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Global Corporate Tax Reform to the Worse? – Assessing the OECD Proposals

Risk of an Overshooting Corporate Tax Reform

The ongoing digitalization has set the ground for new means of value creation that create considerable challenges for the existing system of global corporate taxation. Understanding digital business models and their similarities with traditional research and development activities provides the chance for careful adjustments to the system of corporate taxation. Yet, a fundamental and potentially overshooting corporate tax reform is at the forefront of the OECD's agenda. The OECD discusses a two-pillar proposal to adjust worldwide corporate taxation.

Pillar One proposes a "Unified Approach" that is designed to allocate taxing rights to market jurisdictions. It is proposed to split worldwide, consolidated corporate profits in routine and non-routine profits. Under this approach, routine profits are distributed among jurisdictions in line with the prevailing transfer pricing system (Amount B). A fraction of the residual profit is allocated, based on the proportion of sales, across all countries in which the corporation generates revenues (Amount A). The remainder of the residual profit should be allocated according to the existing arm's length principle (Amount C). Granting taxing rights on an arbitrary amount of profits to market jurisdictions – even beyond the existence of legal entities – is overshooting and increases tax complexity and administrative burdens.

Pillar Two, the "Global Anti-Base Erosion" (GloBE) proposal, intends to counteract all remaining profit shifting risks by introducing a coordinated global minimum tax and a deduction disallowance that should in general apply to all transactions. Yet, existing controlled foreign corporation legislation already ensure the taxing right of residence countries and many jurisdictions already have some forms of deduction disallowances in place for interest and royalty expenses. Broadening taxing rights considerably increases the risk of double taxation.

KEY RECOMMENDATION //

Reform Should Concentrate on Indirect Taxes

As an alternative to the OECD proposals, we recommend to concentrate on indirect taxes to generate tax revenues at the location of user participation. Enforcing value added taxes on digital services, the sharing economy and on non-monetary transactions is a promising solution to some of the most pressing tax issues in the era of digitalization.

TAX CHALLENGES IN THE ERA OF DIGITALIZATION

Digitalization Puts Pressure on Global Corporate Taxation

The ongoing digitalization of our economy poses the largest disruption to business models since the industrial revolution. In general, academics and supranational organizations are confident about the positive impact of the digital transformation on society, economic prosperity and innovative developments. However, the digital revolution has created considerable challenges for the existing system of global corporate taxation. The debate on the most pressing challenges and reform proposals has started to gain momentum in response to the recently intensified discussion at the level of the Organization for Economic Co-operation and Development (OECD). In its 2018 released Interim Report on "The tax Challenges Arising from Digitalisation", the OECD has affirmed three major challenges: (i) the nexus of taxation, (ii) the attribution of value to data and its usage, and (iii) the characterization of payments that are attributable to new business models. The Interim Report lacks an empirical evaluation if digital businesses are more tax aggressive than less-digital corporations. Among other scholars, Olbert and Spengel (2017) and Ludwig et al. (2019) have acknowledged key pressure areas for taxing digital businesses and recommended careful adjustments to the prevailing system of corporate taxation to realign the taxation of profits with value creation. Early 2019, the OECD proposed a two pillar strategy to address asserted tax challenges of the digitalized economy. On the one hand, the OECD proposes the revision of the profit allocation regulation and recommends to establish new nexus requirements (Pillar One). On the other hand, a global minimum tax is proposed which goes beyond reforms that address the digitalization of the economy but presents a more fundamental change to the global system of corporate taxation (Pillar Two).

OECD'S TWO PILLAR STRATEGY

Pillar One – The 'Unified Approach'

Introduction of a New Profit Allocation Rule

The OECD develops a new "Unified Approach" in its most recent public consultation document. In general, the proposed "Unified Approach" introduces a new profit allocation rule that should complement the arm's length principle. The proposal suggests to calculate a deemed residual profit at consolidated group level using simplified methods and to allocate a fraction of this profit – based on sales – to market jurisdictions. Routine tasks should be remunerated with arm's length principle based transfer prices.

The suggested measure, especially the sales-based allocation of Amount A, require multinational enterprises, with often highly integrated and globally dispersed business models, to precisely track the location of their sales. In most cases, only the headquarter of the enterprise has a holistic view of the firm's operations. Thus, authorities in the nation of an enterprise's headquarter would be required – for example via a supranational competent authority – to credibly report the eligible share of sales to the tax jurisdictions that are entitled to tax Amount A.

