Working Paper

Remarks on the OECD/G20 Program of Work:

Profit Allocation and Minimum Taxation

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January 2020

Abstract

The OECD proposes new nexus rules and formula-based allocation of large digital and consumer-oriented MNE's residual profits to market states where the respective MNEs serve their customers (Pillar One Proposal, POP) combined with a worldwide minimum taxation regime (Pillar Two Proposal, PTP).

POP creates a hybrid system of international profit allocation because it comes on top of the traditional arm's length principle (ALP). The new hybrid system causes the risk of double taxation due to overlapping tax bases. In addition, MNEs have new tax planning opportunities when determining the amount of residual profits in the market states.

PTP suggests an internationally agreed effective minimum tax rate combined with a (residence-based) income inclusion rule and a (source-based) undertaxed payment rule. In principle, the income inclusion rule would be sufficient and avoid an otherwise necessary priority rule. Without setting a minimum tax rate, the allocation of MNEs' profits to market states in effect also establishes a minimum taxation regime. Therefore, waiving POP as well as PTP in favor of a full-fledged formula-based profit allocation scheme is a valid tax policy option.

POP and PTP call for an unprecedented level of international tax cooperation. States have to agree on the details of the tax base as well as on the tax rate. Credibility is paramount for such far-reaching international cooperation. Up to now, the OECD has not envisaged an international tax agency, which has the power to establish an effective enforcement procedure.

If the OECD fails to establish a long-term international tax agreement, ongoing tax competition may convert the corporate income tax into a pure benefit tax. National tax policy could adapt by placing a higher personal income tax burden on corporate profit distributions to resident shareholders as well as on resident shareholders' gains from the sale of corporate shares.

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1. Introduction

In the year 2019 the OECD has proposed new nexus rules and formula-based allocation of MNE's profits (Pillar One Proposal, POP) combined with a global anti-base erosion proposal suggesting a worldwide minimum effective tax rate (Pillar Two Proposal, PTP).[1] The OECD has announced to complete the new proposals by the end of 2020.

In the main, the two proposals deal with distributional and efficiency effects of profit taxation. POP addresses the redistribution of corporate tax revenue across states, and PTP sets a lower bound to international tax competition. Nevertheless, the two proposals are interrelated. POP has properties of a minimum taxation regime, and PTP affects the distribution of the states' corporate tax revenue. Both proposals break with time-honored foundations of international business taxation. POP partly overrules the arm's length principle (ALP), and PTP gives up a principle that the OECD had firmly upheld for decades, i.e. that setting the corporate tax rate is not an issue for the OECD but a matter of sovereign states.

When the OECD published the Action Plan on Base Erosion and Profit Shifting (BEPS) in 2015,[2] it was hard to foresee that only four years later the OECD would present another proposal on the same issue that poses a serious threat to the about 100 years old foundation of international business taxation. Given that the Action Plan on BEPS with its overarching aim of taxing profits where value creation takes place[3] seems to be a success story, why do the OECD's new proposals challenge both ALP and tax rate sovereignty?

Paradoxically, the success of the 2015 Action Plan on BEPS seems to drive the new OECD/G20 program of work. In the post BEPS world, states do not mainly compete for internationally mobile book profits but for internationally mobile real investments.[4] In fact, unbridled international tax competition is going on. In 2018, the U.S. have drastically reduced the federal

[1] See OECD, Programme of Work to Develop a Consensus to the Tax Challenges Arising from the Digitalisation of the Economy, OECD/G20 Inclusive Framework on BEPS, Paris 2019.

[2] See OECD, Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project, Final Reports, 2015.

[3] See Hey, "Taxation Where Value is Created" and the OECD/G20 Base Erosion and Profit Shifting Initiative, Bulletin for International Taxation, April/May 2018, pp. 203-208.

[4] See Keen, Competition, Coordination and Avoidance in International Taxation, Bulletin for International Taxation, April/May 2018, pp. 220-225 who, in a general analysis, points at the use of unconstrained instruments in the presence of coordinated reduction of tax avoidance opportunities.

corporate income tax rate from 35% to 21%. In 2020, the United Kingdom will lower the statutory corporate income tax rate to 17%. Other states (among them member states of the European Union) have reduced the corporate income tax rate or have announced to do so.[5] When MNEs substitute international book profit shifting with international real investment shifting, they are in line with the Action Plan on BEPS because states tax MNEs' profits where value creation takes place (i.e. where assets are used, economic functions are performed and risks are assumed). States suffering from this type of international tax competition face both a loss in profit tax revenue and an economic damage in terms of decreasing investment and employment.

