as requiring each affiliate to be treated as if it were independent of other group members and focussing on the pricing of transactions between them, rather than on the allocation of the overall profit. This encouraged MNEs to create complex corporate structures and attribute high profits to affiliates in countries where they are taxed at low or zero rates, resulting in the doubling of overall losses of corporate tax and of the share of corporate profits shifted to tax havens between 1995 and 2005 (EU Tax Observatory 2023, p. 50). This "arm's length principle" is illusional, since MNEs can earn super-profits from economies of scale due to their size and synergy, so that the whole is much greater than the sum of its parts.

A turning point in the BEPS project was the proposal from the G-24 group of developing countries, arguing that MNEs should be taxed in every country where they

have a "significant economic presence" (SEP), with fractional apportionment of their total profits (G24 2019). This would replace the physical concept of a "permanent establishment" for a taxable nexus, which is long outdated. It would also provide a fair method for determining the allocation of net profit for taxation by each country, based on factors reflecting the factors that generate profits: employees, physical assets, and sales. Taxation of a share of net income in this way would be a more appropriate alternative to the widely used withholding taxes, including digital services taxes, which apply to gross revenues, taking no account of profitability.

The G24 signalled a better direction for the BEPS negotiations, towards replacing the ALP with the FAM. This principle was accepted, as Pillar One's so-called Amount A is

based on treating MNEs as unitary enterprises, with a formulary allocation of a share of their global consolidated profits based on sales, regardless of physical presence.

However, this would apply to just a small share of the profits of only around 100 of the largest and most profitable MNEs, leaving in place the current defective rules based on the ALP for all other purposes. Layering this new approach on top of the existing rules, instead of replacing them, only creates new complexity and increased costs of compliance, while resulting in a relatively low reallocation of MNE profits. Implementation would require ratification of the multilateral convention for Amount A (MLC) by a critical mass of states, which will be a major political challenge. Rather than simply wait for ratifications that may never occur, the time is right for a new initiative that can build on the progress made.

Recommendations

The G20 should support an initiative for states to act in concert and move towards taxing MNEs as unitary enterprises based on formulary apportionment. Adopting the standards agreed in the Two Pillars would ensure coherence.

Taxable Nexus

The draft MLC now defines a simple taxable nexus as a quantitative threshold of revenues from sales (€1 million, or €250 thousand for countries with below €40 billion annual GDP). This could replace the complex definitions used by states which have enacted a taxable nexus based on SEP aimed at digitalised services, but would apply to sales of all goods and services.

A quantitative threshold is simple to apply, and is needed because taxing the profits of businesses with no physical presence and low sales in the country is hard to justify and administratively difficult. Furthermore, data show that a relatively small number of large MNEs account for the bulk of profits from cross-border sales. However, there is no need for the very high thresholds of global sales and profitability of Amount A, that restrict its scope to around only 100 MNEs worldwide. A simple national quantitative threshold of sales revenues is all that should be needed.

The SEP test for taxable presence can be adopted in domestic law, as many countries have done, but it is not consistent with tax treaties, so could not be applied directly to a resident of a treaty-partner. Many developing country treaties include a provision for a “Services PE’, based on article 5.3.b of the UN model, if a non-resident furnishes services through local personnel for a specified period, though the interpretation of this is contested (Picciotto 2021, 15-16).

Pending revision of treaties, a simple solution is to require non-residents that reach the specified level of local sales revenues to form a local affiliate, as is done for example in Nigeria's Companies law. This would be a requirement for doing business in the country, independent of tax law, and so would not be affected by tax treaties, although it may arguably contravene market access rules in sectors for which the country may have made commitments under trade and investment agreements. A similar mechanism is used to apply sales or value-added tax on a destination basis to non-residents (OECD 2017).

Net profits taxation could be either a replacement for or an alternative to withholding taxes or DSTs. Taxation on net profits may be more acceptable to MNEs and their home countries than a tax on gross revenues which may be high in relation to profitability. MNEs could either be required to register for net income taxation once their sales exceed the threshold, or offered this as an alternative to withholding taxes, like article 12B of the UN model convention for taxation of automated digital services.

However, this option may not be appropriate if the MNE already has a local affiliate performing functions related to sales (e.g. marketing, customer support), while attributing revenues from sales to a different and non-resident affiliate. Here, it is more appropriate to treat the existing local affiliate as the sales agent, and hence a PE of its parent, which is possible under existing tax treaty rules (Le Gall 2007, Avi-Yonah and Tinhaga 2014).

Determination of the Net Income

A formulary method starting from the MNE's global consolidated profits is the only effective way to determine net profits derived by a non-resident from sales in a country with little or no local physical presence, since the costs will fall in other countries.