In general, we reject the idea to develop a sales based nexus rule and assign taxing rights to a destination country without any legal involvement such as a permanent establishment or a subsidiary. Creating a taxable nexus based on sales, with no need for a physical presence, would extend the taxing right to all types of businesses, even to exports. The suggestion to reallocate an arbitrary amount of the residual profit presumably increases the risk of double taxation and the administrative burden for tax administrations. Instead, we promote the idea to re-examine the formulary apportionment of residual profits and to combine this approach with traditional transfer pricing methods (e.g. Avi-Yonah and Benshalom, 2011).

Pillar Two – The 'GloBE' Proposal

Introduction of a Minimum Tax and a Deduction Disallowance

The second pillar of the OECD recommendations is devoted to any post-BEPS risks of profit shifting to low-tax jurisdictions. The proposed coordinated introduction of both a minimum tax and a deduction disallowance are neither restricted to digital firms, nor can the specific characteristics of digital business models provide a rationale for the introduction of this fundamental reform option. The minimum tax proposal suggests to include the income of controlled affiliates in the domestic tax base if the foreign income is subject to a low effective tax rate. According to the most recent OECD contribution, the tax on the foreign income should be topped-up to at least a generally applicable minimum tax rate and member states should refrain from applying their statutory tax rate to foreign income. This proposal would strengthen the residence principle as corporates' worldwide income would be subject to at least the minimum tax in the residence country. The second proposal of Pillar Two – the tax on base eroding payments – provides a counteracting force. This recommendation proposes a deduction disallowance for payments to related entities that are not subject to a minimum tax rate and suggests to tie treaty benefits to an appropriate tax level in the recipient jurisdiction. This measure would prevent the tax base erosion by intra-company transactions to low-tax jurisdictions and strengthen the source based principle.
The proposed coexistence and reinforcement of the residence and source based taxation principle might lower the attractiveness to relocate income to low-taxed jurisdiction and to relocate the residence of companies. Nevertheless, the new measures could also increase tax competition between OECD member states with the coordinated minimum tax level being the lower bound. Furthermore, the risk of double taxation increases if all jurisdictions try to expand their access to the tax base of multinational enterprises.

ALTERNATIVE RECOMMENDATIONS

OECD's Strategy Aims at Increasing Taxing Rights

So far, all OECD initiatives to adjust the system of corporate taxation, including the well-known BEPS Action Plan, exclusively aim at protecting tax revenues of member states at the expense of improving conditions for investment and, thus, employment including underlying revenues from taxes and social security contributions. The most recently proposed reforms step in the same direction. The OECD's two-fold strategy intends to ensure market countries a fair share of taxation right (Pillar One). Simultaneously, the proposed global minimum taxation and deduction disallowance regulations aim to restrict tax competition and to strengthen both the residence and the source principle (Pillar Two).
A global minimum tax likely distorts ownership structures if not all countries adopt worldwide taxation and credit foreign taxes. In addition, the location of real investment will be distorted if some countries refrain from adopting the deduction disallowance regulation. Severe economic distortions can only be prevented if corporate taxation is fully harmonized on a global basis including tax rates (Tanzi, 1995).
As an alternative, referring to minimum taxation, we first recommend to rely on existing CFC legislation for outbound investment. Regarding inbound investment, we recommend to levy withholding taxes at source comprehensively and consistent on all cross-border transactions. Extending withholding taxes in an internationally coordinated way ensures source taxation and thus the allocation of taxing rights.[1] In line with the existing system, double taxation can be avoided by crediting withholding taxes in the residence country. The proposal would dry out tax havens.
To refer the allocation of taxing rights to market countries (Pillar One), we recommend to concen-

1 Fuest et al. (2013), p. 319.

trate on indirect taxes to generate tax revenues at the location of user participation. The value added tax (VAT), as an already existing suitable tool to tax consumption in market countries. Enforcing VAT on digital services thoroughly is a crucial step to generate and protect tax revenue in market jurisdictions.[2] Furthermore, the increasing relevance of the sharing economy contributes to a defragmentation of the economy and the appropriateness of small-business VAT exemption regulations is debatable for highly digitalized interactions between market participants with systematic and complete knowledge of transactional data. Moreover, enforcing VAT on non-monetary transactions, i.e. the exchange of user data for services such as Google or Facebook, could be a viable solution to ensure tax revenues at the market jurisdiction and is in line with existing tax principles.

Focus on VATs Instead of Digital Taxes

Overall, we highlight the potential disadvantages of the recent OECD reform proposals if they are not harmonized globally and our briefly sketched recommendations – to expand the concept of withholding taxes and to shift the focus on VATs – could provide pragmatic short-term solutions to some of the most pressing tax issues in the era of digitalization.

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2 An assessment by the ZEW for the German Ministry of Finance estimates that the total revenue of digital services exceeds 5.7 billion Euro in Germany in 2016. ZEW (2017), p. 20.

FURTHER INFORMATION //

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