These observations lead to the central question: Can we reasonably expect that the new OECD program of work will effectively restrict harmful international tax competition? In what follows, the paper tries to give an answer to this question. The text sets aside the many technical problems involved with POP and PTP,[6] and instead addresses the more fundamental issues, which may be decisive for a successful implementation of the OECD's program of work.

The rest of the paper organizes the arguments as follows. The second section deals with the international double taxation risk and tax planning opportunities caused by the two types of international profit allocation introduced by POP. The third section examines the two types of minimum taxation established by POP and PTP. The fourth section evaluates the prospects of international tax coordination based on POP and PTP. Finally, the fifth section draws conclusions for national tax policy.

2. Profit Allocation

The 2015 Action Plan on BEPS did not fully address the tax challenges of digitalization and did not answer the question of how to allocate taxing rights on income from cross-border digital activities among states. Critics feel that the traditional nexus rules as well as the relating profit allocation rules fail to capture the value-added created by MNEs' digital business in states where these MNEs serve their customers (market states). From an economic perspective, this

[5] See OECD, Tax Policy Reforms 2019: OECD and Selected Partner Economies, OECD Publishing, Paris 2019, sec. 3.2.2.

[6] See Englisch/Becker, International Minimum Taxation-The GLOBE Proposal, World Tax Journal 4/2019, published online: 20 September 2019. Greil, Die Besteuerung der digitalen Wirtschaft und Zuordnung von Besteuerungsrechten – A Brave New World, Deutsches Steuerrecht 31/2019, pp. 1653-1660.

critique is flawed. The economic concept of income relates to the changes in net assets of (natural or legal) persons but not to places where these persons earn income.[7] Therefore, value judgments determine the place of value creation. In the international tax arena, the allocation of taxing rights based on value creation is an issue of inter-nation equity. Internationally agreed legal conventions, not an economic concept of income, decide the allocation of taxing rights among states.

Against this background, POP puts forward new nexus as well as new profit allocation rules. The new rules aim at allocating a share of MNEs' taxable profits to market states. POP is limited to large MNEs (one could think of revenues above a 750 Mio. EUR threshold) engaged in digital or consumer-oriented business. MNEs not covered by POP, i.e. MNEs below the threshold and MNEs above the threshold with non-digital and non-consumer-oriented business, are still exclusively subject to profit allocation according to the ALP. In this regard, POP displays some similarities with the Digital Service Tax (DST) that the European Commission has proposed in 2018.[8] The main difference between POP and the DST is the tax base. POP rests on large MNEs' group profits, whereas the DST burdens large MNEs' revenues.

POP combines elements of formula-based profit allocation with profit allocation according to the ALP. Creating a new taxing right and based on internationally agreed accounting rules (e.g. modified IFRS), a new three-tier mechanism,[9] at tier one level, allocates a share of the group's residual profit (i.e. group profit exceeding an internationally agreed routine profit) to market states using an internationally agreed revenue-based formula. Resting on traditional taxing rights, at tier two level, the new mechanism assigns a fixed amount of profit to affiliates in market states for baseline marketing functions using the ALP (e.g. the cost plus-method) with the possibility of internationally agreed remuneration ratios. At tier three level, the mechanism allows for an additional amount compensating functions performed in the market state exceeding the baseline marketing functions.

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[7] See Ault/Bradford, Taxing International Income: An Analysis of the US System and Its Economic Premises, in: Razin/Slemrod (eds.), Taxation in a Global Economy, 1990, pp. 30-31.

[8] See European Commission, COM (2018) 148 final, Bruxelles, 21.3.2018.

[9] See OECD, Public consultation document, Secretariat Proposal for a "Unified Approach" under Pillar One, 9 October – 12 November 2019, pp. 5 and 9.

Obviously, POP combines two strictly opposing accounting concepts in a single profit allocation scheme. The ALP is an element of separate entity accounting, whereas formula-based allocation of MNEs' group residual profits is an element of unitary group accounting. The resulting hybrid system is not only very complex, most likely increasing MNEs' compliance cost as well as states' administrative cost, it may also create overlapping tax bases. The latter is the case if in the realm of the new taxing right the share of MNEs' residual profits assigned to market states at tier one level comes on top of the profits assigned to all states (including market states) under extant taxing rights and the ALP at tier two and tier three level. Existing double taxation avoiding rules built on the ALP and separate entity accounting. These rules are not suited for double taxation caused by overlapping tax bases of a hybrid allocation scheme for MNEs' group profit. Because avoidance of double taxation is at the heart of the international taxation regime, this is an essential issue not yet sufficiently addressed in detail by the OECD.