A comprehensive technical basis for determining net income is now provided by the MLC under Pillar One. This starts from the MNE group's global consolidated financial accounts, and specifies adjustments necessary for tax purposes (MLC, Annex B section 2). This total net income can be apportioned by applying relevant factors. In the MLC this applies in proportion to sales in each country, but to only a small share of the profits, 25% of the "residual', but the methodology could be applied to the total profits and applying factors reflecting production as well as consumption.

Strict application of this method would entail some new reporting requirements for MNEs. Consolidated financial accounts are normally publicly available, although not for privately owned groups. The detailed adjustments for tax purposes specified in the MLC depend mainly on data internal to the MNE. Some could be approximated from the Country-by-Country reports (CbCRs), although these are required only for MNEs with at least €750m global turnover, and are supplied only to countries where the MNE is taxable under current rules. Many developing countries still do not have any access to these reports, and the US has agreements to exchange with only 44 countries. Countries that do have access to CbCRs could use the data they provide as a check.

Two options are possible for a country wishing to adopt the FAM. It could require the local affiliate or PE of an MNE to supply the global consolidated accounts adjusted for tax purposes based on the internationally agreed template in the MLC for Amount A. Adoption of this requirement by countries acting in concert would encourage and facilitate compliance. For MNEs that remain unwilling to comply, the published consolidated financial accounts should provide an adequate alternative starting point. Appropriate adjustments could be made by the tax authority on a presumptive basis, which the MNE could be allowed to rebut by filing its own adjusted accounts.

An alternative is to start from the MNE's revenues in the country concerned, and apply its global operational profit margin to produce an estimate of net profit to be apportioned. This is the method provided in the UN model convention's article 12B as an option for source country taxation of income from automated digital services, and was proposed to be adopted its domestic law by India in 2019 (India 2019).

The Apportionment Factors and their Weighting

The FAM proposal put forward by the G24 in 2019 argued that profits should be apportioned between states where the MNE has activities based on a balance of supply-side and demand-side factors. The rationale is that while assets and employees are necessary to generate income, profits can only be realised through sales. This principle has been applied in FAM systems in countries such as Canada and the US, and proposed for the EU. Inclusion of a sales factor is important also because it reduces the temptation to offer tax incentives for inward investment if tax is based on assets and employees.

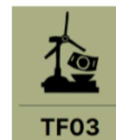
Technical standards for defining and quantifying these three factors have been developed in the work on the Two Pillars: for sales in the MLC for Pillar One's Amount A (which provides important rules defining the source for various kinds of sales revenue), and for physical assets and employees in the substance-based income exclusion for the global minimum tax under Pillar Two.

The most common formula for weighting apportionment factors is one-third each for physical assets, employees and sales. To take account of the divergence of wage rates between countries, the employee factor should be divided 50:50 between costs of remuneration (as defined in the global minimum tax) and the full-time equivalent number of employees (headcount). An argument can be made for dispensing with the assets factor, due to the declining importance of physical assets, big differences of capital-intensity

between economic sectors, and problems of valuation of assets. This suggests a simple formula evenly split between employees (costs and headcount) and sales.

A standard formula should be applied as far as possible, for reasons of simplicity, and because firms are often active in several business sectors. However, specific variations are appropriate for some sectors, which can be dealt with by modifications in the factor definitions. In particular, sales of natural resources should not be attributed to the country of consumption, but to the country of origin, since the gains from extraction of such resources are essentially a rent.[1]

[1] For a more detailed discussion of the apportionment factors see Picciotto, Ahmed et al. 2023.



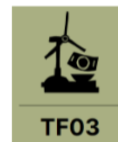
Scenario of Outcomes

G20 support for such a concerted initiative could build on the progress achieved under its mandate in 2013 for the BEPS project, while also going beyond it towards a more comprehensive reform of the taxation of MNEs. The approach we propose would:

- ensure that MNEs can be taxed on their global profits only once and at least once;
- be based on rules that are relatively easy to administer, creating greater certainty for MNEs and tax administrations;
- provide a balanced and fair allocation of rights to tax MNE profits between countries where they have real activities;
- boost national revenues from corporate tax that are important for the sustainable development of all, especially developing countries; and
- ensure the equality of competitive conditions in taxation between MNEs and local business entrepreneurs.

These ambitious aims cannot be achieved in one step, or through a single multilateral agreement. Rather, as recent experience has shown, what is needed is a combination of collaborative and coordinated initiatives by like-minded governments, led by the G20 and supported by civil society. The new approach entails a paradigm shift requiring a change in mindset among international tax advisers, but this is overdue and indeed essential to ensure effective reforms.

This initiative would be greatly facilitated by the creation of a Framework Convention on International Tax Cooperation, now under negotiation in the UN, which the G20 should also support. We are confident that there would be wide support from public



opinion around the world for effective reforms that could ensure fair taxation of large and powerful MNEs, which is essential to restoring confidence in the legitimacy of taxation, thereby supporting the ability of states to achieve the sustainable development goals.

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