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The Future of International Taxation under the 2020s Compromise

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INTRODUCTION

- Significant changes to international tax on two levels: (1) update the rules and deal with abuse of the base, and (2) rethink on how to tax the highly digitalised businesses.
- What are the key reforms?
- What fundamental tenets to the 1920s and 1930s compromise are being challenged?
- How are they being revised by the 2020s compromise?
- Paper asserts that three trends are progressed by these developments (recognising that the changes are strategically important while the immediate impact is modest)

BRIEF HISTORY OF THE 1920S AND 1930S COMPROMISE

- ***The 1920s compromise:*** *was an "arbitrary assignment" of taxing rights*

More practical than principled, not the four economists first choice.

- ***The 1930s compromise:*** *Mitchell Carroll replaced Thomas Adams as the as the US representative on the Fiscal Committee of the League of Nations*

In 1935 Carroll proposed the tenets of the taxable nexus of the permanent establishment and the calculation of profits on the arm's length basis:

"With regard to the remainder which was called "business income" the Committee agreed that if an enterprise with its fiscal domicile in one Contracting State has a permanent establishment in another Contracting State, there should be attributed to the permanent establishment the net income which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions."

The 2020s compromise

Pillars One and Two have been agreed to by over 140 countries

1. **Pillar one focuses on the largest and most profitable multinationals**.

For these approximately 100 companies worldwide 25% of residual profit (Amount A) will be allocated to market jurisdictions based on a revenue allocation key linked to sales. The source country nexus is sales at a level of at least €1 million. Implementation in 2023, it is expected to reallocate US$125 billion of profit to market countries

2. **Pillar two introduces a new minimum level of tax (15%)** on a much broader range of multinational enterprises (turnover of €750 million).

As well, new treaty-based rule will authorise source jurisdictions to impose source taxation on the payments of interest, royalties, and other specified payments where the recipient payee is a related party subject to tax below a nominal rate of 9%. Implementation is expected by 2023, and new revenues are forecast at US$150 billion per annum

THREE TENETS CHALLENGED BY THE 2020S COMPROMISE

1. A threshold nexus of a permanent establishment

The vanishing ability to tax business profits was caused by both the failure of source and residence-based taxation. States had tried unilateral measures. Pillar one radically revises.

2. Allocation of taxing rights on business profits

Traditionally, taxation of cross-border transactions has largely occurred on a place of origin basis. Pillar one provides destination-based, demand orientated taxing models for allocating profits.

3. Separate entity and arm's length principle to determine profits

The arm's length principle, which had been "manipulated" through splitting routine and residual profits is adjusted (by formula) to allocate profits to the market jurisdiction.

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Trend One: More effective source Taxation

- Recognise that over time there has been continual reform and expansion of the PE concept in order to address (mostly) tax planning opportunities
- Pillar one sweeps away the PE concept in certain circumstances
- To the extent it allocates taxing rights to the market jurisdiction, it incorporates destination focused principles which suggest robust effectiveness (based on consumption taxes and the relatively immobile base)
- There are clearly some issues with potential double taxation, resultant dispute resolution, and whether income is being allocated correctly based on sales

Trend two: Towards multilateralism

- As scholars have noted there has been a transformation, and an axial change in balance between domestic tax systems and international tax rules
- This has necessitated greater multinational cooperation, which can be described (perhaps overly simplistically) as consensus international tax law (CITL)
- CITL is not customary international law, but it can create mandatory binding obligations in extreme, more usually norms of cooperation and consensus facilitating tax compromises
- CITL is made up of the institutions (i.e. Inclusive Framework), instruments (MLI etc), and interpretation (i.e soft law, common interpretation and reliance on foreign judgments)
- Perhaps even the mutual adoption (or threats to do so) of DSTs can be viewed through this lens of multilateralism

Trend three: Towards cooperation

- Countries have long pursue their own interest in providing regimes and incentives which undermine the international consensus
- The consequence of such competitive behaviour, according to Devereux and Vella, is that it "cannot provide a stable long-run system"
- International consensus has moved from harmful practices to greater global tax coordination
- According to Clausing et al, it is critical to demonstrate fair taxation of the winners from globalisation otherwise domestic voters turn protectionist and xenophobic. Furthermore the race to lower corporate tax rates protects progressive individual income tax rates (otherwise wealthy people earn all their income in domestic corporations).

CONCLUSION

- The paper focuses on changes to the international tax regime, not on what is being retained
- Arguably three key tenets of the 1920s/1930s compromise are being redefined
- The 2020s compromise arguably confirms, at least, three directions of travel
- More effective source taxation, a balance towards multilateral processes and instruments, and a trend towards cooperation and not competition
- The 2020s compromise, if it is successfully implemented, is an illustration of the process of consensus international tax law (CITL)