To avoid overlapping tax bases, the amount of MNEs' profits assigned to market states within the scope of the new taxing right has to reduce the profits allocated to affiliates within the scope of the ALP under existing taxing rights. An internationally agreed ratio could govern the pro rata deduction of residual profits allocated to market states under the new taxing right by formula from the profits allocated to MNEs' affiliates under the ALP and existing taxing rights. Such a procedure would move POP even more in the direction of formula-based apportionment of profits, exacerbating the hybrid character of POP.

In addition to avoidance of international double taxation, resistance to international tax planning is another overwhelming issue of an international taxation regime. Here, POP seems to score well. Formula apportionment of MNEs' residual profits (tier one level) is more resistant to international tax planning in terms of book profit shifting than profit allocation under the ALP, once an internationally agreed formula is in place. Still, MNEs' tax planning may have influence on the relevant markets and the amount of residual profits assigned to these markets.[10]

[10] See Devereux/Auerbach/Keen/Osterhuis/Schön/Vella, Residual profit allocation by income, WP 19/01, Oxford 2019, pp. 65-68.

MNEs’ may challenge the new taxing right by redirecting sales from states with high tax rates to states with low tax rates. For this purpose, MNEs could interpose an independent distribution company as purchaser in a low tax state. This company then provides the services and sells the products to the MNEs’ customers in the high tax state. One may classify the interposition of the independent distribution company as a B2B transaction outside the scope of POP. If the interposition of the independent distribution company should be within the scope of POP, this in principle allocates MNEs’ residual profit to the low tax state. Given the independent distribution company’s functions, this company should earn a comparatively low routine profit in the high tax state. Obviously, anti-tax avoidance rules have to complement POP and residual profit allocation to market states. Look-through rules could be a possible solution. Lock-through rules are familiar in case of affiliated companies, but may be difficult to implement in case of independent companies.

Asides from this type of tax planning, residual profit allocation to market states could relate to MNEs’ overall residual profit or to the residual profit generated by MNEs’ value-added chains. Both options have different consequences for MNEs’ international tax planning. Breaking down MNEs’ activities into different value-added chains faces problems well known from transfer pricing under the ALP because it demands the same cost accounting procedures, which govern the determination of transfer prices based on cost. All costs, direct costs and overhead costs, determine the full cost of a single value-added chain. Overhead cost allocation is essentially arbitrary because it lacks causality (i.e. a single value-added chain does not cause a certain amount of overhead costs). Given this cost accounting imponderability, MNEs would have considerable room to maneuver in allocating profits to market states with comparatively lower taxes.

This tax planning opportunities may be restricted to MNEs where profit allocation according to value-added chains is unavoidable because they are engaged in both B2B and B2C transactions in market states. However, given that some MNEs have to split residual profits along value-added chains, a consistent application of POP may compel the same type of residual profit allocation for all MNEs. In any case, states may conclude that inter-nation equity requires residual profit allocation along value-added chains as a basic principle because MNEs’ marketing activities can substantially differ across states.

Overall, there can be no doubt that tax complexity will substantially increase when formula-based profit allocation within the scope of a new taxing right comes on top of profit allocation based on existing taxing rights and the ALP. Such a hybrid mechanism of profit allocation may not only create new double taxation risks but also new international tax planning opportunities and thereby most certainly increase the MNEs' compliance cost as well as the states' administrative costs.

3. Minimum Taxation

Besides suggesting new taxing rights, the OECD aims at another substantial change to the traditional international tax regime by proposing minimum taxation for all internationally operating businesses.[11] Minimum taxation of profits establishes a lower bound for tax competition among states and stops the race to the bottom in terms of the corporate tax rate. In fact, coordinated minimum taxation limits states ability to attract internationally mobile investments. Moreover, states will find it easier to protect their national tax base against international tax planning efforts of MNEs.

Under PTP, the OECD puts forward a global minimum tax regime for MNEs based on an internationally agreed effective minimum tax rate. An effective tax rate calls for an agreement on both the tax base (i.e. a set of applicable accounting rules) and the statutory tax rate. With respect to the tax base, PTP could build on POP. MNEs' residence states as well as MNEs' source states could establish a minimum taxation regime. The OECD's PTP suggests that both states are involved. Either residence states levy the minimum tax on low taxed foreign income of a resident company (income inclusion rule) or source states levy the minimum tax on payments of a resident company to an affiliated low taxed foreign company (undertaxed payment rule).

Both the income inclusion rule and the undertaxed payment rule address low tax states and especially tax havens. The undertaxed payment rule is applicable if a MNE has a taxable nexus (a subsidiary or a permanent establishment) in the source state. If a low taxed company provides services or sells products directly (without establishing a nexus) to customers in other states, only the income inclusion rule is applicable. In principle, the income inclusion rule can

[11] See OECD, Public consultation document, Global Anti-Base Erosion Proposal ("GloBE") – Pillar Two, 8 November 2019 – 2 December 2019, p. 6.

also capture low taxed profits that otherwise may be subject to the undertaxed payment rule. Therefore, the income inclusion rule has the wider range of application, and a comprehensive minimum taxation regime could solely rest on income inclusion. This is the case because inclusion of foreign profits in the domestic income has the well-known properties of worldwide income taxation: Foreign tax rates below the (domestic) minimum tax rate do not attract domestic investments and profits, and all domestic taxpayers face the same minimum tax burden irrespective where they earn the profits.

It may well be that the OECD for fiscal reasons suggests both source-based and residence-based taxation. This grants all states access to the tax revenue generated by minimum taxation. If, however, all states actually implement both rules, they have to make sure that the profits subject to both rules (e.g. profits of a low taxed affiliate stemming from payments of another affiliate) do not overlap. Consequently, an internationally agreed minimum taxation regime along the lines of PTP has to include an agreement which state (the source state or the residence state) in which cases has priority in taxing low taxed or untaxed foreign profits. A priority rule could recognize the taxing right of the source state combined with the obligation of the residence state to avoid double taxation or restrict source taxation in favor of residence taxation. Because PTP is silent about the details of the priority rule and thereby lets the tax revenue effects open, the envisaged design of the minimum taxation regime is essentially unclear.

In comparison, POP and PTP seem to focus on completely different aspects of international taxation: PTP addresses international tax planning by minimum taxation and POP deals with corporate tax revenue distribution across states. In fact, however, POP does not only alter the tax revenue distribution among states, but (irrespective of the abovementioned possible new tax planning issues) also places considerable restrictions upon MNEs' tax planning by in part allocating MNEs' profits to market states. To the extent that POP does effectively assign profits to states, where MNEs sell products and provide services to their customers, but not to states, where MNEs invest, international investment shifting does not save taxes.[12]

[12] See Devereux/Auerbach/Keen/Osterhuis/Schön/Vella, Residual profit allocation by income, WP 19/01, Oxford 2019, pp. 59-64.

Hence, POP as well as PTP have the potential to bridle international tax competition. POP does so by allocating a part of MNEs' profits to an internationally immobile tax base (depriving low tax states or tax havens of the respective profits), and PTP does so by establishing a minimum level of profit taxation for an internationally mobile tax base. POP is limited to digital and consumer-oriented businesses, and it is very likely that the respective customers are in fact internationally immobile. POP indirectly (via profit allocation to market states) determines a minimum level of taxation of MNEs' profits depending on the amount of profit allocated to market states and the tax rates of the market states. It is worth stressing that minimum taxation effected by POP works without an internationally agreed effective tax rate as a mere byproduct of the new profit allocation rules.

Although the minimum taxation effects of POP and PTP are in principle comparable, both proposals have a very different range of application. Nevertheless, POP und PTP overlap in cases, where both sets of minimum taxation rules are applicable. Insofar as POP indirectly effects minimum taxation, this should rule out direct minimum taxation under PTP, i.e. profits allocated to market states under POP should not be subject to PTP. Such carve out makes sure, that PTP exclusively focuses on internationally mobile profits. In fact, if all states agree on a minimum tax rate under PTP the market state should not apply a profit tax rate below the minimum tax rate.

POP is limited to some MNEs but has the potential of curbing international tax competition much more effectively. Instead of limiting profit allocation to market states to a share of large digital and consumer-oriented MNEs' residual profits, a comprehensive, revenue-based profit allocation scheme could assign MNEs' overall group profits to market states. Insofar as MNEs' customers are internationally immobile, investment shifting becomes useless und international tax competition ceases to exist. As a result, additional minimum taxation along the lines of PTP is no longer necessary. In the absence of international tax competition, it is impossible for former low tax states to compensate potentially poorer real investment conditions with comparatively low taxes. Conversely, higher taxes in states with comparatively favorable real investment conditions do not deter foreign investment. Once profit taxation does not distort MNEs' investment location decisions, states providing the more advantageous economic environment are more attractive for real investment. Consequently, in states where MNEs invest, the overall welfare effect of allocating MNEs' profits to market states could be positive.

From a fiscal perspective, however, assigning MNEs' overall group profit to market states is a radical approach that would disentitle non-market states to tax MNEs' profits, which seems unacceptable in terms of public good provision by non-market states. This speaks for allocating a part of MNEs' profits to non-market states by designing POP as full-fledged formula apportionment of large MNEs' group profits.[13] As the three-tier mechanism of POP, formula-based profit allocation may differentiate between routine profits and residual profits. As a first step, such a formula determines the amount of routine profit assigned to affiliates in market and non-market states under traditional taxing rights. As a second step, the formula assigns the remaining residual profit to market states where affiliates with traditional nexus are located or where the new taxing right applies.

Overall, there are good arguments to waive both the highly complex POP and PTP in favor of a single formula-based profit allocation scheme that assigns a share of large MNEs' group profits to market states. Such a move would reduce compliance and administrative costs and simultaneously establish a minimum taxation regime that limits tax competition to routine profits.

4. Tax Cooperation

International tax competition gives taxpayers an exit-option, and this may exert pressure on states to keep the balance between taxes levied and public goods provided. On the other hand, international tax competition endangers the integrity of the income tax system. Profits shifted to foreign corporations enjoy a lower tax burden than domestic profits, and low taxed foreign profits may escape the higher domestic income tax by means of tax deferral or non-taxation. In the end, international profit shifting undermines horizontal as well as vertical fairness of the progressive income tax and leads to undesired income redistribution effects. As a result, states face a tax sovereignty dilemma: In order to preserve the integrity of their

[13] See Avi-Yonah/Clausing/Durst, Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split, Florida Tax Review 2009, pp. 497-553. Avi-Yonah, Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation, World Tax Journal 2010, pp. 3-18.

progressive income tax system, they have to give up some elements of their tax sovereignty by entering into an international agreement on profit taxation.

This observation leads to the most relevant question for the OECD's program of work. Are the states in a position to deal with the tax sovereignty dilemma? The answer to this question depends on the prospects of international cooperation in tax matters. At first glance, the chances for enhanced international tax cooperation seem to be very good. The OECD has set out to pave the way, and states seem to back the OECD's proposals for far reaching international tax cooperation.

With respect to POP, the OECD states: "Any dispute between the market jurisdiction and the taxpayer over any element of the proposal should be subject to legally binding and effective dispute prevention and resolution mechanisms."[14] Nevertheless, the design and the modus operandi of such a dispute prevention and resolution mechanism are up to now essentially unclear.

There can be no doubt that POP calls for an unprecedented level of international tax coordination. POP builds on an internationally agreed set of accounting rules in order to determine the group profit and several internationally agreed ratios to account for the routine profit (related to economic functions performed by MNEs' affiliates in different states), the market states' overall share of the residual profit, and each market state's share of this residual profit. Only for the remuneration of baseline marketing functions and additional functions performed, states can use accounting information of MNEs' resident companies, but may have also to agree on remuneration ratios. All the necessary international agreements affect the negotiating states' corporate tax revenues. If states in effect play a zero-sum tax base game (i.e. the amount of profit one state loses is equal to the amount of profit another state gains) they may find it very difficult if not impossible to come to an agreement on the several elements of POP.

Concerning the allocation of the MNEs' residual profit, states have to rely on shared information on the groups' overall profit as well as the groups' routine profit. Elimination of routine profits from the OECD's three-tier profit allocation scheme and application of a

[14] OECD, Public consultation document, Secretariat Proposal for a "Unified Approach" under Pillar One, 9 October – 12 November 2019, p. 9.

formula to the overall group profit could reduce complexity.[15] To a certain extent, this line of reasoning also applies to profit allocation resting on full-fledged formula apportionment of MNEs' routine as well as residual profits. The complete replacement of POP with formula apportionment of large MNEs' profits could reduce complexity to an even higher degree. On one hand, reducing the complexity of international profit allocation cuts down compliance and administrative costs. On the other hand, a mechanism that pushes back the ALP in favor of simpler apportionment formulas may make it more difficult to reach a consensus with respect to the resulting tax revenue distribution. Residence states of MNEs serving the world market might be very reluctant to agree to a redistribution of profits largely in favor of market states. Against this background, it does not come as a surprise that the U.S. Treasury Secretary in a letter to the OECD expressed serious concerns about moves to abandon the ALP and existing taxable nexus standards and floated the idea of a safe harbor regime[16] that in effect could allow the U.S. to opt-out an international agreement.

The OECD's PTP faces comparable problems. With respect to the income inclusion rule and the undertaxed payment rule, PTP explicitly mentions the need for an "ordering rule"[17] in situations where more than one state apply the rules to the same structure, but is completely silent about the desirable design of such a rule. In fact, states may find it difficult to agree on a priority rule, given the revenue implications for either the source state or the residence state.

Besides the priority rule, the main issue of PTP is the agreement on the effective minimum corporate tax rate, which would consequently be also applicable under POP (restricting the market states' room for maneuver). This entails an agreement on a common set of applicable accounting rules as well as on a common statutory tax rate. Only if all states agree to common

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[15] See Fuest/Parent/Toubal, International Corporate Taxation: What Reforms? What Impact?, Les notes du conseil d'analyse économique, no 54, November 2019, p. 11.

[16] See Reuters, Business News, U.S. floats 'safe harbor' proposal in global taxation reform drive, December 4, 2019 (https://www.reuters.com/article/us-usa-tax-digital/u-s-floats-safe-harbor-proposal-in-global-taxation-reform-drive-idUSKBN1Y82F8, accessed 09 December 2019).

[17] OECD, Public consultation document, Global Anti-Base Erosion Proposal ("GloBE") – Pillar Two, 8 November 2019 – 2 December 2019, p. 6.

accounting rules under POP in the first place, PTP reduces to an agreement on a common minimum statutory tax rate.

The OECD supports the internationally agreed minimum tax by pointing out that a state-specific minimum tax “would result in a more complex and opaque international framework”.[18] It is striking that the OECD says virtually nothing about how to integrate conflicting interests into an international agreement on minimum taxation. PTP is also silent on what could be the amount of the minimum tax rate. In fact, these issues pose the main problem of an international agreement on minimum taxation.

To start with the minimum tax rate, there are most probably conflicting interests in choosing the appropriate tax rate. In the first place, all states, be they low tax or high tax states, should have an interest in a high minimum tax rate and the resulting increase in tax revenue they can share in. This is certainly the case for large high tax states suffering from international tax competition. These states should be in favor of a minimum tax rate that is close to (or even higher as) their actual statutory profit tax rate. Low tax states, however, may balance between tax revenue gains and overall economic losses. These states may oppose minimum tax rates above their actual statutory tax rates because higher tax rates may deter MNEs’ investments or restrict the states’ ability to compensate less advantageous real investment conditions with lower taxes.

It is very likely that low tax states try to negotiate a safe-harbor rule, in effect granting them to opt-out a minimum tax regime. Of course, high tax states may persuade low tax states objecting to minimum taxation by political pressure in other fields than taxation or by non-tax advantages granted in the event of agreeing to the minimum tax. In the end, all states may find it in their interest to come to an international agreement on minimum taxation. In this event, PTP has the characteristics of an international tax cartel. If the tax cartel works, MNEs tax planning is unable to achieve effective tax rates below the minimum rate.

This leads to the integration of conflicting interests into an agreement on minimum taxation. Here lie the main difficulties of PTP because there are good reasons to expect that states do not succeed in forming a long-term tax rate cartel. The fiscal and economic position of

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[18] OECD, Programme of Work to Develop a Consensus to the Tax Challenges Arising from the Digitalisation of the Economy, OECD/G20 Inclusive Framework on BEPS, Paris 2019, p. 27.

negotiating states *before* they come to an agreement (their ex ante position) differs substantially from their fiscal and economic position *after* the agreement has come into existence (their ex post position). In the ex ante position, all states face an internationally mobile tax base. It is therefore in their common fiscal interest, to substantially reduce (or even eliminate) tax base mobility and to share in the resulting tax revenue increase. By contrast, the states' ex post position is different. Once states have concluded the international tax agreement, all states face a lower bound on tax base mobility. Some (smaller) states may find it in their interest to deviate from the agreement by setting tax rates below the minimum tax rate in order to increase their share in internationally mobile investments at the expense of other states.

With respect to the minimum taxation characteristics of POP or comparable formula-based profit allocation schemes, the chances of reaching an international agreement may be better because states negotiate the international allocation of the profit tax base, but retain tax rate sovereignty. The difficulties are, however, not completely different from minimum taxation according to PTP. Ex ante, negotiating states may be in favor of an international agreement on pro rata profit allocation to market states because this reduces tax competition. Ex post, however, market states facing an immobile tax base may find it in their interest to increase their tax take by deviating from the agreed profit allocation scheme. Non-market states may also deviate ex post from the agreed profit allocation scheme insofar as they consider the tax base to be immobile, i.e. non-market states may tax quasi-rents associated with sunk capital.

If all negotiating states anticipate that other states may deviate from the agreed rules, at least some states could be reluctant to agree to the rules in the first place. The negotiating states cannot overcome the problem of non-participation by simply committing themselves to the rules. Such a commitment lacks the necessary credibility as long as it is not legally binding.[19] To overcome non-participation, the credibility of the international tax agreement is paramount. Therefore, enforcement of the agreed rules has to be an integral part of an international tax agreement. Enforcement, however, calls for an international tax agency,[20]

[19] See Keen/Konrad, The Theory of International Tax Competition and Coordination, Handbook of Public Economics 2013, Vol. 5, p. 287.

[20] See Tanzi, Taxation in an Integrating World, Washington, D.C. 1995.

which has the means and the power to establish an effective enforcement procedure. An institution with these powers does not exist, and sovereign states may not be ready to accept such an enforcement mechanism in the near future.

Against this background, the OECD's efforts to establish an international tax regime along the lines of POP and PTP may not yet have reached the critical point. What matters first, the enforcement problem of an international tax agreement, seems not to be the OECD's central work priority. What comes second, the technical details of nexus, profit allocation, tax base determination, and carve-outs, are at present the main concern of the OECD. However, not addressing the enforcement problem in the first place may seriously damage the OECD/G20 proposals.

In the event the OECD fails to establish a long-term international tax agreement, states may put aside the taxation principles underlying POP as well as PTP and instead reconsider the traditional nexus rules and the ALP for digital and consumer-oriented businesses.[21] However, it may also well be that states do not return to the traditional profit allocation rules. In this case, Pandora's Box of unilateral uncoordinated action in the field of international profit taxation is open.

5. Tax Policy Options

Although it is impossible to predict how states' tax policy will react if the OECD's proposals for enhanced international tax coordination fail to set a limit to tax competition, it is not unlikely that a certain common national tax policy pattern may emerge. Market states facing an internationally immobile profit tax base may unilaterally impose taxes along the lines of POP. The DST (as the European Commission proposed it) or other revenue-based profit taxes with a much wider range of application than the DST may become attractive tax policy options for many states. In fact, France and Austria have already implemented a tax on certain online services in 2019. Other states, among them Italy, Spain and the United Kingdom have announced to implement taxes on online services. These new taxes, be they implemented or be they announced, have to be seen in the light of the OECD/G20 program of work: The OECD reports that states have agreed to abolish unilaterally implemented taxes on digital services

[21] See Spengel/Olbert, Taxation in the Digital Economy – Recent Policy Developments and the Question of Value Creation, ZEW Discussion Paper No. 19-010, 04/2019.

when they will reach an international solution.[22] Conversely, this means that the respective states will further levy these taxes in the event an international agreement fails.

Taxes on online services in particular and revenue-based profit taxes in general are in stark contrast to the established rules of the OECD Model Tax Convention on Income and on Capital (OECD MTC). If states with large consumer markets establish new revenue-based profit taxes, the rules of the OECD MTC could not deal with the resulting double taxation. In a simplified scenario where a MNE's production and sales are located in different states, the states where production is located come under pressure, when the MNE's sales are subject to new types of revenue-based taxation. Because production states face a largely mobile tax base (i.e. profits from internationally mobile investments) an increasing tax burden of MNEs' my force production states either to grant a targeted tax relief for revenue-based taxes levied by sales states or to improve local investment conditions by a lower profit tax rate.

High tax states suffering from international tax competition could unilaterally enact minimum taxes along the lines of PTP. The high tax states' room to maneuver is, however, quite narrow. Behavioral responses of MNEs limit the capability of high tax states to implement minimum tax regimes because low tax states without a minimum tax regime would become even more attractive for MNEs' investments. Minimum taxation based on the income inclusion rule (and thus extending existing CFC rules) affects all foreign low taxed profits increasing MNEs' overall effective tax rate. This creates an incentive to relocate the legal seat of MNEs' headquarters or affiliates. Minimum taxation based on the undertaxed payment rule does not affect all foreign profits, but increases the tax burden on MNEs' local investments. This may also deter the affected investments. Given these adverse investment effects, uncoordinated minimum taxation does not substantially reduce the pressure exerted by international tax competition on the statutory profit tax rate.

Ongoing international tax competition and continuing international profit shifting[23] may drive the corporate income tax rate down to a level that is justified by the provision of local public

[22] See OECD, Tax Policy Reforms 2019: OECD and Selected Partner Economies, OECD Publishing, Paris 2019, sec. 3.2.5.

[23] See Janský/Palanský, Estimating the scale of profit shifting and tax revenue losses related to foreign direct investment, International Tax and Public Finance 26/2019, pp. 1048-1103 for recent estimates of tax revenue losses.

goods. In this case, the corporate income tax essentially works as a benefit tax. The corporate tax is then no longer an integral part of the progressive income tax. This would clearly damage the fairness of existing income taxes. Fairness perceptions of taxpayers, however, are essential for the acceptance of the income tax and of the tax system as a whole. Therefore, public opinion may exert considerable pressure on national tax policy to levy an adequate amount of taxes on corporate profits. However, in a world with international tax competition, states will find it increasingly difficult to meet such requirements of public opinion. Instead of levying taxes on mobile tax bases, such as corporate profits, states may shift a greater part of the tax burden to immobile tax bases, such as local labor income and local consumption.

In the field of corporate taxation, a feasible tax policy option could be to readjust the relationship between profit taxation at the corporate level and at the shareholder level. Given that private resident shareholders are internationally far less mobile than corporations and corporate profits, income tax systems can adapt to tax competition by shifting profit taxation from the corporate level to the shareholder level. Higher income taxes on corporate profit distributions, received by resident natural persons, as well as on gains from the sale of shares in corporations, earned by resident natural persons, could compensate for lower corporate taxes.

6. Summary

The actual OECD/G20 program of work rests on two pillars. The pillar one proposal (POP) deals with new nexus rules for digital and consumer-oriented large MNEs in market states and the corresponding profit allocation rules. The pillar two proposal (PTP) focuses on an international effective minimum taxation regime for MNEs' profits. Both, POP and PTP aim at curbing international tax competition, i.e. the states competition for internationally mobile investments and profits.

So far, the OECD/G20 program of work deals with the details of the two technically highly complex proposals. The OECD is certainly aware of the unprecedented level of international cooperation entailed with POP and PTP. Nevertheless, up to now, the OECD does not explicitly address the design and the modus operandi of the respective international tax agreement. The states' economic and fiscal interests are diverging. Even if the envisaged international tax agreement should overcome conflicting interests and negotiating states should be willing to give up substantial elements of their tax sovereignty, any long-term tax agreement lacks credibility if it is not binding and enforceable. Obviously, an international tax agency that has the means and the powers to establish an effective enforcement procedure does not exist, and the OECD has not yet proposed an institution with these powers. Consequently, there is a high risk of failure for the OECD/G20 program of work.

If the OECD/G20 efforts to bridle tax competition are not successful, the states involved in the process may not go back to the status quo ante, i.e. the traditional rules of international profit taxation. Instead, some states could unilaterally proceed with revenue-based profit taxation and minimum taxation along the lines of POP and PTP. This would most probably intensify tax competition and lead to double taxation, which the time-honored international tax rules are unable to deal with. Such an outcome of the actual OECD/G20 program of work has the potential of seriously damaging the international tax system.

In their best interest, the negotiating states' tax policy should prepare for such an unfavorable outcome by adapting the national tax system to ongoing international tax competition and to emerging changes in the international tax environment. A possible path for national tax policy to preserve the fairness of the income tax could be to compensate for the diminishing corporate tax burden by placing a higher personal income tax burden on corporate profit distributions to resident shareholders as well as on resident shareholders' gains from the sale of corporate shares.